

POINT & COUNTERPOINT

The Future of Corporate Tax Reform: A Debate

Editor's Note: On Friday, May 10, 2013, the Section's Teaching Taxation Committee presented a two-hour Lincoln-Douglas debate covering three questions posed by Professor Joshua Blank of New York University School of Law, who served as Speaker of the House. The debaters were (in alphabetical order): Professor Deborah A. Geier, Cleveland-Marshall College of Law, Cleveland State University, Cleveland, OH; Professor Omri Y. Marian, University of Florida Levin College of Law, Gainesville, FL; David S. Miller, Cadwalader, Wickersham & Taft LLP, New York, NY; and Professor Adam H. Rosenzweig, Washington University School of Law, St. Louis, MO. Four debaters (constructive affirmative and negative; rebuttal negative and affirmative) spoke on each proposition; the debate also featured audience cross-examination of each constructive speaker. Because debaters were assigned different roles, their remarks did not necessarily represent their views on a particular topic. Statements below are arranged by affirmative and negative rather than by constructive and rebuttal. Space limitations prevent the *NewsQuarterly* from including the entire debate and the audience comments.

The debate included the remarks below from Steven Douglas's opening speech in the first debate in Ottawa, Illinois, on August 21, 1858. They are a fitting introduction to the topics debated on May 10. —Gail Levin Richmond, Davie, FL

LADIES AND GENTLEMEN: I appear before you to-day for the purpose of discussing the leading political topics which now agitate the public mind. By an arrangement between Mr. Lincoln and myself, we are present here today for the purpose of having a joint discussion, as the representatives of the two great political parties of the State and Union, upon the principles in issue between those parties; and this vast concourse of people shows the deep feeling which pervades the public mind in regard to the questions dividing us.

Resolution #1:

"Be it resolved that the United States should impose a corporate income tax."

Affirmative: We Need to Tax Corporations at the Entity Level

By Omri Y. Marian*

In 1889, 1% of U.S. households owned about three-quarters of all net wealth in the United States. See Thomas G. Shearman, *The Owners of the United States*, VIII FORUM 262 (1898). Today, the wealth distribution figures are still not great, but

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* The views expressed herein do not necessarily reflect the views of the author.

certainly much better. The top 1% of households own about 35% of the net wealth in the U.S.

The outrageous figures of the late 19th century in the United States are attributable, in part, to the fact that most of the wealth of the top 1% went untaxed throughout that century, because such wealth was kept in corporations. Back then, corporations were not taxable entities. The largest conglomerates of the period all operated in a corporate form, owned and managed by America's richest. To name a few examples, Standard Oil was incorporated by John Davison Rockefeller in 1870 in Ohio. The American Sugar Refinery Company was owned and managed by Henry Osborne Havemeyer. The Vanderbilt and Gould railroad empires operated through multiple state-chartered corporations incorporated during the 19th century, and the Astors' fur trading empire was operated, among others, via the American Fur Company, incorporated in New York in 1808. Such corporations amassed non-taxable earnings throughout the 19th century.

At the same time, low and middle-class individuals carried the brunt of the burden of financing the U.S. government through tariffs and, on several occasions throughout the 19th century, personal income taxes.

It is this sorry state of affairs that eventually led to the enactment of the Corporate Excise Tax in 1909. Scholars are continuously debating what exactly Congress was trying to get at, namely, whether it was the wealth of the Astors, Vanderbilts, and Rockefellers, or whether it was the power they accumulated through the corporations. See Reuven Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001). The bottom line justification for taxing corporations, however, was clear—corporate tax was a just tax. Indeed,

corporate taxation supports fairer society in multiple ways.

First, and probably most importantly, without corporate taxation corporations will simply be used as an instrument to avoid taxes. Shareholders would simply stuff earnings in such entities, as historically has been the case. This will not only hurt revenues, but more importantly would simply kill the idea of progressive taxation. Corporate taxation, for that matter, is a much needed instrument to get at the wealth of shareholders, thus maintaining horizontal equity (when it comes to similarly situated taxpayers only some of whom own corporate stock) or vertical equity—which is the more likely case—because rich taxpayers have most of their income generated from capital (such as dividends and selling corporate stock), and not from wages.

Second, in a world where the largest corporations are publicly traded, corporate taxation supports progressivity, administratively speaking, as it is much easier to collect tax at the entity level than at the shareholder level. It also serves to support an argument under which corporate taxation is a fee for liquidity. See Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1989). In this context, it is important to note that most equity in publicly traded corporations in the U.S. is owned by U.S. taxpayers, which in turn means that taxation of such entities helps to support the taxation of such U.S. residents in their individual capacity.

Third, in the case of publicly traded corporations, corporate taxation is also a necessary tool to support good corporate governance. In the absence of corporate taxation, corporate managers who also own equity in the corporation will have their own interests in mind when making corporate-level decisions that affect shareholder-level taxes. When corporate tax is imposed, managers' and shareholders' interests are more closely aligned, as they all have an interest in reducing corporate level tax. In essence,

corporate taxation is an instrument to address shareholder-level tax-heterogeneity. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). So again, corporate tax supports the less-powerful in our society, who happen to own some of their wealth in the form of corporate stock.

Finally, corporate taxation, and the reporting requirements associated with it, puts government in a better position to regulate unwanted behaviors by corporate managers. In fact, this is another explicit reason noted in support of the enactment of the first functional corporate tax in 1909. The abuse of power by managers of wealthy corporations was a real concern, and corporate tax was understood to be part of the solution. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).

We keep hearing that the tax rates in the United States are the highest in the world. We keep hearing that the corporate tax puts U.S. corporations at a competitive disadvantage. The competitiveness arguments are, in fact, false. There is no conclusive evidence to support the argument that U.S. corporations *effectively* pay more taxes than their international counterparts. In fact, a recent study suggests that U.S. multinationals pay on average *less* than their European counterparts. See Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX L. REV. 375 (2012). Some studies even suggest that the corporate tax burden in the United States is the *second lowest* in the industrialized world. See Chuck Marr & Brian Highsmith, *Six Tests for Corporate Tax Reform*, CTR. ON BUDGET & POLICY PRIORITIES, rev. Feb. 24, 2012, at 3, available at <http://www.cbpp.org/files/2-28-11tax.pdf>.

Unfortunately, these days it seems that history repeats itself. When the Apples, GEs and Googles of the world operate multinational businesses, they

can engage in tax planning techniques, shifting income to their foreign subsidiaries. These techniques are not available to the local convenience store, or the neighborhood plumber. Once again, the top echelon of U.S. society can keep its earnings untaxed, by stuffing such earnings into corporations. In substance, there is little difference between today and the late 19th century. The only difference is that today's "corporations" are "foreign." Those entities, of course, are not truly "corporations" and they are not really "foreign." They are, for the most part, pocketbook entities, with no real existence (except for a mailbox), wholly owned by a U.S. parent. The burden is thus shifted, once again, to small business owners and to U.S. employees whose main income is from salaries.

It is appropriate to end this argument by quoting directly from President Taft's message to Congress on June 16, 1909, supporting the enactment of the first functional corporate tax in the United States (44 CONG. REC. 3344 (1909)) (Message from President Taft):

While the faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.

Corporate tax is still a just tax. We need to tax more corporations, and we need to tax them more. That is, of course, unless the reality of the

19th-century wealth distribution is the reality we want to get back to.

Affirmative

By Deborah A. Geier

The old saw highlighted in the May 5, 2013, *Wall Street Journal* op-ed piece by Congressman Kevin Brady (*Tax Reform Needs Accurate Tax Tables*, at <http://online.wsj.com/article/SB10001424127887323309604578429013359147292.html>)—that we need to integrate in order to lower the cost of capital, which will, in turn, increase business spending on buildings, equipment, and software, which will, in turn, increase labor productivity and increase real wages, thus benefiting American workers—is never supported by any showing that businesses are starved for investment dollars because the cost of capital is so darn high, making it difficult for businesses to form and expand. That assumption appears to be not just untrue but glaringly, obviously untrue. Interest rates are at historic lows, with lots of talk of a "global savings glut" looking for places to invest. Indeed, some argue that the chase for a place to invest the global savings glut contributed to the dot-com and housing bubbles. And corporations are sitting on literally trillions of undistributed profits—a huge pool of untapped capital. The CRS report at the time of the 2003 Bush integration proposal said that the proposal was unlikely to stimulate the economy.

The corporate tax levied essentially only on publicly traded corporations can be defended either as an appropriate toll charge for liquidity (an enormous benefit) or as a benefit tax to pay for the costs of the regulated securities market. Maintaining a regulated public market ain't cheap, people. Those who mainly benefit from it should pay for that benefit via the corporate tax.

In 1977, the late, great Professor Mike McIntyre of Wayne State published a short piece in *Tax Notes* against corporate integration in the style of the

17th-century French philosopher and mathematician Blaise Pascal, who wrote *Penseés*. Mike entitled it *Penseés on Integration: Where's the Reform?* (at http://faculty.law.wayne.edu/mcintyre/text/mcintyre_articles/Tax_reform/pensees_revisited.pdf). He updated it in 2003 at the time of the Bush proposal to integrate via dividend exemption. I'm going to channel Mike here by quoting a few of his *Penseés* and adding a few of my own.

- Why does the business community rail against the double tax on profits and keep silent on the double tax on wages in the form of the Social Security and Medicare taxes? Let them answer.
- Integration makes the simplifying assumption that a corporation is the docile agent of its shareholders. For most publicly traded corporations, however, a shareholder cannot obtain his share of the profits at his discretion without selling his stock at a price that reflects retained earnings. If we do not think that the corporation is the alter ego of its shareholders, why do we consider a corporate tax and a shareholder tax to be a double tax? Is it a double tax when a person hires a maid, and both the maid and the employer pay tax on the same income? Double taxation is a slogan, not an explanation.
- The corporate tax has had much greater success than the income tax in placing substantial tax burdens on the rich. Why should we want to end our most progressive tax?
- *Objection.* The incidence of the corporate tax is on consumers (in the form of higher prices) and labor (in the form of reduced wages), both of which are bad policy.
- *Reply.* If so, it results in a double tax on consumers and workers, not on shareholders. Tax relief for shareholders would therefore be doubly wrong.
- Some of the people who argue for shareholder relief on the ground that the corporation is the alter ego of the

shareholder oppose current taxation of the earnings of controlled foreign subsidiaries. A domestic company is an alter ego but a foreign company is not?

- Where is the “double tax” when a tax-exempt foundation receives a corporate dividend?

I will add that the tax-exempt sector plays a major role in U.S. capital markets and in the corporate capital market in particular. The Treasury, in its 1992 integration study, recited that 46% of corporate bonds and 37% of corporate equity were held by tax-exempt entities. The trend lines from 1950 to 1992 were steeply up in that report, so I imagine that their shares of corporate equity and debt are higher today. The corporate income paid out as interest on the corporate bonds held by tax-exempts is not subject to even a *single* level of tax. Rather than integrate with respect to equity distributions, we need reform so that at least a single level of tax is imposed on corporate profits paid to tax-exempts!

Negative: The United States Should Repeal the Corporate Income Tax

By David S. Miller

The United States today does not impose anything remotely resembling a corporate income tax. And the United States shouldn't impose one. Instead, the United States should impose a more rational tax on business.

To begin, the United States does not impose a true corporate tax. Two-thirds of all U.S. corporations are S corporations and are not subject to any corporate tax. And of the remaining one-third of U.S. corporations, many entirely avoid income tax altogether. For example, regulated investment companies, real estate investment trusts, and tax-exempt organizations are

completely or effectively exempt. So our current business tax is not really a corporate tax.

And for those relatively few U.S. corporations that are subject to entity level taxation, their tax liability bears no evident relationship to income. Over the past five years, Apple paid federal income tax at an average rate of 8.2%, Amazon paid 6.0%, Ford paid 4.2% and Facebook paid 2.4%. On the other hand, Walmart paid an average annual effective rate of 33.6% and Disney 36.5%.

So the United States doesn't really tax corporations and it doesn't really tax income and it shouldn't.

But let's first ask: Why do we have a corporate tax?

One justification for a corporate tax is that it serves as a proxy for the taxation of shareholders. Quite simply, it's easier to collect the tax from a corporation than the shareholders.

But is this really true? The United States is perfectly capable of taxing partners in master limited partnerships and publicly-traded private equity firms. So a corporate income tax is not necessary to collect tax from the shareholders.

The second justification for a corporate tax is that it serves as a fee for the benefits government provides to shareholders (like limited liability) or as a fee for liquidity for access to the capital markets. But if the corporate tax was ever a fee for limited liability, it certainly is not today when limited liability is available for noncorporate entities (like limited liability companies), and the corporate income tax isn't imposed on many corporations. It's also hard to justify the corporate tax as a fee for liquidity because there's no relationship between a corporation's income tax and the liquidity of its stock.

The third justification for the corporate tax is that it is needed to control the excessive accumulation of power in the hands of corporate management. But if that's really true, why do the biggest

companies like Apple pay the lowest rates of tax? And why do REITs and mutual funds escape it entirely when they may be managed by people with a very small percentage of the company's stock.

Whatever the justifications for a corporate tax, they are far outweighed by the detriments. Corporate tax is a tax penalty on doing business in corporate form; it discourages dividends; it encourages debt; it encourages foreign accumulation of earnings; and it requires squadrons of tax lawyers to help avoid it. We need to move away from the notion of a corporate income tax towards a rational system of business taxation.

Consider some alternatives. First is Ed Kleinbard's business enterprise income tax (or BEIT). The BEIT would tax all businesses, regardless of their legal form, based on their income less a cost of capital allowance deduction equal to the value of capital invested times the risk-free rate. Interest would not be deductible. Individuals would accrue tax based on their investment times the risk-free rate, plus an additional tax on cash flows in excess of that rate. Individuals could take a deduction if cash returns are less than their risk-free rate inclusions. Notably, the BEIT is an integrated income tax. All income is taxable only once.

Alternatively, we could adopt Joseph Dodge's proposal. We'd retain the current single level of tax for private companies like sole proprietorships, partnerships and S corporations, repeal the corporate level income tax, and tax shareholders of public companies on a mark-to-market basis. Again, under this system, all income would be subject to a single level of tax.

To wrap up, we don't really have a corporate tax because we don't tax most corporations; we don't really have an income tax because tax liability bears very little relationship to income; there's really no good reason to have a corporate tax; and, there are much better alternatives.

Resolution #2:

“Be it resolved that, assuming integration is desirable, the best way to achieve it is by exempting dividends from taxation in shareholders’ hands.”

Affirmative: Dividend Exemption Is the Best Method of Corporate/ Shareholder Integration

By O. Y. Marian†

It is a standard complaint that our classical system of taxing corporations is inefficient. Taxing the same income twice, once at the corporate level and once again at the shareholder level, distorts behavior in many undesirable ways. Thus, calls for the integration of corporate and shareholder taxation have long taken a central role in corporate tax reform debates in the United States. The question is, of course, how to best achieve such integration?

As a preliminary matter, it is worth differentiating between three major schools of thought regarding corporate/shareholder integration. Obviously, each has its own offshoots and sub-schools of thought, but the three major categories are as follows: The first is an *imputation* system, under which corporations are taxed, and shareholders get credit for their proportional share of corporate-level tax; The second is a dividend *deduction* system, in which corporations are allowed a dividend paid deduction, which effectively eliminates corporate level tax; The third, and the one I shall argue for, is an *exemption* system, under which corporations are taxed at the entity level, but distributions to shareholders are exempt.

Selecting between the three methods is hardly a new policy question. As much as we like to think of ourselves as leaders in the formulation of world tax

policy, corporate integration is an area in which the United States is not. The United States is in fact tailing the rest of the world. Most other industrialized countries have already engaged the issue, and their comparative experiences offer important insights.

One controlling trend in the past two decades is that countries that abandon the classical system of taxation usually opt for the exemption method. Another interesting trend is that countries that already had integration systems in place tend to abandon imputation systems in favor of an exemption system. No country that I am aware of has a dividend deduction system in place. Strikingly, 24 of the 36 OECD member countries employ some form of exemption. For a discussion on recent trends, see Georg Kofler, *Indirect Credit versus Exemption: Double Taxation Relief for Intercompany Distributions*, BULL. INT’L TAX’N, Feb. 2012, at 77. I believe this comparative experience is a helpful departure point. It demonstrates that exemption is, in the eyes of many jurisdictions, a preferable system of integration. As I show, exemption is at least as good as, but in most instances preferable to, deduction or imputation by any conceived benchmark.

First, there is the standard suggested in the Bush administration 2003 proposal, which is that integration is aimed at eliminating as much as possible distortions created by corporate tax. The Bush proposal mentions at least three such distortions: the preferences for debt over equity financing, the bias against dividend distributions, and the bias against operating in a C-corporation form. Let’s address each in turn.

1. In terms of bias against dividend distributions, I think the issue has been largely resolved by the Bush

tax cuts, and dividend exemption will not change that. In this context, imputation achieves the same result. However, dividend deduction, while eliminating shareholders’ bias against dividends, creates strong incentives for managers to distribute dividends in order to eliminate corporate level tax, even if reinvestment is desirable. This causes a new behavioral distortion.

2. The debt equity issue is unresolved under all systems of integration. Clearly, under an exemption system, payment of interest is preferred at the corporate level, but this is also the case for imputation. One could theoretically argue that debt preference is solved in the case of dividend deduction. See Reuven S. Avi-Yonah & Amir Chenchinski, *The Case for Dividend Deduction*, 65 TAX LAW. 3 (2011). That is not the case, however. To obtain a deduction, dividends must be distributed, while interest is deducted even if accrued but not paid. Thus, under a dividend deduction system we have a strong bias to distribute cash even if that is not optimal. In turn, this creates an incentive to finance new investments with corporate level debt, rather than using available cash at hand.
3. The main issue stemming from the Bush 2003 proposal is that an integration system needs to achieve the goal of single taxation, thus eliminating the bias against operation in a corporate form. While all three suggested systems achieve this main purpose, this theoretical premise is only true if we view the world as a single

† The views expressed herein do not necessarily reflect the views of the author.

taxing jurisdiction, where all corporations and all shareholders are “domestic.” Once we look at cross-border transactions (aka reality) only an exemption system can unilaterally achieve single taxation, while the other methods would require foreign governments’ cooperation to achieve single taxation.

In the case of dividend deduction, single taxation to U.S. shareholders of foreign corporations will be achieved only if the foreign jurisdiction also grants dividend deduction. In the case of inbound taxation, if the U.S. grants deduction, but the foreign jurisdiction in which foreign shareholders reside has a territorial system, then no tax is imposed. (The reverse, of course is also true—if we grant an exemption but a foreign jurisdiction grants a deduction, there will be zero taxation on outbound investment of U.S. shareholders. That said, no country currently grants deduction.) Imputation will only achieve single taxation if the shareholders can obtain accurate information from a foreign corporation’s tax returns, which is highly unlikely.

Exemption is preferable because it is the only system that assures single taxation in a globalized environment. In such a case, U.S. corporate tax will function as a proxy for income tax of domestic corporate shareholders, and as a proxy for territorial taxation in the case of foreign shareholders.

The second benchmark under which we should evaluate the three possible systems is as follows: whatever system of integration we adopt must not interfere with the policy purposes for which we tax corporations to begin with. For that purpose let me connect back to the previous discussion, and let’s assume that a main purpose of corporate taxation is to exert a tax burden on shareholders,

or to regulate managers of publicly held entities.

If we seek to tax shareholders through the taxation of corporations in which they hold interests, this purpose is achieved in both the exemption and imputation methods. It is not necessarily achieved in the context of dividend deduction, because corporate level tax is eliminated. For example, a tax-exempt taxpayer that holds equity in a corporation gets a windfall under a deduction system.

If we want to regulate managers and achieve better corporate governance, exemption is the best system. It aligns shareholders’ and managers’ tax interests, because it is in the interest of both groups to reduce corporate level taxation, and they have no diverse tax interest at the shareholder level. Exemption eliminates the problem of shareholder-level tax heterogeneity. Imputation and deduction do not achieve such results, because shareholder level tax remains relevant.

The third benchmark, under which we must decide which integration system is preferred, is whether any adopted system is expected to create new distortions. For example, an exemption levels the playing field between foreign and domestic shareholders for inbound investment in publicly traded corporations. Both are subject to the same tax at the entity level. Exemption also creates a competitive environment for outbound investment, because it effectively achieves the same result as a territorial system. Deduction and imputation do not achieve such results. For example, deduction essentially exempts corporations from tax on U.S. earnings, while dividend payment depends on the tax treaty network. In the case of outbound investment, two-level tax remains a problem because we cannot force foreign jurisdictions to grant dividend deductions to U.S.-controlled foreign corporations. Imputation could theoretically achieve the desired result, but it is simply

impractical, and indeed, countries who adopted imputation in the past rarely applied it to foreign shareholders.

Finally, the system we opt for should be administratively feasible. Exemption is the easiest system to administer compared with the other alternatives. There is only one relevant taxpayer: the corporation. Imputation is clearly the worst in terms of administration. Deduction is probably not as bad, but shareholders still must account for their dividend income.

I think the comparative experience with which I started is telling, but hardly surprising. As I believe I have demonstrated, compared to other methods of integration, an exemption system achieves most of the purposes of integration, while generating little headache in the process. It is therefore the preferred mode of integration.

Affirmative

By Adam H. Rosenzweig†

Exemption is the best form of integration for one simple reason: nobody has any idea who bears the incidence of the corporate income tax. Both the deduction and imputation methods implicitly assume that shareholders bear the *entire* incidence of the corporate income tax.

Take the following example: a corporation would earn \$1 million in net profit absent an income tax. Now introduce a 35% income tax. The corporation would pay \$350,000 in cash tax out of the \$1 million profit, leaving only \$650,000 to be distributed to the shareholders. Under an imputation method, the shareholders would receive a distribution of \$650,000, grossed up to \$1 million, and subject to a credit for the \$350,000 in taxes paid by the corporation. Assuming a 40% shareholder tax rate, the \$1 million dividend would result in \$400,000 of tax, offset by \$350,000 in credits. The shareholders would owe a net of

\$50,000 in cash tax, leaving a total of \$600,000 cash in pocket.

But instead assume that the corporation could cut salaries by \$500,000—solely as a result of the tax—such that its pre-tax income is now \$1,500,000. The corporation pays \$525,000 in taxes, leaving a total of \$975,000 in after-tax profits. The corporation distributes the \$975,000 to the shareholders, grossed up to \$1,500,000 with a credit of \$525,000. The shareholders owe tax of \$600,000 less the credit of \$525,000, for a net of \$75,000 in cash taxes. This leaves \$900,000 cash in the pockets of the shareholders. Now, instead of a 40% tax on the \$1 million of profit, the shareholders bear only a 10% tax on the \$1 million of profit. Assuming a 40% tax on salary, labor bears the \$300,000 difference (\$500,000 lost salary less \$200,000 in tax savings). If the tax rate on labor is lower than the rate on shareholders, the problem gets even worse.

Of course, this is a simplified example, but it demonstrates the idea that this result occurs solely because the shareholders are entitled to receive the *entire* tax credit when they may bear only a portion of the economic incidence of the tax. Since there is no way to know who bears the incidence of the corporate income tax, and it could vary depending on company or industry, this problem will always arise under an imputation method.

Under a deduction method shareholders would bear the entire cost of the tax on dividends. For shareholders in many corporations this would result in a net increase in taxes. Presumably, then, at the margin (taking into account capital gains taxes), under the deduction method such shareholders would oppose making distributions and prefer for the corporation to pay an entity level tax. Put differently, if shareholders are not indirectly bearing the incidence of the corporate level income tax why would they agree to directly bear it through a

deduction method? For a discussion of the tension between shareholders and managers in the corporate integration context, see Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009).

Even worse, shareholders have different tax attributes (the so-called clientele effect). Some are tax-exempt organizations, some are foreign individuals, some are corporations entitled to the dividends-received deduction, and some are taxable U.S. individuals. All of these constituencies would prefer different dividend policies. So instead of paying the tax through the deduction or imputation method, shareholders would simply sort themselves according to their preferences—exempt shareholders and U.S. corporations would own dividend paying stocks while taxable U.S. and foreign individuals would own only non-dividend paying stocks. See Mark P. Gergen, *How Corporate Integration Could Kill the Market for Corporate Tax Shelters*, 61 TAX L. REV. 145 (2008). Don't believe this would happen? Just look at how many mutual fund shares as opposed to tax-exempt bonds are owned through tax-free retirement accounts.

The exemption method avoids all of these problems. As my partner on this resolution points out, for a similar reason the exemption method also addresses a number of international complications as well. Taken together, the dividend exemption method is clearly the best form of integration.

Negative

By Deborah A. Geier

Dividend exemption is the worst form of integration because it ignores crucially important framing effects. With the rise of the behavioral economics movement, we all have become increasingly aware of the importance of cognitive biases and framing effects. Integration using this method requires the corporation to maintain both the EDA

(excludable dividend account) and REBA (retained earnings basis adjustment). All corporate-level earnings that are actually taxed would be either actually or deemed to be distributed. Actual distributions from the EDA would be excluded, while deemed distributions from the REBA would increase stock basis, thereby reducing gain on sale of the stock. Even if we assume that the incidence of the corporate-level tax paid falls on these same shareholders, the amount actually included on their individual tax returns would plummet, which would result in the public's perception that the rich are not paying much income tax. Polls show that much of the public already believes that—rightly or wrongly. This particular route to integration would even worsen that perception.

The vast majority of qualified dividends and capital gains are realized by the very rich. Marty Sullivan's work in *Tax Notes (Is the Income Tax Really Progressive?)*, 125 TAX NOTES 1135 (2009)) demonstrates that even those with AGI between \$200,000 and \$500,000 realize only 12.5% of that AGI in the form of qualified dividends and capital gains. In contrast, those with more than \$10 million of AGI see more than 60% of it in the forms of qualified dividends and capital gains. As Len Burman noted in his recent Senate Finance testimony (*Tax Reform and the Tax Treatment of Capital Gains: Hearing Before the S. Comm. on Finance and the H. Comm. on Ways and Means*, 112th Cong. (2012) (Statement of Leonard E. Burman), at www.finance.senate.gov/imo/media/doc/092012%20Burman%20Testimony.pdf), in 2010 the top 1% realized almost 70% of capital gains and the richest 1 in 1,000 households accrued about 47%. Only 1.1% of the tax preference accorded to net capital gain and qualified dividends is enjoyed by taxpayers in the bottom 60%. The Tax Policy Center estimated that the top 1% would capture 42% of the benefit of the dividend exclusion approach in the Bush 2003 proposal.

Because of this concentration of qualified dividends and capital gains in the richest households, Marty Sullivan has shown that effective tax rates of the merely rich are higher than for the very rich. (*Is the Income Tax Really Progressive?*, 125 TAX NOTES 1135 (2009), and *Busting Myths About Rich People's Taxes*, 135 TAX NOTES 251 (2012).)

These framing effects are important. In the last election, it was widely reported that President Obama paid an effective federal income tax rate of 26.3% in 2010 on AGI of \$1.7 million, while Governor Romney paid an effective federal income tax rate of only 13.9% on AGI of \$21.6 million. While the usual suspects argued that Romney's effective tax rate was actually much higher than it *appeared* because he *indirectly* suffered the incidence of the corporate tax, the general public wasn't buying it. (As an aside, I have to add that it's ironic that these same outlets that argued that Romney's effective tax rate was higher than it appeared because he indirectly paid the corporate tax also consistently argue that the corporate tax is unfair because its falls mainly on labor, not capital. Can't argue out of both sides of your mouth, people!) At bottom, because of these framing effects, the tax event *must* remain visually at the owner level if it is to have any chance of broad-based support.

In addition, state and local governments that base their own individual income tax bases on federal AGI would suffer significant reductions in revenue with dividend exemption and REBAs. States would also have a much harder time issuing tax-exempt bonds if dividends are also wholly or partially exempt. Moreover, tax-exempt dividends would significantly increase the opportunities for tax-rate arbitrage tax shelters. Just as section 265(a)(2) is impossible to police with respect to 103 bonds, so would be any concomitant provision with respect to tax-exempt dividends.

Dividend exclusion does nothing to reduce the biggest distortion of the

classical corporate tax system: the incentive to capitalize with debt rather than equity.

In the closely held Sub C context (as opposed to the Sub S context), the dividend exclusion would create a new preference for dividend distributions over salary payments to employee-shareholders, which would reduce the amount of payroll taxes going to the Medicare and Social Security trust funds, exacerbating the perilous position of the Medicare fund in particular. In other words, the John Edwards and Newt Gingrich gambits would migrate from Sub S to Sub C.

Under the CBIT (Comprehensive Business Income Tax) as an alternative to dividend exemption, both shareholders and bondholders would exclude the dividends and interest received, and the corporation would deduct neither. The benefit of the CBIT approach to integration is that it does away with the bias for debt-financing, but it suffers from the same fatal flaw as dividend exemption: exclusion at the owner level. That's a no-go.

A much better method of integration is one that lodges the tax event at the shareholder-level, either through a dividends-paid deduction to the extent that the dividend is paid out of actually taxed corporate-level income, a credit imputation method like those once enjoyed by European countries before the ECJ ruled them discriminatory because they provided no credit to foreigners receiving dividends, or a mark-to-market system for publicly traded stock like the one described by Joseph Dodge (*A Combined Mark-to-Market and Pass-Through Corporate Shareholder Integration Proposal*, 50 TAX LAW REV. 265 (1995)). More on a modified version of that third possibility under the third resolution.

There is a final point to stress with respect to either a dividends-paid deduction or dividend exclusion system. Every such proposal deems distributions to come *first* from post-enactment,

corporate-taxed income. Under the Bush proposal, for example, distributions would be deemed to come first from the EDA (resulting in exclusion), then from the cumulative REBA (or CREBA) (also resulting in exclusion but also a stock basis reduction), and only last from untaxed corporate income (resulting in inclusion). These includable dividends represent undistributed E&P at the time of enactment or current-year corporate-level preference income. The fair rule—if we are to be stuck with dividend exemption or a dividends-paid deduction—is to treat all distributions as made *first* out of pre-enactment undistributed E&P (until fully distributed)—no dividends exclusion or dividends-paid deduction; *second* out of current-year preference income—ditto; and only *third* out of corporate-level taxed income (excludable under the exemption system or nondeductible under the dividends-paid deduction approach). To defer or even forgive, in effect, the shareholder tax on pre-enactment earnings would be to grant a huge capital windfall to those who had received the maximum deferral benefit from the separate-entity theory of the corporate tax. Here's one of my favorites from Mike McIntyre's *Penseés*: Should a supporter of integration also support a large capital levy to soak up the windfall gain resulting from the end of the two-tier system? Or is the whole purpose of integration to create a windfall gain?

Negative

By David S. Miller

Dividend exemption would be the worst way to achieve integration, especially where, as today, the individual income tax rate exceeds the corporate rate. First, a dividend exemption would provide a pure subsidy to taxpayers in the highest bracket and would dilute the progressivity of our tax system. Second, it would obligate the United States to provide the exemption to residents of its treaty partners. Third, it would tend to

enhance the subsidy of equities over fixed income securities. Fourth, it would be very difficult to ensure that the exempted dividends really are subject to corporate tax. And, finally, a dividend exemption would tend to increase the rates on tax-exempt bonds and decrease state tax revenues, squeezing states and municipalities.

The corporate income tax rate is 35%, and the highest individual marginal rate on ordinary income is effectively 44.7% (after taking into account the 3% Pease limitation and the 3.8% Medicare tax). Assume a corporation earns \$100, pays \$35 in corporate income tax and distributes the remaining \$65. If an individual can exclude the \$65, she will be subject to aggregate tax at a rate of only 35%, which is much lower than the highest marginal rate, which is at least 39.6%. In this case, the individual is much better off than she would have been had the business been run as a sole proprietorship.

Moreover, this high income individual would have paid tax on the corporate income of \$100 at the same combined marginal rate as a shareholder in the lowest marginal rate so the exemption system is not at all progressive. And, because wealthy taxpayers have disproportionately more stock than poor taxpayers, wealthy taxpayers would enjoy a disproportionate benefit from the exemption.

Second, if the United States exempts its own residents from tax on dividends, under the nondiscrimination provision of many treaties, it would have to exempt dividends paid to residents of the treaty jurisdiction. So the United States would lose the tax it collects from these foreign investors.

Third, because for high income taxpayers, corporate earnings would enjoy a lower effective rate than bonds, exempting dividends would increase the subsidy that equities enjoy over bonds.

Fourth, it will be difficult to exempt only the portion of corporate profits that are subject to corporate tax. Assume that a shareholder contributes \$1,000 to a wholly-owned corporation. The corporation has a \$100 loss in year one and \$100 of income in year two, uses its year one loss to offset the income in year two (so it pays no corporate tax), and distributes \$100 in year two. If an individual shareholder could exclude the distribution without reducing his basis, he'd be able to sell his stock for a tax loss without suffering any economic loss. We'd need a complicated system to prevent corporations from being used to generate tax losses in this manner.

Finally, if dividends become exempt, tax-exempt bonds become less attractive, which would raise tax-exempt bond rates. Also, since states piggyback on federal taxable income, if dividends are exempt, states would collect less revenue.

Resolution #3:

“Be it resolved that, assuming the United States imposes a corporate income tax, it should lower the statutory rate below 35% in a revenue neutral way.”

Affirmative

By Adam H. Rosenzweig§

The United States has the highest statutory corporate income tax rate in the OECD. More troubling, however, is that this has not occurred due to any affirmative policy choice by the United States to charge a higher corporate tax rate than the other OECD member countries, but rather merely due to attrition over time as every OECD member country other than the United States has lowered its corporate income tax rate. At a minimum, this proves it is time to revisit the statutory corporate tax rate and what it should be. The best answer would be to lower the corporate

tax rate below 35% in a revenue neutral way.

It is often argued that having a high corporate income tax rate makes U.S. business unable to compete with foreign owned business. It is often unclear, however, what competitiveness means in this context. Does it mean access to capital? Does it mean prices charged to consumers?

For this reason, competitiveness alone is not a reason to reduce the corporate income tax rate. If it were, the corporate income tax rate should be reduced across the board, and dramatically so, regardless of revenue.

Instead, the corporate income tax should be reduced in a revenue neutral way, but not for traditional competitiveness reasons. Rather, the rate

should be reduced due to the combination of the distributional impact of the high statutory rate and the competitive pressures on multinational businesses to manipulate their effective tax rates. More specifically, a high statutory rate results in companies with highly mobile tax bases and multinational business models using aggressive tax strategies to lower their overall worldwide effective tax rate. Meanwhile, those companies with immobile tax bases or primarily domestic business models are left paying the higher tax rates. As an example, it has been reported that Apple paid federal income tax at an average rate of 8.2% and Facebook paid 2.4% while Walmart paid an average annual effective rate of 33.6% and Disney 36.5%.

§ The views expressed herein do not necessarily reflect the views of the author.

Why the disparity? Has there been an affirmative policy choice of the United States to tax Walmart at a higher rate to subsidize Apple? Is there a reason for Disney to pay more to subsidize Facebook? Of course, the answer is no. This is merely the result of the interaction of international competitive pressures and a high statutory corporate income tax rate. Companies like Apple with highly mobile intellectual property and worldwide sales feel the need to aggressively lower their effective rates through offshore planning because their competitors are doing so, while it would be much more difficult for Walmart to do so for the simple reason that Walmart owns (and sells) a lot of real, tangible stuff inside the United States. So if the goal is to equalize the tax treatment of primarily domestic U.S. corporations and primarily multinational ones, the answer must be to lower the nominal tax rate in a revenue neutral way.

There are other benefits from lowering the rate as well. Lower rates would make evasion less profitable, meaning on the margins fewer corporations would engage in wasteful tax planning rather than productive investment. Since corporations on the margin were not paying the tax to begin with, the efficiency gains would be free money to the economy. There is even a chance that corporations would pay slightly more tax in a lower rate world to take advantage of the certainty of completely legal taxes at a lower rate rather than exploiting potentially risky tax avoidance structures under a higher rate. Even so, it is unlikely that the increased efficiency gains plus any certainty gains generated from those corporations on the margin would be sufficient to offset the reduction in corporate revenue incurred by lowering the statutory tax rate on all corporations. So some other revenue would be necessary to lower the statutory corporate tax rate in a revenue neutral way.

The traditional way to do this would be to lower the rate while broadening the

base, say by repealing accelerated depreciation, or increasing the scope of the Subpart F anti-deferral regime, or adding to the number of foreign tax credit baskets, or capping corporate research and development credits. The problem with these approaches is that, in the past, the base broadening measures have seemed to have little long-term effect—as increasingly clever corporations find increasingly clever ways around them—while the statutory rate reductions become permanent.

Perhaps, then, it is time to reconsider what revenue neutral means in this context. There is no reason it need be limited to base broadening. For example, what about a corporate excess profits tax to make more profitable corporations subsidize less successful ones? Or a carbon emissions excise tax to force polluting companies to subsidize clean ones? Other proposals, including one described by my partner on this resolution, could be considered as well. All of these would raise revenue to offset the statutory rate reduction. But what becomes clear is that no choice of revenue instrument is neutral. Any choice to increase revenue to offset other cuts must have distributional consequences. Both sides, therefore, should have affirmative policy goals built into them.

Once we move away from tying rate reductions to base broadening, there is no reason to limit ourselves to these more traditional tools. In fact, if the point of lowering the corporate tax rate is to equalize the treatment of similarly situated corporations (at least based on income), why not explicitly tie the corporate tax rate to this goal instead of indirectly trying to get there through other means? In other words, perhaps lowering the corporate tax rate in a revenue neutral way would mean abandoning the notion of having a single corporate tax rate applicable (effectively) to all corporations and replacing it with a dynamic, self-adjusting tax rate in which

every corporation would pay its own company-specific tax rate.

What would a dynamic, self-adjusting tax rate look like? First, consider the incidence of the corporate tax. When a corporation pays tax, who ultimately bears the cost—consumers, labor or capital? The well-established answer is ... nobody knows. Even worse, it is not just that nobody knows but that nobody can know, as it depends on the relative elasticity of these three groups. But one thing we can know is that during periods of very high unemployment and near zero interest rates, the elasticity of labor becomes much lower than that of capital, at least as compared to more “normal” times of lower unemployment and higher interest rates. In such a case, the incidence of the corporate tax would increasingly be shifted onto labor and away from capital as compared to “normal” times.

So perhaps in response the corporate tax rate should float on a company-by-company basis in some way to reflect this. Although there are a number of potential ways to do so, one would be to reduce the corporate tax rate for corporations that do not shift the cost of the tax onto labor while, at the same time, increasing the corporate tax rate for corporations that do. The details in getting there may be a little messy, for example it may require comparing each individual corporation's employment decisions to some independent metric such as regional or sectoral unemployment. But there is no reason to believe this would be more complex, messy, or difficult to implement than the current income tax with high rates and the resulting transfer pricing, hybrid equity instruments, Double Irish Dutch sandwiches, and reverse hybrid structures, among others.

As a result, the corporate income tax would no longer treat companies differently based on the happenstance of their business model or whether they are primarily domestic or multinational. Some corporations would pay more

under the dynamic self-adjusting tax than under current law and some would pay less, but overall (based on relatively reasonable assumptions) these should wash out over time. Taken together, reducing the corporate income tax rate in this manner could prove not only revenue neutral but also pro-growth and pro-employment, all at the same time. For a more detailed discussion, see Adam H. Rosenzweig, *A Corporate Tax for the Next One Hundred Years: Incorporating Macro-Economic Conditions and Fiscal Policy into the Corporate Income Tax*, 108 Nw. U. L. REV. ____ (forthcoming 2013), available at <http://ssrn.com/abstract=2327852>.

What is clear is that the current system is not necessarily better than the alternatives simply because it came first. High statutory rates lead to perverse distributional consequences with little to no policy behind them. If the United States wants to subsidize companies with significant intellectual property over those with significant inventory, or capital intensive industries over labor intensive ones, or multinational industries over domestic ones, it should do so explicitly. But the current model where this occurs unintentionally due to the combination of a high statutory rate and the ability of some, but not all, corporations to structure around it is the worst of all worlds.

The time to change the statutory tax rate in a revenue neutral manner is now.

Affirmative

By Deborah A. Geier

I am focusing on the “revenue-neutral way.” We need to combine lower section 11 rates with (1) mark-to-market taxation for publicly traded securities (at ordinary rates), extending Dave Camp’s proposal to require mark-to-market taxation of derivatives, (2) forced pass-through taxation for all non-publicly traded stock, including corporate subsidiaries, to reduce the games-playing that would otherwise arise with a low

section 11 tax and no mark-to-market tax at the owner level, and (3) repeal of CFC deferral. In light of the data that I provided earlier regarding the extreme concentration of these holdings by the very wealthy, mark-to-market taxation of publicly traded stock is the *only* way that would have a hope of being distributionally neutral, and that’s imperative.

But it’s even better than that! It’s the best of all worlds. It would decrease the significant revenue loss under section 1014. It would provide a powerful counter-cyclical effect on the bursting of our inevitable stock-market bubbles. It would be administratively easy (unlike with mark-to-market taxation of other sorts of assets). It would be defensible because holders of publicly traded stocks benefit *hugely* from easy liquidity—or Goldman Sachs and Facebook would never have gone public, and firms would never have rushed to do IPOs during the dot-com craze. They should pay not only for liquidity access but also for the government costs incurred to regulate the public securities market. It would eliminate the need for the E&P concept for distributions, would reduce the lock-in and bunching effects (if real), etc.

Finally, we *must* eliminate deferral of CFC income. It’s the second largest corporate tax expenditure (after only accelerated depreciation), and it applies almost wholly in the Sub C context (unlike depreciation). Ending deferral is the *only* sane way to deal with the intractable transfer-pricing abuses that unequivocally eliminate tax on what should be considered U.S.-source income, in addition to creating untaxed stateless income, as so well described by Ed Kleinbard. The territoriality alternative exacerbates these problems.

I would love to get this scored. My guess is that requiring mark-to-market taxation of publicly traded stock (taxed at ordinary rates) and forcing pass-through taxation of all privately held entities, including CFC income, would likely permit a section 11 rate that is lower than any of the current proposals. It’s the best of all worlds! Let’s do it!

Negative: It Is Impossible to Reduce the Corporate Income Tax Rate in a Revenue Neutral Manner

By David S. Miller

We can’t possibly reduce the corporate tax rate in a revenue neutral way, and we shouldn’t even try.

First, why would we even try to reduce the corporate tax rate? The only reason ever given is to improve the competitiveness of U.S. multinationals. But that’s exactly why Germany lowered its combined tax rate to 30% in 2008; and, as Omri Marian pointed out in his 2012 *Virginia Tax Review* article, this effort was at best only a mild improvement and at worst an utter failure.

In fact, if we reduce corporate tax rates in a revenue neutral way, we imply that the average effective rate remains the same. How are U.S. multinationals going to be any more competitive if their average effective rate stays the same? At best, Disney, which is subject to a 36.5% effective rate, would become more competitive, but GE, which pays tax at a 3.6% rate, would become less so. Moreover, if the real competition is with tax havens (as some have argued), reducing the tax rate won’t have any real effect because 25% is still much more than 0% or even 12.5%.

So if the reason to reduce corporate tax rates is to improve competitiveness, but it won’t have that effect, we shouldn’t bother.

Second, it’s utterly impossible to reduce corporate rates in a revenue neutral way. The number one corporate tax expenditure is accelerated depreciation. Accelerated depreciation is responsible for about 30% of corporate revenue loss. But accelerated depreciation is responsible for 80% of individual business revenue loss. Revenue neutrality would mean that we

reduce accelerated depreciation only for C corporations.

But if we eliminate accelerated depreciation only for C corporations, then individuals will develop their businesses and depreciate their assets through sole proprietorships and partnerships and claim deductions at the high individual rate, and then contribute the business assets to C corporations and shelter the income at the lower corporate rate.

While Congress could repeal accelerated depreciation for all businesses in order to generate sufficient revenue to reduce the corporate tax rate, this is hardly revenue neutral from the perspective of the small business owner, who would pay a higher effective rate without any benefit. And because the repeal of accelerated depreciation would hurt small business owners, it has no chance of enactment.

Besides, if we reduced accelerated depreciation, we would remove the single greatest tax incentive for new investment. This is one reason that economists object to the idea of revenue neutral rate reduction. The other objection is that revenue neutral rate reduction would reward old capital, that is, existing investments made in the previous high-tax environment whose returns will enjoy the lower tax environment. ■

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