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NEWS ANALYSIS: THE OBSTACLES TO CORPORATE TAX INTEGRATION.

The Treasury Department is spending a lot of time studying corporate tax integration. Academics are excited by the prospect that integration might become a reality in the next few years. Practitioners, meanwhile, wonder aloud why Treasury does not devote its resources to something more constructive, such as whittling down the list of incomplete regulations projects. Business owners -- who like the idea of reduced business taxes but do not like the prospect of having to pay out earnings -- suspect that integration might be paid for by means of higher income taxes for corporations or their investors. Integration has faltered many times in the past because business owners would rather have their tax reduction in some other form. This article addresses the practical obstacles to integration.

The impetus for this most recent consideration of integration was the desire to narrow the tax differential between debt and equity. (See Tax Notes, February 12, 1990, p. 756.) Corporations were seen to be putting too much debt on their balance sheets, so that a single tax on equity financing would level the playing field. To the extent that overleveraging was a problem, the financial markets have corrected it. Since the Campeau default, it has been nearly impossible to sell a new issue of junk bonds, the kind of debt that members of Congress worry about most. Bankruptcies have increased, and lenders of all kinds are nervous. A recent Securities and Exchange Commission (SEC) report confirms what is already obvious -- that the market for low-quality, high-yield debt is moribund. (For the full text of the SEC report on the status of the high-yield bond market, see Highlights & Documents, April 3, 1990, p. 69.) Last fall, an oblivious Congress acted to close the barn door after the horse was already gone by enacting restrictions on the deduction of original issue discount interest and the use of net operating losses created by acquisition borrowing.

With the perceived problem out of the way, what is the point of studying integration? We are told that we must resolve the problem of the hated double tax not four years after Congress acted to fortify it. We are even told that we must have dividend integration because our European trading partners have it. Now, Europe offers many things worth emulating, but the tax systems are not among them. Those who would copy their tax systems should remember that Europe also has steep corporate income taxes, stock transfer taxes, low capital gains taxes, and a poor distribution of shareholding among individuals.

The U.S. could adopt the German system by simply raising the tax rate on retained earnings and lowering it on distributed earnings. The state of Europe's largely

undeveloped capital markets (except for London) makes it imperative for their governments to try to improve the flow of capital in their societies by minimizing the tax burden on it. In contrast, no one has ever suggested that the United States has a problem moving investment capital efficiently. Indeed, according to Treasury Secretary Nicholas F. Brady and others, our problem seems to be getting capital to stay in one place for any length of time.

Treasury leans toward the view associated with economist Arnold Harberger that the corporate tax falls on all owners of capital. Treasury also worries that it adds to the cost of capital. At the May 21 National Tax Association-Tax Institute of America discussion of integration, Deputy Assistant Treasury Secretary for Tax Analysis Harvey Rosen stated that Treasury believes that even if the savings rate is immutable, integration would increase social welfare by allocating capital more efficiently. Treasury further adheres to the traditional view that integration would encourage firms to pay out more of their earnings as dividends.

The new view is that tax has very little to do with whether corporations pay dividends. If the traditional view is adopted, however, then the Administration's advocacy of a capital gains exclusion is inconsistent, according to John Samuels, vice president and senior tax counsel of General Electric. A capital gains exclusion gives managers and investors a reason to keep earnings in the corporation. Samuels argued that investors should get a basis adjustment for corporate tax paid on retained earnings instead.

Aside from design questions, there are several obstacles that must be overcome before integration of the corporate and shareholder income taxes becomes feasible. First and foremost is revenue. Treasury admits that it has not estimated the cost of any integration scheme. At the NTA-TIA meeting, Samuels and economist Emil Sunley of Deloitte & Touche both asked where the Administration would get the revenue to pay for corporate tax integration. Sunley suggested that the same money could be put to better use, such as investment incentives, if the concern is the effect of the corporate tax on the cost of capital or the level of investment. Deputy Assistant [P. 1169] Treasury Secretary for Tax Policy Michael Graetz jokingly responded, "If there is no double tax, it's hard to believe we could lose any money by integrating it." Humor aside, finding the revenue for what is widely and properly perceived as a tax cut for wealthy individuals will be extremely difficult. (A good discussion of the obvious revenue constraint appears in Tax Notes, May 21, 1990, p. 1003.)

Separate Taxpayers

The second obstacle is tax structure. As a political matter we tax corporations because they are separate income-producing entities. Think what you will of Citizens for Tax Justice Director Robert McIntyre's tactics; but the thought that General Electric might not pay tax makes the hair rise on the back of a lot of necks. Try explaining that General Electric will not formally have an entity- level tax liability to a member of Congress who busies himself holding hearings on the dangers of over-the-counter diet pills. That there should be only one level of tax for corporations and shareholders is not engraved on any stone tablets.

It also might be conceptually wrong to assume that one level of tax is the correct answer. "One tax is not a given. It may be appropriate to view a corporation as a separate entity," Joint Committee on Taxation Chief of Staff Ronald A. Pearlman told an American Bar Association Tax Section audience in February. Professor Rebecca Rudnick at Indiana University School of Law finds a normative foundation for the current corporate tax regime, that is, that liquidity of ownership interests justifies the double taxation of equity. (Rudnick, "Who Should Pay the Corporate Tax in a Flat Tax World?" 30 Case Western Reserve L. Rev. 965 (1989).) What a relief to know that there is a real economic argument for what is essentially a populist political choice. And to think that the poor benighted Congresses all these years have imposed a separate tax on large aggregations of income in public corporations on the basis of a mistaken notion of incidence. The corollary of this, of course, is that we are not too serious about double-taxing closely held businesses, regardless of the size of their income or assets.

Individual shareholding is a political value that needs to be preserved, although in a world in which corporate managers act as investment bankers for shareholders, the shareholder tax is deferred and its impact greatly blunted. Rudnick notes that the corporate tax is appropriate where the corporate managers are making save-or- consume decisions separate from the corporation's owners. The ability to liquidate their investment, Rudnick argues, justifies a separate tax on the owners. It is the separation of ownership from control of the corporation that justifies the tax. Evidence of this separation is rampant in recent years, as defensive managers accuse large investors of being raiders and of unwarranted meddling in managerial prerogatives. Rudnick's approach is consistent with Congress' decision to treat listed partnerships as corporations. Nonetheless, her theory of the corporate tax amounts to a user fee for the use of the public markets. An excise tax on liquidity does not make economic sense.

Tax-Exempts and Debt Finance

This leads to the third point: that attempts to eliminate the tax differential between debt and equity may be costly failures. Our taxpaying businesses are very efficient at organizing themselves in the way that allows them to incur the least tax. Taxable investments tend to find their way to exempt investors; the capital markets provide as much integration as investors demand. Treasury lawyers are aware of the erosion of the base, and in the view of some, they are advocating integration as a graceful way of throwing in the towel.

Nearly half of the equity and most of the debt of public companies is held by institutional investors who are either legally (pension plans and foreigners) or functionally (insurance companies and other financial intermediaries) exempt from tax. Even when these corporations do pay out earnings to taxable shareholders, they often do so in ways that do not invoke dividend taxation, such as by means of stock repurchases. Barring a few really huge S corporations and public partnerships, every business of significant size files a consolidated income tax return. Anyone else who can possibly organize themselves on a passthrough model such as partnership or subchapter S has done so by now.

The treatment of tax-exempt shareholders is not a mere design issue; it is a fundamental question that must be answered before integration can be seriously considered. Tax-exempt institutions, individually and as a group, are too powerful to take on for the small benefits to the efficient use of capital that corporate tax integration might provide. And if Treasury is thinking about finding the revenue for integration from business, then the revenue offsets could raise the cost of capital by as much as integration lowers it, as Sunley pointed out at the NTA-TIA meeting. His point was that marginal gains in the efficiency of capital allocation may not be worth the trouble. An additional observation is that dividend integration lowers the cost of capital only [P. 1170] for distributing companies while the revenue offsets necessary to pay for it may raise the cost of capital for everyone.

At present, a corporate tax is paid on income earned by equity capital owned by tax-exempt institutions. Because of the corporate level interest deduction, little or no tax is paid on income earned by debt capital owned by these institutions, who do not pay tax on the interest they earn. Where the holders are exempt, corporate debt finance goes beyond integration in the eyes of some, who argue that either the interest deductions should be limited or denied or even that a special excise tax be imposed on the privilege of taking money out of the corporation. (For a discussion of this issue, see Tax Notes, May 14, 1990, p. 778.)

A level playing field is not really what some integration advocates want; what they want is less debt financing. The threat of a few big bankruptcies has already seen to that. We are then told that for the future -- when Wall Street goes on another inevitable borrowing binge 20 years from now after everyone has forgotten the October 1987 crash -- the right system should be in place. The right system presumably does not give a tax advantage to debt financing.

The hardest question is not how to design such a system but how to sell anything short of total tax exemption for returns to equity capital to the tax- exempt institutions who control the nation's capital markets. (Design questions are fully explored in Taylor & Aidinoff, "Approaches to Debt: Is Integration the Answer?" Taxes -- The Tax Magazine, December 1989, p. 931. The authors conclude that a shareholder credit is the only workable method.)

If Treasury chooses to advocate a shareholder credit for corporate tax paid on income distributed as dividends, and then proposes to deny the credit to tax-exempts, the latter will be very angry. They will argue strenuously that they are the engine of savings and that taxing them would ruin America's competitiveness, or some such argument. Never mind that Treasury Secretary Brady and the senators from Kansas, among others, worry that tax-exempt investors' focus on quarterly returns is already harming the country's ability to compete. The senators have proposed taxing the short-term gains of pension funds. (For prior coverage, see Tax Notes, March 19, 1990, p. 1364.) Others have suggested that tax-exempts ought to be taxable on their portfolio earnings as a matter of policy; but no one who has ever suggested this ever thought it would come to pass.

Suppose tax-exempt shareholders, both domestic and foreign, are persuaded that they

should be denied a shareholder credit. (A shareholder credit is the only design that permits denial of the benefits of integration to foreigners because of tax treaties.) Equity would find its way to taxable investors, and tax-exempts would buy debt, because there is often no tax at any level on debt-financed returns. No tax is preferable to even a single level of tax. Perhaps the government could opt for Graetz' suggestion of a shareholder credit for distributions with respect to both debt and equity. Even if debt financing and equity financing were on an equal tax footing, institutions may still prefer to buy debt because it offers higher returns and the certainty that the principal will be returned. Corporations may still prefer to be financed primarily by debt, because management wishes to run a private company free from interference from outside shareholders. Either way, not much would have been accomplished, and much revenue would have been lost getting there.

Nor does it accomplish anything to tax taxexempts on their portfolio interest. They have the ability to demand that borrowers make them whole for the extra taxes. Fulfilling this demand would raise borrowing costs. The prevailing interest rate, as Lord Keynes established, is the hurdle that any business investment, no matter how it is financed, must clear to be viable. Raise the prevailing interest rate and the cost of capital is higher for everyone. Congress is already well along in denying interest deductions, and is still worried that the tax system might encourage some corporations to borrow too much. Pearlman has warned that we have not seen the last of interest expense deduction limitations of various kinds. The disallowance of an interest deduction raises the cost of capital.

Closely Held Business

Until the 1986 Act, closely held business abused subchapter C; now with the fun taken out of subchapter C, they have opted for subchapter S or even subchapter K. The point is that closely held business never paid the double tax, and no one outside the IRS seriously wants to make them do so. Closely held business is already integrated. Discussions of integration are relevant only for public corporations.

The first volume of **Robert Wood**'s Corporate Taxation: Complete Planning and Practice Guide (Prentice Hall 1989) gives us the lay of the land now that the paramount considerations in how to organize [P. 1171] are rate inversion, General Utilities repeal, the passive loss rules, and regular taxation of capital gains. Wood, who is with Steefel, Levitt & Weiss in San Francisco, and whose previous tome concerned closely held enterprises, still focuses inordinately on the shareholder-employee relationship with the business. Wood sets out all the factors to be taken into account in choosing a form of doing business in a way that is clearly understandable by even law students but makes no value judgments. In the eyes of many other observers, the tax law's message for individual owners is not to organize a closely held business as a C corporation if they can possibly avoid it, unless they plan to die next week. Instead, they should delay incorporation until access to public capital makes it worthwhile.

Full integration would make subchapter S irrelevant, but the latter would have to stay in place as a political sop to closely held business. (We should banish the euphemism "small

business" from the language, and think about businesses that are closely held but not small by any other criterion.) Congress thought about the size problem in granting transitional relief from General Utilities repeal only for corporations with a certain level of gross income and assets. Subchapter S is about to be made more available, but size limits are not on the shopping list.

Perhaps allowing more shareholders in S corporations and allowing shareholders who are not otherwise subject to U.S. tax to own S corporation stock is as far toward integration as we need to go. The most radical proposal is to allow S corporations to have subsidiaries, or even to be a part of a group filing a consolidated return. This requires some thinking about the nature of consolidated returns, an area where there are enough problems without policymakers introducing new ones.

-- Lee A. Sheppard

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