9-25-2010

The Case for Dividend Deduction

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu
Amir C. Chenchinski
Ernst & Young, LLP, amirchen1@hotmail.com

DRAFT 9/25/10

THE CASE FOR DIVIDEND DEDUCTION

Reuven S. Avi-Yonah[1]
Amir C. Chenchinski[2]

1. Introduction: The Integration Experiment

On January 1, 2011, the tax rate on dividends is currently scheduled to go up from 15% to 39.6%, while the tax rate on capital gains will rise from 15% to 20%. This will reverse the partial integration of the corporate and shareholder taxes adopted by Congress in 2003, when it set both the dividend and the capital gains rate at 15%. Congress may, of course, act before next January to change this result and leave the dividend and capital gains rate at 15% (as the Republicans want) or raise both of them to 20% (as proposed by the Obama Administration). It seems very unlikely, however, that we will see a return to the Bush Administration proposal of 2003, which would have completely exempted dividends to achieve corporate/shareholder integration.

Given this uncertainty and the likelihood of some Congressional action, now may be a good time to revisit the integration issue. Another reason for revisiting the topic is that several proposals have recently been made to restrict the deductibility of interest at the corporate level as a way of reducing the pressure on the distinction between debt and equity, which has also been one of the reasons to adopt partial integration in 2003.[3] The President's Economic Recovery Advisory Board has recently identified integration as a top policy priority in its report on options for federal tax reform.[4]

---

[1] Irwin I. Cohn Professor of Law, the University of Michigan. I would like to thank Steve Bank, Yariv Brauner, Michael Schler, Jeff Trinklein…

[2] Senior Manager, Ernst & Young, Israel; SJD, University of Michigan Law School, 2004. This article is based in part on Mr. Chenchinski's SJD dissertation, "The Road Not Yet Taken: Integration and Dividend Deduction" (Univ. of Michigan, 2004) written under the supervision of the first author.

[3] See, e.g., The President's Economic Recovery Advisory Board, Tax Reform Report (August 27, 2010), 72-74 ("PERAB Report"); Edward D. Kleinbard, Rehabilitating the Business Income Tax, 115 Tax Notes 1213 (2007). For previous critiques of the corporate interest deduction that propose limitations on it see, e.g., Herwig J. Schlunk, The Zen of Corporate Capital Structure Neutrality, 99 Mich. L. Rev. 410 (2000); Michael S. Knoll, Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking, 38 Vill. L. Rev. 1461 (1993); William D. Andrews, Tax Neutrality Between Equity and Capital Debt, 30 Wayne L. Rev. 1057 (1984); Alvin C. Warren**,** Jr., The Corporate Interest Deduction: A Policy Evaluation, 83 YALE L.J. 1585 (1974).

[4] PERAB Report, 74-76.

Traditionally, three reasons have been given to adopt some form of corporate/shareholder tax integration.[5] The classical system of corporate taxation, under which corporate income is subject to tax and dividends are not deductible and are fully taxable to shareholders, leads to three distortions. First, there is a bias against operating as a "C" corporation, because only C corporations (typically, publicly traded corporations) are subject to the double tax. Second, there is a bias against dividend distributions (which trigger the double tax) and in favor of earnings retention or distributions in the form of capital gains (which are subject to tax at a lower rate). Third, there is a bias against equity and in favor of debt because interest is deductible and dividends are not.

When the Bush Administration proposed to exempt dividends from tax in 2003, they argued (following the 1992 Treasury Report) that such a move would reduce all three distortions.[6] If the corporate rate and the individual rate are the same, then for taxable US shareholders dividend exemption would mean that there is no bias against the corporate form because income earned through C corporations and income earned directly or through pass-through entities would be subject to the same rate. The bias against dividend distributions would be eliminated because they would not trigger tax at the shareholder level. Finally, the distinction between debt and equity would matter less because interest would be taxable at the shareholder level while dividends would be taxable at the same rate at the corporate level.

It is not clear whether the 2003 reform as enacted achieved any of these goals. The bias against C corporations remained to the extent that shareholders are tax exempt, because they may bear the burden of the corporate tax but are not taxed on noncorporate income. The bias against dividends may have been mitigated, but the data indicate that dividend distributions did not increase after the 2003 reform more rapidly than before 2003, while redemptions grew dramatically.[7] Finally, the debt/equity distinction remained in place because interest could still

---

[5] See generally PERAB Report, 74-76; U.S. Department of the Treasury, Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once (1992) ("1992 Treasury Report"); Alvin C. Warren Jr., Integration of Individual and Corporate Income Taxes, American Law Institute 1993 ("1993 ALI Report"); Alvin C. Warren, Jr., The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 719 (1981).

[6] Joint Committee on Taxation, Eliminate the Double Taxation of Corporate Earnings, Jan. 2003, available at http://www.ustreas.gov/press/releases/docs/bluebook.pdf

[7] Reuven S. Avi-Yonah, The Redemption Puzzle, 128 Tax Notes 853 (Aug. 23, 2010). These data do indicate that when there is no tax on a distribution and shareholders are powerful (e.g., hedge funds), an increase in distributions results, but this does not generalize to other shareholders. See also Jesse Edgerton, Effects of the 2003 Dividend Tax Cut: Evidence from Real Estate Investment Trusts (working paper, April 2010) (increase in dividends after 2003 tax cut was matched by distributions from REITs, whose dividends did not qualify for reduced rate, so that tax cut had at most a modest role in driving increase); Jennifer Blouin, Jana Raedy and Douglas Shackleford, Dividends, Share Repurchases, and Tax Clienteles: Evidence from the 2003 Reductions in Shareholder Taxes (NBER Working Paper 16129, June 2010) (while the tax

be deducted and recipients were frequently tax exempt, while dividends could not be deducted, so equity was still taxed more heavily than debt even though dividends were subject to a lower rate than interest in the hands of taxable recipients.

However, proponents of integration would argue that we simply did not try hard enough in 2003, both because we only partially exempted dividends, but also because there is a better, more thorough integration alternative. This is the Comprehensive Business Income Tax (CBIT), first proposed in the 1992 Treasury Report.

Under CBIT, all business entities, whether incorporated or not, are subject to a business level tax at the same rate. Dividends and interest are both not deductible, but are exempt at the recipient level.[8] This solution takes care of all of the three biases directly. There is no distinction between C corporations and other business entities, which eliminates the bias against the corporate form. There is no tax on distributions of any kind, which eliminates the bias in favor of retention. And since dividends and interest are both non-deductible, there is no debt/equity distinction.

In recent years, there have been various proposals building on the CBIT concept. Edward Kleinbard has proposed the Business Enterprise Income Tax (BEIT), which differs from CBIT primarily because it permits all business entities a deduction for a Cost of Capital Allowance (COCA) reflecting the "normal" return on capital, which is then taxable at the investor level.[9] Dividends and interest are not deductible or includible under BEIT. The Bush Tax Reform Advisory Panel proposed the Growth and Investment Tax (GIT), a business level cash flow tax under which all capital expenditures are deductible, as are wages, but dividends and interest are not deductible (but subject to a 10% rate at the recipient level).[10] The Obama PERAB proposals also envisage applying corporate taxation to a broader class of entities.[11] All of these proposals seek to achieve the same integration goals as CBIT, although GIT goes further in effectively converting the business tax into a consumption tax or VAT.[12]

---

cut did spur some firms to increase dividend payouts, this effect was the greatest at firms in which corporate directors and officers held large stakes).

[8] 1992 Treasury Report, supra.

[9] Kleinbard, supra.

[10] President's Advisory Panel on Fed. Tax Reform, Simple, Fair, and Pro-Growth. Proposals to Fix America's Tax System (2005).

[11] PERAB Report, 74-76.

[12] We support a VAT, but in addition to, not as a replacement of, the corporate and individual income tax. See Reuven S. Avi-Yonah, Designing a Federal VAT: Summary and Recommendations, 63 Tax L. Rev. 285 (2010). Each of these three taxes has a different goal: The VAT is primarily for raising revenue, the individual income tax primarily for redistribution, and the corporate tax primarily for regulation, so we (like all other OECD countries) need all three. See Avi-Yonah, Taxation as Regulation (2010).

In our view, the problem with all of these proposals is that they omit to ask the crucial question of why we should tax business entities in the first place. Taxes, the economists tell us, are always borne by human beings, not by legal entities. Why should legal entities, be they corporations or other forms of business entity, be subject to tax at all? Would it not be easier to just tax people?

It turns out that there are two good reasons to tax some business entities under some circumstances. Specifically, we believe that publicly traded corporations should be subject to tax (a) because it is hard to tax them on a pass-though basis, and if they are not taxed they become vehicles for tax deferral, and (b) because they are economically important and taxing them is a means to regulate the behavior of the people who run them.

However, if those are the reasons for taxing business entities, then we believe that the right form of achieving corporate integration is not CBIT or its progeny, or dividend exemption, or imputation (giving shareholders a credit for the corporate tax). The right form of integration, we would argue, is dividend deduction. Dividend deduction is frequently mentioned in the literature on integration, but rarely analyzed.[13] In what follows, we will try to explain why it is a superior form of integration, and resolve some of the hard questions it raises (which are why, unlike dividend exemption and imputation, it has not yet been tried anywhere as far as we know, although several countries have adopted a lower rate for distributed than for retained earnings).[14]

2. Two Rationales for Taxing Corporations and their Implications

Why do we subject business entities to tax? Taxes are borne by human beings, not legal entities. When we tax legal entities, we create uncertain and shifting tax burdens. Fifty years of intensive research by economists from Harberger onward have failed to conclusively establish the economic incidence of the corporate tax.

There are in our opinion two valid arguments for subjecting any business entities to tax, but they both apply only to publicly traded corporations. The first reason is deferral. If individuals are subject to tax but business entities are not, and if business entities are treated as separate from their owners, then it is tempting for individual owners to earn income through business entities because if it is not subject to tax until it is distributed then the owners achieve deferral of the tax, which given the time value of money is tantamount to a reduction in the effective tax rate.

[13] It was rejected in both the 1992 Treasury Report and the 1993 ALI Report. A deduction for dividends on new equity, but not other dividends, was proposed in William D. Andrews, American Law Institute, Federal Income Tax Project: Subchapter C (Supplemental Study), Reporter’s Study Draft (June 1, 1989).

[14] See Peter Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries (1996). The Czech Republic and Germany (before 2001) are two examples.

This argument does not hold, however, if we can look through business entities and tax their owners directly on the income earned by them. In the case of business entities that are not publicly traded, this is relatively easy, and in fact we apply pass-through taxation to the vast majority of those entities (sole proprietorships, partnerships, LLCs and S corporatons). In those cases we do not (closely held C corporations, trusts and estates) there is in our opinion no good reason not to do so.[15]

However, publicly traded corporations are hard to tax on a pass-through basis, because the shares change hands constantly and the identity of the shareholders may be hard to determine. Because of this, pass through or complete integration is generally considered not to be a feasible alternative for publicly traded business entities (corporations and publicly traded partnerships, which we treat as C corporations for this reason).

Theoretically, it is nevertheless possible to solve the deferral problem even for publicly traded business entities without imposing an entity level tax. The solution would be to treat them as if they were PFICs: Tax shareholders either on a current basis (with an election by the entity to let the shareholders know how much income is attributable to them), or upon distribution with an interest charge, or on a mark to market basis. The problem is that all of these would be quite unpopular politically. In particular, the mark to market alternative is attractive because by definition there is no liquidity or valuation issue for publicly traded stock, but given the recent vagaries of the stock market, the problem of phantom income for shareholders and revenue instability for governments is likely to doom any such proposal.

Because of this, we believe that entity level taxation is needed for publicly traded business entities to address the deferral issue.

The second reason to tax business entities is the regulatory argument. Publicly traded C corporations are very important players in the economy, and their managers make decisions that affect the lives of millions of citizens. Not surprisingly, Congress has opted to use the corporate tax as a vehicle to regulate the activities of corporate managers by rewarding activities it likes (e.g., investment tax credits, expensing) and punishing activities it dislikes (e.g., tax rules related to boycotts, bribes, and penalties). This is in our opinion the strongest reason to have a corporate tax, and the one that was foremost in Congress' mind both when it enacted the tax a century ago and when it maintains it today.[16]

---

[15] We would treat closely held C corporations as S corporations (mandatory S election), treat non-grantor trusts as simple trusts (i.e., tax the beneficiaries currently) or impose an interest charge on distributions to beneficiaries of complex trusts, and abolish the estate tax and replace it with a tax on heirs. See Lily L. Batchelder, What Should Society Expect from Heirs? A Proposal for a Comprehensive Inheritance Tax 3-7 (N.Y.U. Ctr. for Law, Econ., & Org., Working Paper No. 08-42, 2008).

[16] See Reuven S. Avi-Yonah, Corporations, Society and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193 (2004).

Once again, this reason only applies to publicly traded business entities, because as a practical matter most large business entities need to access the equity markets and therefore become publicly traded C corporations. There are very few large privately held businesses in the United States, and in those cases the regulatory aims could be achieved by taxing the controlling shareholders directly, since they are also the managers.

If these are the two reasons to tax business entities, then our current system gets it approximately right: It generally applies the corporate tax only to publicly traded entities but not to privately held ones. If that is the case, then the various proposals to extent entity level taxation to privately held entities, such as CBIT, BEIT and GIT, are misguided.

This, however, leaves the question of integration. Is there a way to mitigate the three biases in the classical system without adopting CBIT and its progeny? We would argue that the answer is to adopt dividend deduction, and that this method of integration both satisfies the two goals of taxing business entities and addresses the three biases adequately (or at least better than dividend exemption or imputation).

Before we go into the details of the dividend deduction proposal and compare it to other integration methods, we would like to emphasize its superiority to the other proposals in achieving the two goals of taxing business entities. First, unlike CBIT and its progeny, it is not overbroad in that it only applies to publicly traded C corporations. Second, it directly addresses the deferral issue because by definition if a corporation distributes a dividend, there is no deferral and no need to tax that income at the corporate level. Dividend exemption and imputation, as well as CBIT and its progeny, continue to tax income at the corporate level even when it is distributed, which is inconsistent with the anti-deferral rationale for the corporate tax. Third, dividend deduction meets the regulatory goal of corporate taxation because once management decides to distribute a dividend, it does not control the funds any more and there is no need to impose a corporate level tax in order to regulate its use of the funds. Again, CBIT and its progeny, dividend exemption and imputation overtax corporate managers by continuing to tax corporate income even when it has been distributed to shareholders.[17]

3. The Dividend Deduction Proposal

[17] Arguably, this line of thought indicates that the definition of dividend should be expanded to cover any corporate distributoion to shareholders, eliminating the “earnings and profits” limitation (as is done in other countries like the UK). See Andrews, "Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends, 69 HARV. L. REV. 1403 (1956). But this would raise a concern that corporations would borrow to distribute dividends and deduct both the interest and dividends. On the recipient side, both dividends and interest should be fully taxable to shareholders, and if dividend deduction is adopted there is no need for a reduced rate for dividends or for redemptions (except that both should be eligible for recovery of basis). Regular capital gains on sales of stock should be fully taxable for controlling shareholders (including corporate shareholders), but tax-free to portfolio shareholders because the portfolio capital gains of foreign shareholders cannot be taxed.

The proposal, therefore, is to allow corporations an unlimited deduction for both dividends and interest.[18] The corporate tax will only apply to retained earnings.

Both dividends and interest will be taxable at the recipient level.[19] If the recipient is a U.S. taxable individual or corporation, the result would be one level of tax at the recipient level, at graduated rates (with no dividend received deduction for corporations, although dividends would still be eliminated in a consolidated group). This result maintains progressivity (if the shareholder rate is higher than the corporate rate, the shareholder rate applies, which is not true in CBIT or in dividend exemption since those methods only apply the corporate level tax. Imputation and BEIT also maintain progressivity).

The hard issue for a dividend deduction system is what to do when the recipient is (a) a lower bracket U.S. individual, (b) a tax-exempt U.S. institution, (c) a foreigner. In the case of a lower bracket domestic recipient, there is no reason to tax her at a higher rate, and dividend deduction achieves the correct tax result from a progressivity perspective. There is no reason why lower bracket individuals should be subject to tax at 35% merely because they earn their income through a C corporation rather than directly.

In our opinion, the same analysis applies to tax-exempt domestic institutions. If we believe that they truly should be exempt, we should not subject them to a 35% tax indirectly if they invest in a C corporation. This change will be expensive, given that over 50% of U.S. equities are held by tax exempts, but if Congress thinks otherwise it could make dividends and interest from C corporations to tax exempts taxable as UBIT income.[20]

Foreign recipients are probably the main reason why no country has adopted dividend deduction (just like they are the main reason why countries have shifted from imputation to dividend exemption once the pressures of globalization and the ECJ case law meant that they would have to extend imputation credits to foreigners). No country likes to lose its corporate tax base to foreign recipients. And yet countries have accepted that situation, to a large extent, when they allow interest to be deductible and not subject to a withholding tax even when paid to recipients in tax havens (thin capitalization rules are the only bulwark against complete erosion of the corporate tax base in this instance). Thus, we do not see foreign shareholders as a reason not to adopt dividend deductions, because at least dividends paid to foreign shareholders are subject to

---

[18] As discussed below, it may be necessary to apply the earnings stripping limitations of IRC section 163(j) to dividends to foreign parents, as well as to interest.

[19] We would also support treating dividends and redemptions alike by (a) allowing a deduction for redemptions and (b) allowing basis recovery for both dividends and redemptions. The same rule would apply to redemptions from foreign shareholders. See Avi-Yonah, The Redemption Puzzle, supra; Ethan Yale, Corporate Distribution Tax Reform: Exploring the Alternatives, 29 Va. Tax Rev. – (2010).

[20] See H.R. 3838, 99th Cong., 1st Session, sec. 311 (1985) and H. Rept. No. 426, 99th Cong., 1st Sess. (1985), 240 (adopting dividend deduction and treating a portion of dividends as UBIT).

one level of tax in most cases: 30% if there is no treaty, 15% if there is one, and 5% in most cases for direct dividends to foreign parents. In fact, Congress has recently strengthened the dividend withholding tax against abuse by means of derivatives, while leaving interest withholding (or lack thereof) unchanged.[21]

If we adopt dividend deduction, we could reconsider our treaty policy. Given dividend deductibility, we could impose a 30% tax on all outgoing dividends without creating a higher barrier to foreign investment than is posed by the current corporate tax. But even if we do nothing we do not see foreign shareholders as a reason not to adopt dividend deduction given that we allow interest and royalty deductions without a withholding tax. In the absence of higher dividend withholding we would, however, support applying the limits of IRC section 163(j) to dividends as well as to interest, especially since some dividends to foreign parent corporations are now subject to no withholding under our treaties.[22]

4. Comparing Dividend Deduction, Dividend Exemption, Imputation and CBIT

How does dividend deduction compare with the other integration methods as a way of addressing the three biases?

In terms of the bias against the corporate form, we would argue that dividend deduction is as good as dividend exemption or imputation. In all three cases, there is only one level of tax imposed, at the shareholder level for dividend deduction or imputation, and at the corporate level for dividend exemption. If the top shareholder tax rate is higher than the corporate tax rate, then both imputation and dividend deduction are superior to dividend exemption, because with dividend exemption noncorporate investments are taxed at a higher rate than corporate ones (so that the bias is reversed).

One special case that should be mentioned is corporate level preferences. Most commentators agree that corporate preferences (that reduce the corporate rate below 35%) should not be passed through to shareholders because, in accordance with the regulatory goal of the corporate tax, they are intended to influence management behavior and not to benefit shareholders. But in both dividend exemption and imputation it is necessary to construct very complicated mechanisms to prevent corporate preferences from being passed to shareholders, while in the case of dividend deduction this happens automatically because if there is no corporate income the deduction disappears.[23]

---

[21] As noted above, Congress should also tax redemptions by foreign and domestic shareholders and allow basis recovery for both.

[22] In the case of branches we would also support applying the rules of IRC section 884(f), which treats branches as subsidiaries for purposes of interest deductions, to dividends as well.

[23] For the complexities of preventing pass-through of preferences under dividend exemption see Joint Committee 2003 Bluebook, supra, and for the complexities under imputation see Reuven S. Avi-Yonah**,** The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis, 44 Tax Law. 195 (1990).

CBIT and its progeny do a better job at eliminating the bias against the corporate form than dividend exemption or imputation, because both of those leave the corporate tax completely intact but apply it only to publicly traded C corporations. Dividend deduction reduces the bias because the corporate tax only applies to retained earnings, but does not eliminate it as thoroughly as CBIT and its progeny. However, we would argue that CBIT and its progeny tax non-public business entities unnecessarily, for the reasons stated above. In addition, we am not sure this bias is very important, for three reasons. First, the empirical literature suggests that it is not very large.[24] Second, one reason for that finding may be that to see a bias against the corporate form one needs to assume that the corporate tax falls on shareholders, which is a doubtful proposition. If the corporate tax is shifted to labor or consumers or both, then there is in fact a bias in favor of corporations because the dividend tax can be deferred whereas pass-through entities are taxed currently. Third, another reason for the empirical finding is that it is not clear that publicly traded entities are substitutes for private business entities (i.e., there may be compelling non-tax reasons to access the public equity markets that overcome any tax bias).

The bias against retention is only partially addressed by dividend exemption and imputation, because distribution decisions are taken by managers who may not care very much about the shareholder tax. There is little evidence that the 2003 dividend exemption increased dividend distributions. Dividend deduction, we would argue, would create a very powerful incentive for management to distribute earnings. In countries where there is a rate differential between retained and distributed earnings this was an effective way of encouraging distributions.[25] CBIT and its progeny are are also inferior to dividend deduction from this perspective because they exempt distributions at the recipient level, which we believe is in many cases not as good a way of encouraging distributions than to allow a full deduction at the corporate level.

[24] Most estimates of the deadweight loss (DWL) from this bias are quite low -- see, e.g., Austan Goolsbee, "The Impact and Inefficiency of the Corporate Income Tax: Evidence From State Organizational Form Data," NBER Working Paper 9141 (September 2002) (an increase in the corporate tax rate by 10 percent reduces the corporate share of firms by 5-10 percent and the corporate share of sales and employment by 2-6 percent). Goolsbee concludes that "[t]he impact of tax rates is an order of magnitude larger than previous estimates . . . and suggests a larger DWL from corporate taxation, but is still relatively modest." As Goolsbee says, previous studies found much lower DWLs. See also Goolsbee, TAXES, ORGANIZATIONAL FORM, AND THE DEAD WEIGHT LOSS OF THE CORPORATE INCOME TAX (“The results indicate that taxes do matter for organizational form decisions but the magnitude of the effect is small. An increase in the corporate rate of .10 raises the noncorporate share of capital between .2 and 3 percentage points. At this magnitude, the dead weight loss of the corporate income tax is less than 10% of revenue.”)

[25] Harris, supra. The case of RICs and REITs in the US is another illustration, since they distribute almost all of their income. See Edgerton, supra. We do not anticipate a similar response from C corporations since unlike RICs and REITs they will have to retain funds to run the business operations, and will not have the option of declaring a dividend without an actual distribution.

Finally, neither imputation nor dividend exemption do a good job on the bias against equity and in favor of debt, because they both tax dividends at the corporate level and interest at the investor level. This creates debt/equity parity only when the rates are the same and when the recipients of interest payments are fully taxable, which is rarely the case. Dividend deduction, on the other hand, creates true debt/equity parity.[26]

CBIT and its progeny also create debt/equity parity, but at a heavy price: They disallow the deduction for interest even though interest is a legitimate cost of doing business. For financial institutions in particular it seems very inappropriate in an income tax context to disallow the interest deduction and effectively tax them on gross interest income. Dividend deduction achieves the same goal but without the inappropriate limits on interest deductions. (BEIT also achieves this goal through the COCA deduction, but this assumes that we can get COCA right and that it would adequately compensate for the loss of both interest and depreciation deductions).

To sum up, we believe that dividend deduction is superior to both imputation and dividend exemption on the second and third biases (in favor of retentions and debt). Dividend deduction is also superior to CBIT and its progeny on the bias in favor of retentions, and is equal to it on the debt/equity issue (but without CBIT's inappropriate limitations on interest deductibility). Dividend deduction is also as good as imputation and better than dividend exemption on the first bias (in favor of noncorporate businesses). It is not as good as CBIT and its progeny on this front, but this seems a small price to pay in exchange for avoiding a dramatic and in our view unecessary expansion of entity taxation.

5. Conclusion

Now that the US is about to revert to the classical system of taxing corporations and their shareholders, it is a good time to reflect on the US integration experience. We do not see much evidence that adopting partial dividend exemption in 2003 had a significant effect on the three biases that are usually cited to support integration.

However, this does not mean that the US should reject integration (although it is certainly not essential). Most of the world has integration, and the US should reconsider it as well. If it does, we do not believe that it needs to adopt a radical expansion of the taxation of business entities, as envisaged by CBIT and its progeny, especially if this requires eliminating interest deductibility. Nor do we think the US needs to reinstate shareholder level integration mechanisms, which benefit the rich disproportionaly (dividend exemption) or are very complex (imputation). Instead, like the original version of tax reform did in 1985, the US should try dividend deduction as a

[26] Even under dividend deduction debt/equity parity is incomplete because interest is deductible when it accrues while dividends are deductible only when paid, but we doubt this makes a big difference except for OID instruments. We could extend the OID rules to equity under IRC section 305, but we doubt this is a good idea because it will enable corporations to obtain the benefit of the deduction without paying out an actual dividend, while the recipients (like holders of OID debt) are likely to be tax exempt.

relatively simple way of achieving integration that is also the most consistent with the two reasons it needs to tax publicly traded corporations in the first place.

SUMMARY: OPTIONS FOR CORPORATE/SHAREHOLDER INTEGRATION

Option	Advantages	Disadvantages
No integration	Current law (1/1/11)- revenue	Bias against corp form Bias agaist dividends Bias against equity
Full integration	Abolish corp tax- no biases	Unadministrable?
PFIC treatment (mark to mkt or int charge)	Abolish corporate tax	Complicated Phantom income for sh Revenue instability
CBIT	No biases x 3	Overtax private entities No int deduction No progressivity No mgmt incentive To distribute
Div exemption	No corp form bias No bias against div No debt/equity	Only if rates same but do mgmt care but if int to tax exempt Complicated re corp prefs No progressivity
Imputation	No corp form bias No bias against div No debt/equity	but do mgmt care but if int to tax exempt Complicated re corp prefs
Div deduction	No corp form bias No bias against div No debt/equity Simple re corp pref Consistent w/ reasons to tax corps	Tax-exempts (UBIT) For sh (w/h tax) Revenue (VAT?)