2011

The Case for Dividend Deduction

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I. Introduction: The Integration Experiment

The December 2010 compromise between President Barack Obama and the Republicans extended the 15% tax rate on dividends through the end of 2012.[1] At that point, however, the rate may revert to the Clinton administration rate—39.6%—or be raised to 20%—as proposed by the Obama Administration.[2] Thus, the United States may either abandon corporate-shareholder integration, maintain partial integration, or perhaps even adopt the George W. Bush administration's 2003 proposal to exempt dividends altogether—as advocated by some Republicans in Congress.

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

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

[1] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 748, 124 Stat. 3296.

[2] *See* THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 36 (2010) [hereinafter PERAB REPORT].

[3] *See id.* at 72–74; EDWARD D. KLEINBARD, THE HAMILTON PROJECT, REHABILITATING THE BUSINESS INCOME TAX 10 (2007). For previous critiques that propose limitations of the corporate interest deduction, see William D. Andrews, *Tax Neutrality Between Equity and Capital Debt*, 30 WAYNE L. REV. 1057, 1057 (1984); Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461, 1508 (1993); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 410–11 (2000); Alvin C. Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1609 (1974).

[4] PERAB REPORT, *supra* note 2, at 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—in accordance with 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 United States shareholders, a 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 dividends would not trigger tax at the shareholder level. Finally, the distinction between debt and equity would matter less because interest would be taxable to the recipients of the interest payments while dividends would be taxable at the same rate at the corporate level.

It is not clear whether the 2003 change, 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 indicates that dividend distributions did not increase more rapidly after the 2003 change, while redemptions did grow

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[5] *See generally id.*; U.S. DEPARTMENT OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, TAXING BUSINESS INCOME ONCE 1 (1992) [hereinafter 1992 TREASURY REPORT]; ALVIN C. WARREN, AMERICAN LAW INSTITUTE, INTEGRATION OF INDIVIDUAL AND CORPORATE INCOME TAXES 3 (1993); Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 798 (1981).

[6] STAFF OF J. COMM. ON TAX'N, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSAL 18 (Comm. Print 2003) [hereinafter STAFF OF J. COMM. ON TAX'N].

dramatically.[7] Finally, the debt–equity distinction remained in place because interest could still be deducted and recipients were frequently tax exempt, while dividends could not be deducted. In the hands of taxable recipients, therefore, equity was still taxed more heavily than debt even though dividends were subject to a lower rate than interest.

However, proponents of integration would argue that we simply did not try hard enough in 2003, both because we only partially exempted dividends[8] and also because there is a better, more thorough, integration alternative.[9] This is the Comprehensive Business Income Tax (CBIT), first proposed in the 1992 Treasury Report.[10]

Under the CBIT, all business entities—whether incorporated or not—are subject to a business level tax at the same rate.[11] Dividends and interest are both nondeductible but are exempt at the recipient level.[12] This solution directly takes care of all three of the biases. First, there is no distinction between C corporations and other business entities, eliminating the bias against the corporate form. Second, there is no tax on distributions of any kind, which eliminates the bias in favor of retention. Finally, since dividends and interest are both nondeductible, there is no debt–equity distinction.

In recent years, various proposals have built on the CBIT concept. Edward Kleinbard proposed the Business Enterprise Income Tax (BEIT). The BEIT differs from the 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 taxable at the investor level.[13] Dividends and interest are not deductible or includible under the BEIT.[14]

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 nondeductible but

[7] *See* Reuven S. Avi-Yonah, *The Redemption Puzzle*, 128 TAX NOTES (TA) 853, 853–54 (Sept. 7, 2010). This data does indicate that when there is no tax on a distribution and shareholders are powerful—*e.g.*, hedge funds—an increase in distributions results. However, this does not generalize to other shareholders. *See* Jennifer Blouin, Jana Raedy, & Douglas Shackleford, *Dividends, Share Repurchases, and Tax Clienteles: Evidence from the 2003 Reductions in Shareholder Taxes* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 16129, 2010) (noting that while the tax 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); Jesse Edgerton, *Effects of the 2003 Dividend Tax Cut: Evidence from Real Estate Investment Trusts* 16–17 (Fed. Reserve Bd., Finance and Economics Discussion Series, Working Paper No. 2010-34, 2010) (noting that 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).

[8] *See* STAFF OF J. COMM. ON TAX'N, *supra* note 6.

[9] 1992 TREASURY REPORT, *supra* note 5, at 39.

[10] *Id.*

[11] *Id.* at 40.

[12] *Id.* at 39.

[13] KLEINBARD, *supra* note 3, at 33.

[14] *Id.* at 13.

are subject to a 10% rate at the recipient level.[15] The Obama PERAB proposals also envisage applying corporate taxation to a broader class of entities.[16]

All of these proposals seek to achieve the same integration goals as the CBIT, although the GIT goes further by effectively converting the business tax into a consumption tax or a value added tax (VAT).[17]

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

It turns out that there are two good reasons to tax some business entities under some circumstances. Specifically, publicly traded corporations should be subject to tax. First, it is hard to tax them on a pass-through basis and if they are not taxed they become vehicles for tax deferral. Second, 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 the CBIT or its progeny, dividend exemption, or imputation—giving shareholders a credit for the corporate tax. The right form of integration, we argue, is dividend deduction.

Dividend deduction is frequently mentioned in the literature on integration but rarely analyzed.[18] In what follows, we will try to explain why dividend deduction is a superior form of integration and resolve some of the hard questions dividend deduction raises. One such question is why, unlike dividend exemption and imputation, dividend deduction has not yet been

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[15] President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 162 (2005).

[16] PERAB Report, *supra* note 2, at 74–76.

[17] We support a VAT, but in addition to—not as a replacement of—the corporate and individual income tax. *See generally* Reuven S. Avi-Yonah, *Designing a Federal VAT: Part I: 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 is primarily for wealth redistribution, and the corporate tax is primarily for regulation; so, the United States—like all other OECD countries—needs all three. *See* Reuven S. Avi-Yonah, *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes* 5–6 (Univ. of Mich. Law Sch. Public Law & Legal Theory Working Paper Series, Working Paper No. 10-020, 2010).

[18] It was rejected in both the 1992 Treasury Report and the 1993 ALI Report. *See* 1992 Treasury Report, *supra* note 5; Warren, *supra* note 5. 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 62–63 (1989).

tried anywhere, as far as we know—although several countries have adopted a lower rate for distributed than for retained earnings.[19]

II. 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 establish conclusively the economic incidence of the corporate tax.[20] In our opinion there are two valid arguments for subjecting any business entity to tax, but both arguments only apply to publicly traded corporations.

The first argument relates to 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. If income 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.

This argument does not hold, however, if we can look through a business entity and tax its owners directly on the income earned by the entity. In the case of business entities that are not publicly traded, this is relatively easy. In fact, we apply pass-through taxation to the vast majority of such entities—sole proprietorships, partnerships, LLCs, and S corporations.[21] In cases where we do not apply pass-through taxation—closely held C corporations, trusts and decedents' estates—there is, in our opinion, no good reason not to apply pass-through taxation.[22]

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 difficult to determine. Because of these problems, pass-through or complete integration is generally not considered a feasible alternative for publicly traded business entities—corporations and publicly traded

[19] *See* PETER HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 95–96 (1996). The Czech Republic and pre-2001 Germany are two examples.

[20] *See, e.g.*, BENJAMIN H. HARRIS, TAX POLICY CENTER, URBAN INSTITUTE AND BROOKINGS INSTITUTION, CORPORATE TAX INCIDENCE AND ITS IMPLICATIONS FOR PROGRESSIVITY 1–2 (2009) (discussing the lack of consensus regarding the incidence of the corporate income tax).

[21] *See* I.R.C. § 1363 (stating that an S Corporation will not be taxed as a C corporation); Reg. § 301.7701-3 (allowing pass-through taxation for entities with a single owner, limited liability companies, and partnerships).

[22] We would treat closely held C corporations as mandatory elected S corporations, treat nongrantor 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).

partnerships, which we treat as C corporations for this reason.[23]

Nevertheless, it is theoretically 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 Passive Foreign Investment Companies (PFICs): Tax shareholders on a current basis—with an election by the entity to let the shareholders know how much income is attributable to them—upon distribution with an interest charge or on a mark-to-market basis. The problem is that all of these alternatives would be quite unpopular politically. In particular, although the mark-to-market alternative is attractive because there is no liquidity or valuation issue for publicly traded stock by definition, 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 argument in favor of taxing publicly traded business entities relates to regulation. 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—for example, investment tax credits and expensing—and punishing activities it dislikes—such as tax rules related to boycotts, bribes, and penalties.[24] In our opinion, this is the strongest reason to have a corporate tax and the one that was foremost in Congress's mind—both when it enacted the tax a century ago and during its maintenance today.[25]

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. In such cases, the regulatory aims could be achieved by taxing the controlling shareholders directly because they are also the managers.[26]

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. Therefore, the various proposals to extend entity level taxation to privately held entities—such as the CBIT, the BEIT, and the GIT—are misguided.

However, this conclusion leaves open the question of integration. Is there

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[23] *See* I.R.C. § 7704(a) ("[A] publicly traded partnership shall be treated as a corporation.").

[24] *See* I.R.C. § 48 (investment tax credit); I.R.C. § 162(a) (deductions for business expenses); I.R.C. § 162(c)(3) (disallowing deduction for kickbacks or bribes); I.R.C. § 162(e) (disallowing deduction for lobbying costs).

[25] *See* Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1196 (2004).

[26] *See* Avi-Yonah, *supra* note 25, at 1203.

a way to mitigate the three biases in the classical system without adopting the CBIT or its progeny? We argue that the answer is to adopt dividend deduction. This method of integration satisfies the two goals of taxing business entities and addresses the three biases adequately—or at least addresses the biases 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 explain its superiority to the other proposals in achieving the two goals of taxing business entities. First, unlike the CBIT and its progeny, it is not overbroad because 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 the 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.[27] 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 longer and there is no need to impose a corporate level tax in order to regulate the entity's use of the funds.[28] Again, the 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.[29]

III. The Dividend Deduction Proposal

Therefore, the proposal is to allow corporations an unlimited deduction for both dividends and interest.[30] The corporate tax will only apply to retained earnings.

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[27] *Id.* at 1201–05.

[28] *See id.* at 1246–48 (discussing the regulatory rationale for the corporate tax).

[29] Arguably, this line of thought indicates that the definition of dividend should be expanded to cover any corporate distribution to shareholders, eliminating the "earnings and profits" limitation—as is done in other countries like the UK. *See* William D. Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403, 1403 (1956) (discussing how the "earnings and profits" requirement of distribution taxation has outlived its usefulness). 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.

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

Both dividends and interest will be taxable at the recipient level.[31] If the recipient is a United States 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 because if the shareholder rate is higher than the corporate rate, the shareholder rate applies.[32] This is not true in the CBIT or with a dividend exemption because those methods only apply the corporate level tax.[33] Imputation and the BEIT also maintain progressivity.[34]

The hard issue for a dividend deduction system is what to do when the recipient is (1) a lower-bracket United States individual, (2) a tax-exempt United States institution, or (3) a foreigner. In the case of a lower-bracket domestic recipient, there is no reason to tax her at a higher rate, and a dividend deduction achieves the correct tax result from a progressivity perspective. There is no reason why lower-bracket individuals should be taxed at a 35% rate 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 these institutions truly should be exempt, we should not indirectly tax them at a 35% tax rate if they invest in a C corporation. This change will be expensive, given that over 50% of United States equities are held by tax-exempt entities,[35] but Congress could make dividends and interest from C corporations to tax-exempt entities taxable under the unrelated business income tax (UBIT).[36]

Foreign recipients are probably the main reason why no country has adopted dividend deduction—just as foreign recipients are the main reason why countries have shifted from imputation to dividend exemption once the pressures of globalization and the European Court of Justice (ECJ) case law meant that countries would have to extend imputation credits to foreigners.[37]

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[31] We would also support treating dividends and redemptions alike by (1) allowing a deduction for redemptions and (2) allowing basis recovery for both dividends and redemptions. The same rules would apply to redemptions from foreign shareholders. *See* Avi-Yonah, *supra* note 7, at 855; Ethan Yale, *Corporate Distribution Tax Reform: Exploring the Alternatives*, 29 VA. TAX REV. 329, 335–37 (2009).

[32] *See* WARREN, *supra* note 5.

[33] *Id.*

[34] *See* 1992 TREASURY REPORT, *supra* note 5, at 17, 39, 95–96; KLEINBARD, *supra* note 3, at 19.

[35] JASON M. THOMAS, PRIVATE EQUITY COUNCIL, THE IMPACT OF H.R. 4213 ON PRIVATE EQUITY INVESTMENT AND EMPLOYMENT 8 (2010), *available at* http://www.pegcc.org/wordpress/wp-content/uploads/Tax-Exempt-Study-06-08-10.pdf.

[36] *See* H.R. REP. No. 99-426, at 240 (1985) (adopting dividend deduction and treating a portion of dividends as taxable under the UBIT).

[37] Reuven S. Avi-Yonah, *Tax Convergence and Globalization* 4–5 (Univ. of Mich. Law Sch. Pub. Law & Legal Theory Working Paper Series, Paper No. 214, 2010), *available at* http://www.law.umich.edu/centersandprograms/elsc/abstracts/2010/Documents/10-019aviyonah.pdf.

No country likes to lose its corporate tax base to foreign recipients. And yet, to a large extent, countries have accepted a loss to their corporate tax base when they allow interest to be deductible and not subject to a withholding tax, even when paid to recipients in tax havens.[38] Thus, we do not see foreign shareholders as a reason not to adopt dividend deduction, because at least dividends paid to foreign shareholders are subject to one level of taxation in most cases—30% if there is no treaty, 15% if there is a treaty, and 5% in most cases for direct dividends to foreign parents.[39] In fact, Congress has recently strengthened the dividend withholding tax against abuse by means of derivatives while leaving interest withholding—or lack thereof—unchanged.[40]

If the United States adopts 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.[41] In the absence of higher dividend withholding, we would, however, support applying the limits of Code 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.[42]

IV. Comparing Dividend Deduction, Dividend Exemption, Imputation, and the 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 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. Therefore, the bias is reversed.

One special case that should be mentioned is corporate level preferences.

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[38] Thin capitalization rules are the only bulwark against complete erosion of the corporate tax base in this instance. *See* Stuart Webber, *Thin Capitalization and Interest Deduction Regulations*, 60 Tax Notes Int'l (TA) 683 (Nov. 29, 2010).

[39] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752; H.R. Rep. No. 99-426, at 235 (1985). However, the rate may vary by treaty.

[40] *See* I.R.C. § 871(m). As noted above, Congress should also tax redemptions by foreign and domestic shareholders and allow basis recovery for both.

[41] I.R.C. § 62(a)(4) (allowing deduction for royalties); I.R.C. § 163(a) (allowing deduction for interest).

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

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.[43] But with both dividend exemption and dividend imputation, it is necessary to construct very complicated mechanisms to prevent corporate preferences from being passed on to shareholders. In the case of dividend deduction, this happens automatically because if there is no corporate income, the deduction disappears.[44]

The CBIT and its progeny do a better job of eliminating the bias against the corporate form than dividend exemption or imputation because both of those methods 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 the bias as thoroughly as the CBIT and its progeny. However, we argue that the CBIT and its progeny tax nonpublic business entities unnecessarily, for the reasons stated above.

In addition, for three reasons, we are not sure this bias is very important. First, the empirical literature suggests that the bias is not very large.[45] Second, to see a bias against the corporate form, one needs to assume that the corporate tax falls on shareholders, which is a doubtful proposition.[46] If the corporate tax is shifted to labor, consumers, or both, then there is in fact a bias in favor of corporations because the dividend tax can be deferred whereas owners of pass-through entities are taxed currently. Third, it is not clear that publicly traded entities are substitutes for private business entities. There may

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[43] *See* WARREN, *supra* note 5; Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 TAX LAW. 195, 195 (1990).

[44] For the complexities of preventing pass-through of preferences under dividend exemption see STAFF OF J. COMM. ON TAX'N, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS 93 (Comm. Print 2003), and for the complexities under imputation see Avi-Yonah, *supra* note 43.

[45] 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* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 9141, 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 Austan Goolsbee, *Taxes, Organizational Form, and The Dead Weight Loss Of The Corporate Income Tax* 7 (Nat'l Bureau of Econ. Research, Working Paper No. 6173, 1997) ("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.").

[46] *See* HARRIS, *supra* note 20, at 3 (discussing indicators that some of the corporate tax is borne by the labor force).

be compelling nontax 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 made by managers who may not care very much about the shareholder tax.[47] There is little evidence that the 2003 dividend exemption rules increased dividend distributions.[48] Dividend deduction, we argue, would create a very powerful incentive for management to distribute earnings. In countries where there was a rate differential between retained and distributed earnings, dividend exemption is an effective way of encouraging distributions.[49] The CBIT and its progeny are also inferior to dividend deduction as a tool for incentivizing management because they exempt distributions at the recipient level. We believe that in many cases, this is not as good a way of encouraging distributions as allowing a full deduction at the corporate level.

Finally, neither imputation nor dividend exemption does a good job at addressing the bias against equity and in favor of debt because both tax dividends at the corporate level and interest at the investor level.[50] This creates debt–equity parity only when both the rates are the same and the recipients of interest payments are fully taxable—which is rarely the case. Dividend deduction, on the other hand, creates true debt–equity parity.[51]

The 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.[52] For financial institutions in particular, it seems very inappropriate in an income tax context to disallow the interest deduction and effectively tax the institutions on gross interest income. Dividend deduction achieves the same goal but without the inappropriate limits on interest deductions. The 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.[53]

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[47] *See* 1992 Treasury Report, *supra* note 5, at 11.

[48] *See* Avi-Yonah, *supra* note 7, at 853.

[49] *See* Harris, *supra* note 20, at 10. The case of RICs and REITs in the United States is another illustration, since they distribute almost all of their income. *See* Edgerton, *supra* note 7, at 10. 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.

[50] *See* 1992 Treasury Report, *supra* note 5, at 105.

[51] Even under dividend deduction, debt to 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 section 305, but we doubt this is a good idea. 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. *See id.* at 107.

[52] *See id.* at 39.

[53] *See* Alvin C. Warren, *Another BEIT at the Apple: Warren Replies to Kleinbard*, 118 Tax Notes (TA) 1254 (Mar. 17, 2008).

To sum up, we believe that dividend deduction is superior to both imputation and dividend exemption at addressing the second and third biases in favor of retentions and debt. Dividend deduction is also superior to the CBIT and its progeny on the bias in favor of retentions and is equal to it on the debt-equity issue but without the 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 the 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, unnecessary expansion of entity taxation.

V. Conclusion

Now that we have two years to consider whether the United States should revert to the classical system of taxing corporations and their shareholders, it is a good time to reflect on the United States integration experience. We do not see much evidence that adopting a 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 United States should reject integration—although integration is certainly not essential. Most of the world has integration, and the United States should reconsider it as well. If it does, we do not believe that the United States needs to adopt a radical expansion of the taxation of business entities—as envisaged by the CBIT and its progeny—especially if this requires eliminating interest deductibility. Nor do we think the United States needs to reinstate shareholder level integration mechanisms that benefit the rich disproportionately—dividend exemption—or are very complex—imputation. Instead, like the original version of tax reform did in 1985, the United States should try dividend deduction as a 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.