Corporate Integration: Chairman Hatch’s Straightforward Approach to Tax Reform

Want to have input on the proposal? There’s no time like the present

By Alexandra Minkovich

There is consensus that business tax reform needs to occur, but disagreement over how best to achieve it. Earlier this year, Sen. Orrin Hatch (R-UT), chairman of the Senate Committee on Finance (Senate Finance), announced that he was developing a corporate integration proposal. Although Chairman Hatch has not yet issued a discussion draft or introduced legislative language, he and his staff have discussed corporate integration in various public fora. In addition, Senate Finance held two hearings on corporate integration in May 2016.1

Companies that want to affect the development of business tax reform should pay close attention to Chairman Hatch’s forthcoming proposal. Now is the time for businesses to participate in discussions and raise important issues for the chairman and Senate Finance to consider.

“There is nothing new in the world except the history you do not know,” President Harry S. Truman famously said. Policymakers have been debating the appropriate method for taxing corporate income since corporate profits were first subject to tax in 1894.2 Initially, the corporate tax system did not assume two levels of tax would be imposed, and the two-tier system we have today that seeks a tax at both the corporate and shareholder levels was not enacted until 1936.

Since 1936, there have been several well-developed recommendations to integrate the corporate and shareholder levels of tax such that only one tax is imposed on corporate profits. Over the years, however, the rationale and the suggested method for achieving integration have changed.

In the 1970s, for example, the Treasury Department proposed corporate integration in part because other countries had integrated their individual and corporate tax systems, and the United States needed to keep pace with its peers. The 1970s proposals included integration methods that would have shifted the liability for the tax on business profits to the shareholder by, for example, expanding the subchapter S regime.

In the mid-1980s, the Treasury Department issued two reports on reforming the corporate tax system, Treasury I and Treasury II.3 Treasury I recommended a dividends-paid
deduction (DPD) but limited the deduction to 50 percent of dividends paid. Treasury II also recommended a DPD, but limited it to 10 percent of dividends paid. In each case, the deduction was limited due to revenue concerns. Despite the limitation, both Treasury I and II sought to move at least some of the liability for the tax on business profits to the shareholder.

In 1992, the Treasury Department went in a different direction to propose a comprehensive business income tax. The CBIT would have retained the entity-level tax on all business entities, denied interest deductions, and allowed shareholders to exclude dividends from their earnings when distributed. This 1992 approach had the advantage of being easier for the Internal Revenue Service to administer, in that there was a single corporate taxpayer to pursue rather than multiple shareholders.

Despite forty years of interest, however, proponents of full corporate integration have yet to successfully enact legislation. That said, partial integration was achieved with the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, which provided that most types of dividends would be taxed to shareholders at the lower capital gains rate.6

In December 2014, the Republican staff of the Senate Committee on Finance issued a white paper, Comprehensive Tax Reform for 2015 and Beyond.5 The white paper, which was intended to provide background on the current state of the tax law and identify potential future reforms, included a discussion of corporate integration in excess of 100 pages. According to the white paper, in 2013 corporate tax revenues were the third largest source of federal revenues, raising $274 billion (or 10 percent of tax revenues) for the fisc. The white paper noted that corporate income tax revenues peaked at 39.8 percent of federal revenues in 1943 and have been steadily declining since.

The white paper proposed to broaden the corporate tax base and eliminate almost all corporate tax expenditures. It identified the following distortions that would be reduced or eliminated if there were only a single level of tax on corporate income: the incentive to invest in noncorporate rather than corporate businesses, the incentive to finance corporations with debt rather than equity, the incentive to retain earnings or distribute earnings in a manner to avoid a second level of tax, and the incentive to distribute earnings in a manner to avoid a second level of tax.6

The white paper also identified and described eight methods for achieving corporate integration (either partial or complete):

1. dividend exclusion
2. shareholder allocation
3. imputation (or shareholder) credit
4. comprehensive business income tax
5. business enterprise income tax (BEIT)
6. dividends-paid deduction
7. mark-to-market treatment for publicly traded stock and flow-through treatment for nonpublicly traded entities, and
8. split rates on undistributed and distributed income.

(This article discusses only the DPD, the method that Chairman Hatch is expected to propose. Companies interested in the details of the other methods for achieving corporate integration should consult the white paper.)

Chairman Hatch has stated publicly that he and his staff have met with companies since the white paper was released, and that those who came in for a meeting have expressed “near unanimous” support for corporate integration.

Taking Deductions for Dividends Paid to Shareholders

Although the specifics of Chairman Hatch’s proposal are not yet available, based on statements he has made publicly and the discussions at Senate Finance hearings, the proposal is expected to permit companies to take a deduction for dividends paid to shareholders and will require companies to withhold taxes at a 35 percent rate on both dividend and interest payments made. Taxes that are withheld will not be refundable. Retained earnings will still be subject to the corporate income tax. The Joint Committee on Taxation (JCT) has apparently reviewed the proposal and determined that it would raise revenue, although Chairman Hatch has stated that he intends to revise the proposal so as to be revenue-neutral. When Chairman Hatch releases his proposal, he is expected to release a white paper describing the proposal, some legislative language, and JCT’s analysis of the proposal. In addition, he will likely seek comments on the proposal from stakeholders.

Under the proposal, shareholders that are currently tax-exempt (including tax-exempt organizations and retirement plans) will be subject to the 35 percent withholding tax. The chairman has acknowledged the concerns these shareholders may have, but has stated that he intends to craft a proposal whereby they receive economic treatment comparable to their treatment under current law. In public statements, he has also emphasized that, because tax-exempt shareholders already bear the economic burden of the corporate level of tax, his proposal will simply make more transparent how much tax tax-exempt shareholders are already subject to.

Foreign lenders and shareholders will also be subject to withholding tax. This will be the case even if existing treaties provide for a lower (or zero) rate of withholding on interest and dividends.
Chairman Hatch believes his corporate integration proposal would offer the following benefits:

- create greater parity between debt and equity;
- effectively lower the corporate tax rate;
- reduce pressure on companies to invert; and
- reduce the lockout effect.

The first of these benefits has taken on increased importance since Treasury issued proposed debt-equity regulations under Section 385 of the Internal Revenue Code\footnote{as of May 17, 2016, Rosenthal} on April 4, 2016. The Section 385 regulations have been widely criticized as being overbroad and potentially invalid. As Chairman Hatch has noted, enactment of a DPD that would eliminate the chief distinction between debt and equity would largely render the need for the Section 385 regulations moot.

Chairman Hatch has been careful to note that he does not view corporate integration as a cure-all for issues currently plaguing the tax code, but instead as an intermediate step that Congress could pass to provide some benefits to businesses while it continues to work on broader reform. He has stated that corporate integration can be enacted either as a stand-alone bill or as part of a broader international tax reform package.

Senate Finance Hearings

Senators Finance held hearings May 17 and 24, and it was apparent that other members of the committee—including other Republicans—had significant questions about corporate integration. Those questions included:

- How would a withholding tax on dividends paid to pension plans affect Americans’ ability to save for retirement? This was of particular concern to Ranking Member Ron Wyden (D-OR), who suggested that corporate integration could replace double taxation of corporate income with double taxation of retirement income.
- How would corporate integration affect the use of credits for economic growth (such as the R&D credit, the New Markets Tax Credit, the Low-Income Housing Tax Credit, and credits for hiring veterans and investing in low-income communities)?
- Would corporate integration encourage what some committee members perceive to be corporate management’s preference for short-term benefits over long-term investments in physical assets and human capital?
- Would a withholding tax on dividends paid to foreign shareholders violate existing U.S. tax treaties?

Integrating the Corporate and Individual Tax Systems

The purpose of the May 17 hearing was to examine the potential benefits of a DPD. Four witnesses testified before the committee: Michael J. Graetz, a tax professor at Columbia Law School; Judy A. Miller, director of retirement policy for the American Retirement Association and the executive director of the ASPPA College of Pension Actuaries; Steven M. Rosenthal, senior fellow in the Urban-Brookings Tax Policy Center at the Urban Institute; and Bret Wells, associate professor of law at the University of Houston Law Center.

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Both Graetz and Wells agreed that corporate integration would further the goals that Chairman Hatch identified and, while they were supportive of corporate integration, they raised political concerns (such as taxing currently tax-exempt shareholders directly) and design issues that Chairman Hatch and his staff should take into account when finalizing the proposal. For example, Graetz noted that imposing a nonrefundable withholding tax on foreign shareholders would violate current tax treaties, saying, “If you withhold on foreign shareholders, you have a treaty problem. If you don’t withhold on foreign shareholders, you’ve given them a tax cut relative to other shareholders.” He suggested that Congress could address this problem by calling the withholding tax by a different name, citing the examples of the U.K. with its diverted profits tax and Australia with its Multinational Anti-Avoidance Law. (It is unclear whether this approach would be effective.) Graetz also pointed out that withholding taxes on corporate interest but not on bank accounts or U.S. Treasuries might affect investment decisions made by foreign and tax-exempt shareholders.

Rosenthal pointed out that who owns stock has changed dramatically over the past fifty years, which has significant repercussions for corporate integration proposals. In The Dwindling Taxable Share of U.S. Corporate Stock, released on May 16, 2016, Rosenthal and Lydia Austin found that, in 1965, 83.6 percent of corporate stock was held in taxable accounts but, by 2015, that number had dropped to 24.2 percent. Their research also found that, in 2015, 37 percent of corporate stock was held in retirement plans and accounts, and foreigners owned about 26 percent of U.S. stock (not including stock held by foreign multinationals with direct investments in U.S. companies). Because an increasing portion of stock is held in nontaxable accounts, Rosenthal and Austin estimated that...
The proposal is expected to permit companies to take a deduction for dividends paid to shareholders and will require companies to withhold taxes at a 35 percent rate on both dividend and interest payments made.

Meanwhile, Miller described corporate integration as “good tax policy in theory, but horrible retirement policy in practice.” Miller’s testimony focused on her concerns about the negative effects that corporate integration could have on savings rates and Americans’ access to retirement vehicles. Several senators—including Wyden, Bob Casey (D-PA), and Rob Portman (R-OH)—shared her concerns. She explained that, under corporate integration, retirement savings would be subject to tax twice: first, taxes would be withheld when dividends are paid, and, second, another tax would be imposed when retirees withdraw money from their retirement accounts. Chairman Hatch disputed this characterization in his opening statement at the May 24 hearing but, without changing how withdrawals from retirement vehicles are currently taxed, it’s not clear how Miller’s concerns were unfounded. She also expressed concern that corporate integration would discourage small employers from providing retirement plans to their employees and, in response to a question from Ranking Member Wyden, said that corporate integration could exacerbate the problem of underfunded pensions because investments in pension plans will be worth less unless the size of the dividends that companies pay grows sufficiently to account for withheld taxes.

Debt vs. Equity: Corporate Integration Considerations

The purpose of the May 24 hearing was to focus on the different tax treatment of debt and equity and the distortions that result from this inconsistent treatment. The following witnesses testified before the committee: Alvin C. Warren Jr., professor, Harvard Law School; Jody K. Lurie, CFA and vice president at Janney Montgomery Scott; John Buckley, former chief tax counsel to the House Committee on Ways and Means and former chief of staff of the Joint Committee on Taxation; and John McDonald, partner, Baker & McKenzie LLP.

Both Warren and McDonald supported corporate integration, with McDonald describing the current two-level system of taxation as a historical anachronism and advocating that Congress shift the burden from highly mobile corporations to their less mobile shareholders. Warren agreed that distortions in the Code could be eliminated or reduced by moving to an integrated tax system and that the chairman’s approach could provide the basis for reform. Warren identified design questions that Chairman Hatch and his staff should consider in developing the proposal, including determining how integration would affect corporate managers’ decisions about how much of a company’s earnings to distribute as dividends and how much to retain and invest.

Buckley, in contrast, advised Senate Finance members to be “cautious and skeptical” about corporate integration, noting that, among other things, it would increase the costs of debt financing and reduce retained earnings (thereby discouraging investment in the United States). Buckley emphasized that retained earnings are necessary to finance corporate growth, particularly for new companies in growing industries. McDonald responded by noting that companies do not grow simply for the sake of getting larger. They grow so that they can, at some point, distribute funds to their shareholders. Chairman Hatch similarly noted that money distributed by a corporation to its shareholders does not simply disappear. It gets reinvested by those shareholders in other areas of the economy.

In addition, Buckley claimed that the proposal, at best, is inconsistent with and, at worst, violates our tax treaties. Chairman Hatch vigorously disputed that assertion, saying, “This is an entirely new system. The treaties were negotiated under the assumption that we would continue our double taxation system. The withholding at issue here is arguably a new type of tax to which the treaties do not apply.”

Lurie’s testimony focused on the market effects of corporate integration; while it could theoretically equalize the treatment of debt and equity, her testimony identified potential unintended consequences of the proposal. Much of her testimony expressed concern that corporate integration could discourage companies from maintaining an adequate cash cushion necessary to ride out down markets and could lead to fewer long-term investments by corporate managers. Her concern about the problem of “short-termism” by corporate managers was shared by senators at the hearing, who expressed concern that funds that would
otherwise be used to invest in plants, equipment, and human capital would instead be used to increase dividend payments for the purpose of lowering a company’s effective tax rate.

During this hearing, Chairman Hatch expressed to the witnesses his frustration with his colleagues’ general lack of interest in his proposal and their unwillingness to work with him to refine it so as to address some of the design considerations the witnesses had raised.

**Evaluating Chairman Hatch’s Proposal**

Historically, companies have been either opposed or indifferent to corporate integration proposals because corporations have generally preferred to retain earnings. As a result, they have historically found a statutory or effective rate reduction a more attractive tax reform proposal than integration. This raises a fundamental question for companies to consider—namely, what, if anything, has changed to make corporate integration more attractive now than it has been during the past forty years?

One thing that has changed is that the retained earnings corporations had in the 1940s, 1950s, and even the 1980s largely had domestic sources. As such, they had already been subject to tax and could be freely invested or paid out to shareholders at management’s discretion. But that is no longer the case. Much of the earnings and associated cash that multinationals own is offshore. The cash cannot be brought back for investment in the United States or for stock buybacks without incurring an incremental U.S. tax and corresponding reduction of after-tax earnings per share for accounting purposes. A DPD would allow multinationals to repatriate offshore cash without tax so long as it was then distributed as a dividend.12

Another change involves perceptions about the benefits of being a U.S.-headquartered company. As the inversions of the last twenty years have demonstrated, companies do not take a haircut in their share trading price when they cease to be U.S.-parented. Moreover, other industrialized countries have significantly reduced their tax rates relative to the rates imposed by the United States.

At the same time, not all corporations will benefit equally from Chairman Hatch’s proposal. For industries where a certain amount of retained earnings are expected or required (such as by non-tax regulators), for companies whose dividend payments exceed the amount of fully taxable income, or for startups that would prefer to retain any earnings to reinvest in the business instead of paying dividends, Chairman Hatch’s proposal may not be attractive.

Nevertheless, if Donald Trump wins the presidency and the Republicans retain control of the Senate, Chairman Hatch will play an even more important role in the development of tax policy than he does now. Therefore, companies should focus on the impact that corporate integration could have on their businesses. Although there are many questions that arise with respect to corporate integration, the discussion below focuses on those questions that are likely to have the greatest impact on companies. As a result, other significant issues, such as the political challenges that may arise from imposing a withholding tax on tax-exempt shareholders, are not discussed below. Nor does this article address the impact that corporate integration could have on small employers’ willingness to offer retirement plans to their employees, because that concern is not expected to be relevant to most TEI members.

**Treatment of Credits Attributable to Distributed Income**

As several senators noted during the Senate Finance hearings, there are numerous credits in the Code—such as the New Markets Tax Credit, the Low-Income Housing Tax Credit, the research and development credit, and credits for hiring veterans and investing in low-income communities—that Congress has included to incentivize companies to engage in specific behavior. Allowing a DPD would reduce the need for companies to use these credits to reduce their tax liability to the extent that the companies were able to distribute dividends equal to their tax liability every year, thereby potentially diminishing—if not eliminating—the effectiveness of these credits to achieve what Congress has established as valuable nontax goals.

Corporations should consider, as a threshold matter, whether they will benefit more from the status quo, a DPD, or the lower corporate tax rate that will likely be associated with comprehensive tax reform. To the extent that the corporation supports the DPD, or supports comprehensive tax reform but believes corporate tax preferences will be eliminated, the corporation should be prepared to explain to members of Congress how Congress could incentivize those goals in some other fashion (such as with direct grants). Several senators made it clear during the hearings that they believe these incentives are important and should be maintained.

**Financing Costs**

To the extent that nonrefundable withholding is required on interest payments to foreign lenders, those lenders may require an increased yield to continue purchasing a company’s bonds. It is unclear how great an increase would be required. Buckley suggested at the May 24 hearing that the entire cost of the withholding would be borne by U.S. corporate borrowers and suggested this could increase the effective interest rate on debt by up to 50 percent. McDonald challenged Buckley’s assertion, noting...
that foreign lenders would have to compete with U.S. lenders, many of which would have been subject to tax on receipt of the interest anyway.

Regardless of whether the lender or the borrower bears the cost of the withholding tax, a DPD will likely alter the cost of debt financing and make it more expensive than it is today. Corporations should consider what impact a DPD would have on financing costs and the capital structure of their company. A DPD will not likely incentivize corporations to replace debt with common equity due to the dilutive effect a common stock issuance would have. Nevertheless, a DPD may result in a heavier reliance by corporations on preferred stock as a financing tool. Corporations should consider this impact when analyzing Chairman Hatch’s proposal.

Furthermore, if there is withholding on dividends and corporate interest payments but not on bank accounts or U.S. Treasuries, Graetz suggested at the May 17 hearing that tax-exempt investors may adjust the types of investments that they make. These consequences could affect companies’ access to necessary capital as well as the cost of capital.

**Tax Treaties**

At both hearings, it was apparent that there was disagreement between Chairman Hatch and some of his fellow senators and some of the witnesses as to whether a nonrefundable withholding tax on foreigners violates the United States’ existing tax treaties. Companies that support corporate integration should either consider design proposals that would ameliorate the treaty concerns, and share those proposals with Chairman Hatch and his staff, or be prepared to advocate to other committee members that the withholding tax does not represent an impermissible treaty override. Whatever position companies take, this issue is likely to be a significant political hurdle.

**Retirement Security**

A DPD may profoundly affect Americans’ ability to save for retirement and to grow those savings at a pace required to fund retirement adequately. Although the retirement security of their workers does not directly affect companies, companies have used retirement plans as a means to attract a qualified workforce. If the value of those retirement plans diminishes, it is reasonable to expect that workers will look to employers to improve the value of other parts of compensation packages to make up the difference. From a political perspective, it is also important to note that a DPD will negatively affect the financial industry that supports tax-advantaged retirement vehicles unless the DPD proposal ensures that those retirement vehicles remain tax-favored. Corporations should take these factors into account when reviewing and responding to Chairman Hatch’s proposal.

**Net Operating Losses**

It is unclear whether the DPD will be treated like any other deduction, such that it could create a net operating loss, or whether the deduction will be limited to positive taxable income. If so, this would make the DPD more attractive to growth companies that may not be able to distribute dividends in their early years but could distribute earnings, generate net loss carrybacks, and in later years receive refunds of taxes previously paid.

**Stock Buybacks**

Much of the cash that corporations distribute to shareholders is not paid out as a dividend. Instead, corporations often have share buyback programs whereby they periodically redeem shares in the marketplace. These share buybacks are often governed by Section 302(a) at the shareholder level and Section 312(n)(7) at the corporate level. As such, the corporate-level E&P reduction is not necessarily equal to the value of the cash the corporation transfers to the shareholder, as would be the case with a regular cash dividend. It is thus far unclear from Chairman Hatch’s public statements how his proposal would treat stock buybacks.

**Impact on Recordkeeping and Reporting**

Although the subject was not discussed at either Senate Finance hearing, companies should analyze what their compliance burden will be if corporate integration is enacted, as well as how quickly they would be able to satisfy that burden. Required compliance changes could include IT changes as well as the need for increased personnel. In addition, companies should consider whether existing IRS forms are sufficient to report required information, or if changes will need to be made to IRS forms. Finally, companies should determine how long it will take them to make necessary changes and should consider requesting an appropriate transition period before any new tax provisions take effect.

**Impact on State Tax Regimes**

Many states use federal income as the starting point for calculating state taxable income. Although it is unclear at this stage how state tax filings might be affected, this is another area that could lead to increased compliance responsibilities and costs for companies.

**Impact on Tax Reform**

Independent of Chairman Hatch’s corporate integration proposal, companies should consider the broader question of what their needs and goals
are for business tax reform. Once a company has completed this analysis, it should consider how corporate integration fits within its broader needs. Because Chairman Hatch's proposal is likely to reduce companies' effective tax rates, some commentators have suggested that it could decrease the sense of urgency for Congress to enact more comprehensive tax reform. In addition, because the proposal would permit companies to remit cash trapped abroad to the United States on a tax-free basis to pay dividends, it may also reduce the incentive to enact legislation to switch from a worldwide system of taxation to a territorial one.

Chairman Hatch is to be commended for the hard work and effort that he and his staff have put into developing a corporate integration proposal and furthering the prospects for tax reform. However, it is noteworthy that both Senate Finance hearings were poorly attended, and none of the committee members in attendance at either hearing expressed support for corporate integration. More troubling, committee members raised significant questions about the proposal's design and its consequences, which—as of this publication—remain unanswered. These outstanding questions, coupled with the political uncertainty inherent in any presidential election year, make enactment of corporate integration in the near future highly unlikely. It is also unclear whether and when Chairman Hatch will release his plan, considering that he did not release it prior to his self-imposed June 2016 deadline. Despite this delay, companies should consider engaging with Chairman Hatch and his staff now to share their views on corporate integration, because recent experience (such as the Bipartisan Budget Act of 2015) has taught companies that legislative proposals can be quickly dusted off and enacted with little time for discussion and debate. In particular, companies that are concerned that enacting corporate integration would decrease the urgency for more comprehensive business tax reform should share those views with Congress and the next administration.


Endnotes

1. On June 24, 2016, the House Republicans issued a “blueprint” for tax reform that would take a different approach by moving toward a consumption-based system. For a copy of the blueprint, see abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.


4. Pub. L. 108-27. This provision was extended several times and ultimately made permanent in the American Taxpayer Relief Act of 2012 (Pub. L. 112-240).

5. The white paper can be found at www.finance.senate.gov/imo/media/doc/Comprehensive%20Tax%20percent20Reform%20percent20for%20percent20the%20percent20Corporate%20percent20System%20percent20and%20Beyond%20percent20(C).pdf.

6. Republican Staff of the Senate Finance Committee, Comprehensive Tax Reform for 2015 and Beyond, page 160.

7. All section references are to the Internal Revenue Code of 1986, as amended.

8. See www.finance.senate.gov/hearings/integrating-the-corporate-and-individual-tax-systems-the-dividends-paid-deduction-considered to read the prepared statements of Chairman Hatch, Ranking Member Wyden, and the witnesses.


10. To take a simple example, if a corporation is subject to the full 35 percent federal income tax rate on all its income, today the corporation must earn $153.85 in order to pay a $100 dividend to its shareholders. Under Chairman Hatch’s proposed DPD system, to pay a net dividend of $100 to its shareholders (i.e., a $100 dividend net of the 35 percent withholding tax), the gross amount distribution would have to be $153.85. However, in the case of large multinationals, not many are subject to the full 35 percent federal income tax rate on all their income today. Thus, it is clear that Ms. Miller’s concerns regarding the DPD system are not unfounded unless the withholding tax rate on dividends is lowered to a rate not significantly higher than the average effective federal income tax rate on U.S.-source taxable income of C corporations.

11. See www.finance.senate.gov/hearings/debt-versus-equity-corporate-integration-considerations to read the prepared statements of Chairman Hatch, Ranking Member Wyden, and the witnesses.

12. An open design question is how Senator Hatch’s proposal will apply to stock buybacks, which are not generally considered dividend-equivalent redemptions.