Penseés on Integration: Where's the Reform?

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Michael J. McIntyre is a professor of law at the Wayne State University Law School in Detroit. In 1977, he published a special report (Tax Notes, Sept. 5, 1977, p.11) on corporate integration that some commentators view as a classic. Borrowing stylistically from Blaise Pascal, the 17th century French philosopher and mathematician who wrote Penseés, McIntyre raised some questions about the benefits of integration of the corporate and individual income taxes. Essentially, he makes a case that partial integration, which usually amounts to no more than dividend relief for the well-to-do, should be rejected. He also suggested that even full integration has serious flaws, due largely to difficult problems of transition. His essay introduced into the integration debate a discussion of ordering rules for determining whether dividends paid would qualify for relief. He suggested that the key to avoiding windfall gains to current owners of stock is the proper design of ordering rules.

The Bush administration's recent proposal for partial integration through dividend relief has put the question of corporate integration back on the national agenda. The issue is of great importance not only to the federal government but to state governments as well because of the possible impact on state revenues under the personal and corporate income taxes. Reproduced below is the original version of the essay, modified slightly to take account of changes in the law since 1977, with two additional penseés (Nos. 20 and 21).

1. Another 'Double' Tax

Why do I like the double tax on corporate profits? And why do I dislike the double tax on wage income -- I mean the personal income tax and the Social Security tax? Is it because I have to pay so very little of the one and so much of the other? Our own interest is a marvelous instrument for nicely putting out our eyes. Why does the business community rail against the double tax on profits and keep silent on the double tax on wages? Let them answer.

2. Tax Shelter

A "double tax" on corporate profits results only if profits are distributed as dividends to the shareholders. It should not be thought that the "double tax" rule is necessarily harsher than a single-tax rule that taxed the shareholders when the income was earned. Average corporate tax rates are around 25 percent [currently 15 percent], much less for some companies. If a company paying low corporate taxes delays paying dividends for a few years, its shareholders can put off (defer) the second part of the double tax. The advantage of delay may be worth much more to a high-bracket taxpayer than the amount of the corporate tax.

3. Forms of Integration

Integration takes two forms. Full integration taxes shareholders on corporate profits in the year that the profits are earned. It treats the corporation as a mere conduit, as a partnership of the shareholders. Under full integration, a shareholder is taxed whether he receives a dividend or not. Partial integration, on the other hand, is a program for reducing the tax on distributed corporate profits. The reduction is achieved either by giving the corporation a deduction for distributions or by giving the shareholder a tax credit for the corporate tax paid on the profits that generated the dividend [or exempting the dividends, as proposed by the Bush administration]. Full integration is the darling of many economists. Partial integration is what the business community wants. The two have little in common.

4. Subchapter S Firms

Corporations with 15 [now 75] or fewer shareholders can elect under current law to be exempt from the corporate tax and to have their income attributed to their shareholders. For many small corporations and some large, closely held companies, the two-tier tax structure can thereby be avoided. In many cases, closely held companies do not elect direct shareholder taxation because the two-tier alternative results in lower tax. Does it make sense, therefore, to exclude corporations eligible for direct shareholder taxation from any program of relief from double taxation? An engaging thought.

5. What Is a Corporation?

Full integration makes the simplifying assumption that a corporation is the docile agent of its shareholders. For most publicly held corporations, however, a shareholder cannot get his share of the profits at his discretion. The assumption is not without merit, however, for in most cases the shareholder can get his approximate share of the profits by selling his stock. To argue for full integration is to argue against the realization rule for the taxation of gains. To argue against full integration is to argue that a corporation is not the alter ego of its shareholders. **[*972]**

6. 'Double Taxation' a Slogan

If we do not think the corporation is the alter ego of its shareholders, why do we consider a corporate tax and a shareholder tax to be a double tax? Is it a double tax when a person hires a maid, and both the maid and the employer pay tax on the same income? Double taxation is a slogan, not an explanation.

7. Progressive Tax

The corporate tax has had much greater success than the income tax in placing substantial tax burdens on the rich. Why should we want to end our most progressive tax?

8. Double Tax on Consumers

Objection. The corporate tax is not paid by the shareholders. It is passed on in higher prices to the consumers.

Reply. If so, it results in a double tax on consumers, not on shareholders. Tax relief for shareholders would therefore be doubly wrong.

9. Corporate Tax Incidence

The economic arguments that the corporate tax is paid by consumers are so remote from the reasoning of men, and so complicated, that they make little impression; and if they should sway some, it would be only during the moment that they see the demonstrations; but an hour afterward they would fear they have been mistaken.

10. Personal Tax Incidence

Some economists feel comfortable with the prospect of full integration because it would, in their minds, end the uncertainty about the incidence of the corporate tax. The real problem, of course, remains -- who then pays the tax on undistributed profits attributable to shareholders? The economic problem, however, vanishes, for most economists are content with the simple assumption that individuals bear the economic burden of the tax imposed on them under the personal income tax.

11. Foreign Subsidiaries

Some of the people who argue for shareholder relief on the ground that the corporation is the alter ego of the shareholder oppose current taxation of the earnings of controlled foreign subsidiaries. A domestic company is an alter ego but a foreign company is not?

12. Tax-Exempt Organizations

The quiet lion waiting to walk off with the kill is the tax-exempt foundation. If the corporate profits tax and the personal income tax are integrated, do we give a refund of the corporate tax to shareholders that are charities? This is the multibillion-dollar question. Where is the "double tax" when a tax-exempt foundation receives a corporate dividend?

13. Details Crucial

We see the true color of a proposal when we see the details. If Congress adopts a plan of partial integration and gives a credit to the shareholders for corporate taxes paid [or exempts the dividends entirely], what should the rule be for profits accumulated before the new law? The revenue costs of giving a credit for old taxes paid would result in a huge revenue loss and a taxpayer windfall of unprecedented proportions. The fair rule is to give no credit. More than this, the fair rule is to treat all distributions as made out of old profits until all accumulated profits have been distributed. As long as current profits are not distributed, there is no double tax. There is instead a deferral of the shareholder tax -- a result in conflict with the rationale for integration -- that the corporation and the shareholders are one and the same.

Some supporters of partial integration will argue that the first-in, first-out distribution rule is unfair. Why not assume that all distributions are out of current profits? The answer is that corporations that have large accumulated earnings have been permitting their shareholders to avoid the personal income tax. The old rules required a two-tier tax. To forgive, in effect, the shareholder tax would be to grant a huge capital windfall to those who had received the maximum benefit from the separate entity theory of the current corporate tax.

14. Benefit Should Be Limited

Another detail. If the objective of partial integration is to eliminate double taxation, distributions to shareholders out of profits not taxed at the corporate level should not carry a tax benefit. In other words, if a corporation has profits of $ 100x and has taxable income of $ 40x, then the shareholders would get no tax credit or other benefit unless profits in excess of $ 60x were distributed.

15. Other Corporate Incentives

Objection. Wouldn't a partial integration plan that treated distributions (for purposes of shareholder tax relief) as paid first out of untaxed profits reduce or even eliminate the impact of many corporate tax incentives?

Reply. Did you expect a tax incentive for distributing profits to encourage reinvestment of corporate profits?

16. First-In, First-Out

Observation. A proposal for partial integration that treated dividends as paid first out of accumulated earnings and next out of untaxed profits, with no tax benefit on such distributions, and that gave a credit only for dividends paid out of current earnings subject to corporate tax -- such a proposal would have few friends. But no other rules are consistent with the objective of reducing double taxation.

17. Accumulated Earnings

Even full integration plans need a rule for the treatment of a distribution by a company with prior accumulated earnings. Doesn't the first-in, first-out rule make sense for full integration as well?

18. Windfall Gain

Should a supporter of full integration or partial integration also support a large capital levy to soak up the windfall **[*973]** gain resulting from the end of two-tier taxation? Or is the whole purpose of integration to create a windfall gain?

19. Real Estate Taxes

An end to the corporate tax is supposed to improve the efficiency of capital markets, on the theory that capital now is fleeing into the noncorporate sector. [One] noncorporate sector of importance, however, is real estate, which is generally taxed at a substantial rate by local governments. Does the efficiency argument also require integration of the federal tax and the multitude of local property taxes? Let us hope not, because the chances of such integration are not promising. If local taxes are not integrated, do we get an overall increase in efficiency from integration of the corporate and personal income taxes? The economic literature is silent.

20. Judging Unclear Proposals

Many of the features of proposals for dividend relief are obscure. The same may be said of proposals for taxing U.S. corporations currently on the income they earn through their foreign affiliates. We should not confound proposals that are similar only in their obscurities. Parts of both sets of proposals are clear. Those parts of the plans for taxing foreign income that are clear are also admirable, whereas the clear parts of the plans for dividend relief give benefits mostly to the rich and powerful. We should not revere the obscurities of a plan when the parts we understand are badly flawed.

21. State Tax Revenues

Contraries. The proponents of dividend relief seek to benefit the well-to-do by exempting them from federal taxes on their dividends. They also seek to mollify business executives, who fear any incentive for dividend payments. The solution they propose is to give double relief to taxpayers who reinvest their earnings and then sell their stock (giving them a stepped-up basis in their stock and also taxing them at a low rate on their capital gain).

How does this mix of dividend relief and incentives for reinvestment affect state tax revenues? Apparently, the proponents of dividend relief hope to impoverish the states by making it difficult for them to tax the dividends of their residents. But the states have a ready response. They can continue to tax their residents on dividends and also tax them on the declared dividends that they elect to reinvest. Unless they do the latter, the reinvested dividends will be free of tax forever.

22. Complexity Would Remain

All proposals for ending "double taxation" of corporate profits would end up retaining the complexities of the corporate tax laws. The shell of the corporate tax would remain; the revenue would be gone.