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Commentary
Corporate Integration: Do the Uncertainties Outweigh the Benefits?

REED H. SHULDINER *

Emil Sunley's article1 (following the lead of the Treasury Report2 itself) divides into two parts. First, the paper discusses different approaches to implementing corporate integration and second, it discusses the overall economic impact of corporate integration. In my comments, I attack the problem in reverse order. I begin by offering a few comments on the economic impact of integration, followed by a discussion of the approach to integration recommended in the Treasury Report.

I. WELFARE GAINS FROM INTEGRATION

As Sunley points out, a major contribution of the Treasury Report is that it makes a serious attempt to estimate the welfare gains from an integrated tax system. In particular, the Treasury Report estimates steady-state welfare gains equivalent to $2.5 billion to $25 billion per year.3 Sunley does an admirable job of summarizing the source of the welfare gains, the methodology used to estimate the gains and the limitations of the assumptions and the methodology. I would like to add a few comments.

The economic models employed in the Treasury Report predict significant gains from integration. As Treasury would be the first to admit, however, the models that estimate these gains are very rough and the underlying behavioral assumptions (that determine the outcome of the models) are, at best, uncertain. In some cases, Treasury has come down squarely on one side of an economic debate4 and in other cases, has

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1 Assistant Professor of Law, University of Pennsylvania Law School. The author benefited from discussions with participants at the Tax Law Review Colloquium on Corporate Integration. In particular, I would like to thank Michael Schler for clarifying the role of § 265.
4 Id. at 111.
5 See, e.g., the discussion of the "new view" versus the "traditional view" of dividends. Id. at 118-18.
adopted a particular view out of the necessity to make a choice.\textsuperscript{5} The need to make such choices highlights the lack of certainty in the estimates.

Second, as the Treasury Report makes clear, the welfare estimates compare a steady-state world with a two-level corporate tax to a steady-state world with an integrated corporate tax. The Treasury Report, however, makes no estimates of the transition costs of switching between the two steady-state systems. The transition costs could reduce significantly or even make negative the net efficiency gains from adopting an integrated corporate tax. For example, assume that the true steady-state benefit of an integrated system is $2.5 billion per year and that the transition to an integrated system will take 10 years. Further assume that during the transition period the net costs of transition are $2.5 billion per year and that the appropriate discount rate for the costs and benefits of integration is 8%. In that case, the present value of the benefits of integration is $14.5 billion, while the present value of the transition costs is $16.8 billion. In other words, overall, moving to an integrated system would cost $2.3 billion in present value terms.

Third, it is easy to misinterpret the presentation of a range of welfare estimates. The range of estimates represents a set of point estimates from distinct general equilibrium models, not a likelihood range.\textsuperscript{6} For example, in the case of the dividend exclusion prototype, the augmented Harberger model with no financial distortions estimates welfare gains of $2.5 billion.\textsuperscript{7} If the best representation of the economy is the augmented Harberger model with no financial distortions, the Treasury Report should be viewed as producing a point estimate of $2.5 billion plus or minus some error. The Treasury Report, however, gives no guidance as to the size of the potential error relative to the point estimate of $2.5 billion.

The Treasury Report notes that the estimates of the gains from integration are of the same order of magnitude of the predicted gains from the Tax Reform Act of 1986.\textsuperscript{8} An interesting question is how well the economic models used to predict the 1986 Act gains performed. The Office of Tax Policy Research of the University of Michigan commissioned a series of studies (the 1986 Act Studies) to evaluate precisely this

\textsuperscript{5} Consider, for example, the discussion of whether it is more appropriate to assume an open or a closed economy. Treasury assumes a closed economy, justifying its decision on the lack of consensus as to the appropriate assumption. Id. at 141.

\textsuperscript{6} Thus, for example, the range of $2.5 billion to $25 billion should not be interpreted as an expected welfare gain of $13.75 billion with a 95% probability that the actual gain will be within the range of $2.5 billion to $25 billion.

\textsuperscript{7} Treasury Report, note 2, at 131 tbl. 13.7.

\textsuperscript{8} Id. at 2 n.4. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.
question. Although the results of the 1986 Act Studies were mixed, overall the studies found that actual responses were smaller than predicted responses. Joel Slemrod, the editor of the 1986 Act Studies, concluded: "[T]here is a strong sense that behavioral elasticities are weaker than previously believed, and thus the efficiency cost of taxation is smaller than had been thought." In particular, in the study most closely related to corporate integration, Roger Gordon and Jeffrey MacKie-Mason looked at the effect of the 1986 Act on corporate financial policy and organizational form. Gordon and MacKie-Mason generally concluded that the responses were significantly smaller than predicted and, in some instances, in the opposite direction.

The 1986 Act Studies do not necessarily prove anything. The studies may have mismeasured the effects of the 1986 Act or they may have missed important variables confounding the analysis. Nevertheless, they do suggest that skepticism is warranted in evaluating the results of the Treasury Report. They also suggest that economic models may tend to have a bias towards predicting too great a response from tax changes. Such a bias could, for example, be introduced if the economic models systematically underestimate the ability of taxpayers to arrange their affairs in such a way as to neutralize the effect of certain tax rules. Additionally, the economic models may underestimate the effect of nontax factors on such questions as organizational form, debt-equity decisions and dividend payment rates.

Where does all this leave us? The fact remains that the Treasury Report represents a best guess that there are significant efficiency gains to integration, a conclusion that most economists likely share. Nevertheless, the considerations discussed above suggest that caution is warranted in assuming that the efficiency gains will be as large as predicted by the Treasury models. As Henry Aaron has pointed out, as efficiency considerations from a proposed change in tax law diminish in importance, the equity considerations become relatively more important.

Considerations of equity are relevant in deciding both whether to move to an integrated system and the choice of integration prototype. Although, as discussed below, Sunley agrees that considerations of equity color the choice of integration prototype, he argues that the question of whether the United States should adopt corporate integration does not depend on the distributional effects of corporate integration because Congress always could adjust marginal rates to maintain the progressive na-

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10 Id at 8.
12 Henry J. Aaron, Lessons for Tax Reform, in Do Taxes Matter?, note 9, at 326.
ture of the income tax.\textsuperscript{13} While Sunley's point is generally correct, there are at least two caveats. First, to the extent that the incidence of the corporate tax both before and after integration is uncertain, it is difficult for Congress to compensate for integration in a meaningful manner. Second, if a form of integration that taxes income from capital at a separate fixed rate (such as the dividend exclusion prototype\textsuperscript{14} or the comprehensive business income tax (CBIT)\textsuperscript{15}) is adopted, Congress' ability to compensate for the distributional effects of integration will, in certain respects, be both limited and enhanced. Congress' ability will be limited because it will be unable to adjust the rate on capital income to take into account an individual shareholder's ability to pay. It will be enhanced because Congress can set the rate of tax on capital income independently from the rate on earned income.

II. Choice of Prototype

While the economic models used by Treasury indicate that integration is worthwhile on efficiency grounds, they do not provide strong support as between prototypes. Therefore, guidance must come from some other source. Sunley begins with a simple proposition: "The goal of corporate integration is to tax corporate income once at the shareholder level, not once at the corporate level."\textsuperscript{16} Implicit in this statement is the proposition that integration must respond both to efficiency concerns (taxing corporate income once) and equity concerns (taxing corporate income at a rate that is appropriate for the individual shareholder). Sunley thus takes the position that even if the decision to move to an integrated tax system is primarily a question of efficiency, the choice of integrated systems must be guided, at least in part, by considerations of equity.

By contrast, the Treasury Report does not seem to give serious consideration to issues of equity in the choice of prototype.\textsuperscript{17} The Treasury Report summarizes the goal of integration as follows: "Broadly speaking, corporate tax integration seeks to reduce tax-induced distortions in the allocation of capital by taxing corporate source income once..."\textsuperscript{18} The Treasury Report is thus focused on the income, rather than the recipient of the income. In fact, it makes this point explicitly. It notes that a traditional goal of integration has been to tax corporate income at the shareholder's rate, but concludes that:

\textsuperscript{13} Sunley, note 1, at 643.
\textsuperscript{14} Treasury Report, note 2, at 17.
\textsuperscript{15} Id. at 40.
\textsuperscript{16} Id. at 10.
\textsuperscript{17} The Treasury Report does analyze the incidence of the proposed prototypes as part of its economic analysis of integration. Treasury Report, note 2, at 146-50.
\textsuperscript{18} Id. at 12.
[a]ssuring that corporate income is taxed once, but only once, does not require that corporate income be taxed at individual rates, however. Attaining a single level of tax—with the most significant efficiency gains we project from any system of integration—can be achieved with a schedular system in which all corporate income is taxed at a uniform rate at the corporate level without regard to the tax rate of the corporate shareholder. 19

Given their divergent goals, it is not surprising that Sunley and the Treasury Report end up with opposite conclusions. The Treasury Report recommends the dividend exclusion prototype as the primary model for integration. 20 Sunley, on the other hand, concludes that “[t]he dividend exclusion prototype endorsed by the Treasury Report . . . is a defective form of dividend relief.” 21

The Treasury Report does recognize that there may be some who consider it important to tax corporate-source income at shareholder rates and does not reject such an approach outright. It simply asserts that it is not a sufficiently important goal at this time:

A decision to adopt a schedular system for taxation of business capital is not irreversible. Future policymakers can, if they wish, add refund and crediting mechanisms to achieve the traditional objective of taxing corporate income at the individual shareholder’s marginal rate, or they can address the issue by adjusting the corporate rate to more precisely approximate individual rates. Our judgment is that neither of these courses is necessary to achieve the principal benefits of an integrated tax system. They are options that can be added once the complexities of transition have been mastered. Deferring them makes the integration prototypes examined in this Report simpler to implement and conserves revenues. 22

Overall, Sunley’s critique of the Treasury Report is well founded. Moreover, a failure to come to grips with the equity issues, both real and perceived, ultimately will backfire. For example, consider the Treasury

19 Id. At one point, the Treasury Report even implies that taxing income from capital at a fixed rate, rather than at a rate depending on the individual shareholder, is necessary for economic efficiency. Id. The Treasury Report does not, however, provide any support for this statement.

20 Treasury also recommends the Comprehensive Business Income Tax (CBIT) model, but not as an immediate goal. Id. at 2.

21 Sunley, note 1, at 626.

22 Treasury Report, note 2, at 13. The revenue is, of course, conserved at the expense of low-bracket taxpayers investing in corporate equities.
Report's discussion of the individual alternative minimum tax (AMT) in relation to the dividend exclusion prototype. The Treasury Report notes that historically, the AMT was adopted to respond to public perceptions that high-income individuals were not paying any (or sufficient) tax. The Treasury Report admits that the exclusion for dividends might result in some high-income individuals paying little or no tax at the individual level "thus raising issues of public perception." The Treasury Report's response is that the prototype's EDA, or earned dividend account:

operates to ensure that any dividends excludable from an individual's gross income have already been subject to one level of tax at the corporate level. The investor's income tax has been prepaid at the corporate level at the 34 percent corporate rate, which exceeds the top individual rate.

To begin with, it is unclear the extent to which the Treasury Report's response is correct, even as a technical matter. Ultimately, the question of the tax burden on holders of corporate equity is one of incidence. As the Treasury Report notes, the incidence of the current corporate tax is uncertain, but probably does not fall entirely on shareholders. Similarly, there is no reason to believe that under the dividend exclusion prototype, the entire incidence of the corporate level tax would fall on shareholders. If, as is probably the case, some part of the burden would be shifted to nonshareholders, the Treasury Report is incorrect when it implies that a shareholder would be taxed at an effective rate of 34% on dividends.

More importantly, the Treasury Report's response misses the point. The Treasury Report correctly identifies the concern behind the AMT as one of perception, yet the Treasury Report's response is purely technical, ignoring the issue of perception. Unfortunately, nowhere in its report does Treasury adequately address the issue of perception. To the contrary, when it discusses issues of equity, the Treasury Report seems to

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23 Id. at 23, 45 & n.25 (discussion of AMT under CBIT).
24 Id. at 23.
25 Id.
26 Id. at 146-47.
27 The Treasury Report implicitly makes this point when, in discussing the impact of CBIT on interest rates, it suggests that the interest rate on CBIT debt may not reflect a 31% tax rate, suggesting, for example, that if a non-CBIT bond bore interest at a 30% pretax rate, a CBIT bond might bear interest at 8%. Id. at 50. Under such circumstances, the holder of CBIT debt would be bearing an implicit tax at a rate of only 20% suggesting that imposition of the AMT might well be appropriate.
28 There is also the minor technical problem that the top marginal rate on an individual taxpayer may exceed 34% when the § 68 phase-out of itemized deductions and the § 151 phase-out of personal exemptions is taken into account.
make things worse. For example, it recognizes that the dividend exclusion prototype could be modified to include a credit mechanism to adjust for shareholder tax rates, but recommends against such a modification based on complexity. The Treasury Report seeks to bolster its position by arguing that relief for low-bracket taxpayers is unnecessary. First, it points out that approximately two-thirds of corporate dividends paid to taxable individuals are paid to individuals with average marginal tax rates of more than 25%, suggesting, presumably, that the difference between a 25% marginal rate and a 34% marginal rate is insignificant. I would have thought that a 36% increase in marginal rate was quite significant. With respect to those taxpayers facing tax rates of less than 25%, the Treasury Report argues that such “low-bracket shareholders who receive dividends clearly own some property, i.e., stock, and it is not clear whether their low taxable incomes accurately reflect their ability to pay.” In a footnote, the Treasury Report goes on to argue that “low taxable income is not necessarily inconsistent with wealth.”

I share Sunley’s somewhat incredulous response to these statements. It is true that income from capital is frequently undertaxed, but I would think that the amount of untaxed income tends to rise, not fall, with an individual’s tax bracket. Thus, for example, if Treasury is proposing a proxy wealth tax, it is remarkable that it is being proposed only for those in the lower brackets.

III. Miscellaneous Issues

In addition to the equity concerns discussed above, there are a variety of technical issues raised by both the dividend exclusion prototype and CBIT. The following is meant to highlight only a few of the technical issues.

A. Transition to CBIT

The Treasury Report recommends a 10-year phase-in for CBIT. Sunley, on the other hand, argues against a long phase-in period and suggests instead a delayed effective date with limited grandfathering of

29 Treasury Report, note 2, at 22. In the section entitled “Low-Bracket Shareholders,” the Treasury Report rests its recommendation not to provide a tax credit on the grounds of administrability and the lack of need for such a credit. Id. Elsewhere, the Treasury Report supports its position based not only on administrability, but also on the revenue saved by not taxing low-bracket shareholders based on their individual rates. See note 22 and accompanying text.
30 Id.
31 Id. at 22 n.28.
32 Sunley, note 1, at 626.
33 Sunley, note 1, at 626.
34 Treasury Report, note 2, at 39; see id. at 91-92.
old debt. Sunley claims that the delayed effective date would give companies time to refinance non-CBIT debt with new CBIT debt and would lower the transactions costs as compared to a long phase-in.

With respect to corporate equity that has an indefinite life, it is clear that a grandfather rule is unacceptable because it would delay indefinitely the adoption of integration. On the other hand, as the Treasury Report recognizes, a significant phase-in period is appropriate to moderate the windfall gains and losses from transition. Debt potentially poses a different case than equity for two reasons. First, debt generally has a limited maturity and second, while dividend payouts can be "renegotiated," absent the threat of bankruptcy, interest payments generally cannot. Therefore, the same transition rules are not necessarily appropriate for debt and equity.

With respect to debt, there seem to be two principle alternatives. First, debt, like equity, could be subject to a 10-year phase-in of the CBIT rules. Second, new debt could be immediately subject to the CBIT rules and old debt could be grandfathered. Overall, I think the latter alternative is preferable. Changing the tax treatment of old debt would lead to a significant windfall gain to existing debt holders and a significant windfall loss to existing borrowers. Additionally, there is potentially tremendous complexity caused by the issuance of new debt subject to a phase-in rule. For example, consider the application of the original issue discount rules to a 10-year "fixed-rate" bond issued at the beginning of the phase-in period. Economically, the parties would like to negotiate a declining interest rate to reflect the progressive adoption of the CBIT rules. Under existing law, however, if the debt provides for a declining interest rate, the OID rules would act to redistribute the income on the bond to produce a constant yield, the incorrect result under the circumstances. On the other hand, if the parties decide to economically front load the interest by setting a fixed rate, the OID rules would respect the interest set by

55 Sunley, note 1, at 633.

56 The Treasury Report points out that some corporate debt can be called after a certain period, permitting a company to refinance its debt during the phase-in period. Treasury Report, note 2, at 91 n.13. In other cases, however, debt is noncallable. If the CBIT rules were applied to existing noncallable debt, companies might be able to repurchase such debt in the market, but there would be little point in doing so since the old debt would sell at a premium reflecting its higher non-CBIT interest rate.

37 It should be noted, however, that grandfathering of pre-CBIT debt may also lead to windfall gains to holders of such debt. As non-CBIT debt becomes rarer, the price for such debt may be bid up by tax exempt and other entities wishing to hold such debt. See Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977). The magnitude of the effect is likely to be small given the existence of substantial categories of permanent non-CBIT debt such as government bonds and mortgages.
The Treasury Report argues against a grandfather rule on the grounds that the coexistence of CBIT and non-CBIT debt “would create difficult, if not impossible, reporting burdens and administrative complexity and would inevitably result in uneven enforcement.” While such considerations are probably valid for corporate equity, given the intended coexistence of CBIT and non-CBIT debt under the fully phased in CBIT system, the Treasury concern seems overblown.

B. Section 265

Section 265(a)(2) currently disallows a deduction for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. In the case of the dividend exclusion prototype, the Treasury Report is agnostic as to the application of § 265(a)(2) to debt incurred to carry stock paying exempt dividends. In particular, the Treasury Report correctly notes that disallowing a deduction for interest paid to a taxable lender would result in the imposition of two levels of tax and is, therefore, inconsistent with the overall goal of integration. In the case of CBIT, however, the Treasury Report recommends that § 265(a)(2) apply to (non-CBIT) taxpayers receiving CBIT interest and dividends. The Treasury Report states that interest disallowance is necessary to prevent the erosion of the CBIT base by investor level rate arbitrage through borrowing.

The need to apply § 265(a)(2) points to a weakness in the CBIT proposal. The problem is that CBIT permits the coexistence of CBIT and non-CBIT debt. Under such a system, a tax-exempt entity can circumvent the CBIT rule by using a taxable individual as a conduit for purchasing the CBIT debt. The tax-exempt entity could simply loan money to an individual who would in turn purchase CBIT debt. The corporation’s tax liability would then effectively be offset by the individual’s interest.
Application of § 265(a)(2) to CBIT interests, however, poses at least two problems. First, as noted by the Treasury Report in the case of the dividend exclusion prototype, application of § 265(a)(2) when the individual borrows from a taxable entity leads to two levels of tax on the underlying income, subverting the goal of integration. Second, § 265(a)(2) is notoriously difficult to enforce.

One alternative to § 265(a)(2) would be to treat non-CBIT debt as CBIT debt if it is used to purchase CBIT interests. Such a solution would, however, pose its own administrative problems. A second solution would be to apply § 265(a)(2) only if the borrowing was from a tax-exempt entity.43

A third solution would be to impose a tax on the receipt of non-CBIT interest by tax-exempt entities. If such a tax were feasible, however, it would significantly reduce the justification for CBIT in the first place.

A final solution would be to expand the CBIT treatment of interest to non-CBIT debt. Consider the effect of such a rule on several different classes of debt. The two largest categories of non-CBIT debt would probably be U.S. government debt and home mortgages. In both cases, the wisdom of CBIT treatment would depend, at least in part, on the extent to which the yield on the debt dropped to reflect CBIT treatment. In the case of government debt, the net effect of CBIT status would depend on the relationship between the weighted average marginal tax rate of current holders of government debt compared to the implicit tax rate reflected in the revised yield on government debt. In particular, holders of government debt would be better or worse off depending on whether their individual marginal tax rate was greater than or less than the implicit tax rate reflected in the revised yield on the debt after the imposition of CBIT. The government would be better or worse off depending on the aggregate mix of holders.

Similarly, in the case of home mortgage interest, homeowners would be either helped or hurt to the extent that their marginal rate on deductions was less than or greater than the implicit tax rate reflected in the yield on CBIT debt. In general, high-bracket individuals would be hurt by such a change while low-bracket individuals and nonitemizers would be helped. Application of CBIT rules to some other classes of debt might

42 The Treasury Report provides an example showing how the same approach can be used to purchase CBIT equity or corporate equity under the dividend exclusion prototype. Id. at 53. Presumably indirect purchases of interests in corporations are not as great a problem under the dividend exclusion prototype because the tax-exempt entity could always directly purchase a debt interest in the corporation and thereby avoid any tax on the corporate source income.

43 Under this approach, a look-through rule would have to be employed to see if the ultimate lender behind multiple layers of debt was a tax-exempt entity. Such an approach also would pose administrative problems.
be more troublesome. For example, if interest received from foreign persons was tax-free, the government would get no compensating revenue from the nondeductibility of the interest. Finally, given the current non-deductibility of personal interest, the exclusion of such interest from income would not be compensated for by a denial of interest deductions to the borrowers.

Overall, none of the solutions to the problem of leveraged investments in CBIT assets looks uniformly attractive. Application of § 265(a)(2) is clearly overbroad; solutions that rely on tracing are likely to be unadministrable; taxing tax-exempt entities is likely to be difficult; and subjecting all debt to CBIT rules is likely to introduce a host of new problems. On the other hand, the problem is real. Absent some restrictions, tax-exempt entities will be able to use non-CBIT taxable intermediaries to avoid the CBIT rules.

C. Other Structural Issues with CBIT

Sunley describes CBIT as a stealth bomber, destroying portions of the tax code without warning. The Treasury Report seems to fail to recognize some aspects of the stealth nature of CBIT. For example, § 163(d) currently limits the deduction of investment interest to the amount of net investment income. Under both CBIT and the dividend exclusion prototype, a holder of a leveraged investment in corporate equity would have no investment income from dividends and, therefore, her interest would become nondeductible. Given that the Treasury Report takes the position that the corporation is paying a proxy tax for the shareholder, the amount of the dividend (grossed up by the amount of the tax) arguably should be included in investment income for purposes of § 163(d).

A final example of the wide-scale effects of CBIT concerns § 263A(f). Section 263A(f) requires the capitalization of interest with respect to self-constructed assets and inventory. The Treasury Report states that under CBIT, § 263A(f) could be repealed. I have always understood that § 263A(f) was intended as an indirect means for taxing the expected in-

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41 IRC § 163(b).
42 While § 265(a)(2) addresses a real problem, the Treasury Report appears to be incorrect when it suggests that § 265(a)(1) should apply to CBIT interests. Section 265(a)(1) disallows a deduction for expenses other than interest allocable to tax-exempt income. Given that income from CBIT interests has already been taxed at the entity level and given the fact that the noninterest expenses allocable to such income are unlikely to be paid to tax-exempt entities, there would appear to be no reason to apply § 265(a)(1) to CBIT interests.
44 The investment interest expense would still need to be subject to § 265(a)(2) or whatever solution to the tax-exempt entity problem discussed above ultimately was adopted.
45 Treasury Report, note 2, at 52.
crease in value in self-constructed assets and inventory. If that is the case, the Treasury Report is correct that § 263A(f) could be repealed. The provision, however, could be repealed not because the underlying problem had been solved by CBIT, but rather because given the general nondeductibility of CBIT interest, the provision would have become ineffective. The underlying problem would, however, remain.