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DEBT VERSUS EQUITY: CORPORATE INTEGRATION CONSIDERATIONS

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DEBT VERSUS EQUITY: CORPORATE INTEGRATION CONSIDERATIONS

TUESDAY, MAY 24, 2016

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Heller, Wyden, Stabenow, Cantwell, Carper, Cardin, Bennet, Casey, and Warner.

Also present: Republican Staff: Mark Prater, Deputy Staff Director and Chief Tax Counsel; Tony Coughlan, Tax Counsel; Chris Hanna, Senior Tax Policy Advisor; Jim Lyons, Tax Counsel; and Eric Oman, Senior Policy Advisor for Tax and Accounting. Democratic Staff: Joshua Sheinkman, Staff Director; Ryan Abraham, Senior Tax Counsel; Michael Evans, General Counsel; and Tiffany Smith, Senior Tax Counsel.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will now come to order.

Welcome, everyone, to this morning's hearing, which is our second hearing on the topic of corporate tax integration. Last week we had a hearing to examine the potential benefits of a dividends paid deduction. Today, we will focus on the differing tax treatment of debt and equity under the current system and the distortions that are created as a result.

As a number of studies have shown, U.S. businesses pay an effective tax rate of about 37 percent on equity financing, while the effective tax rate on debt financing is negative. That is right: negative. The tax code actually gives a subsidy to corporations for debt financing. Experts and policymakers across the ideological spectrum have acknowledged that this is a problem.

For example, President Obama's updated framework for business tax reform, which he released last month, makes this observation: "The current corporate tax code encourages corporations to finance themselves with debt rather than with equity. Specifically, under the current tax code, corporate dividends are not deductible in computing corporate taxable income, but interest payments are. This disparity creates a sizable wedge in the effective tax rates applied to returns from investments financed with equity versus debt."

Now, the Congressional Budget Office and the Joint Committee on Taxation, along with the Treasury Departments of past administrations, agree. The George W. Bush administration's Mack-Breaux tax reform panel and the Obama administration's Volcker tax reform panel came to the same conclusion: our tax code's bias in favor of debt financing causes significant distortions in the economy.

We will talk about a number of these distortions today, but I want to mention just a few here at the outset.

Most obviously, the bias in favor of debt under our tax system incentivizes businesses to base financing decisions, not necessarily on market conditions or their specific situations, but on relative tax consequences. In addition, while debt is not inherently an inferior option, businesses and economic sectors that are over-leveraged are, broadly speaking, more vulnerable to losses in the event of an economic downturn.

This puts consumers at greater risk for things like higher interest rates due to bankruptcies, taxpayer bailouts, and the like. Our system, which puts a premium on debt in the form of a tax preference, adds to these risks.

Finally, the favored tax status of debt incentivizes the use of complicated and often wasteful tax-planning strategies that redirect resources away from projects and ventures that will lead to growth. This includes, for example, the use of financing instruments that will be regarded as debt by the IRS, even though they resemble equity in a lot of ways.

This was apparently the focus of the administration's newly proposed section 385 regulations, which were ostensibly promulgated to prevent inversions, but, as we are finding out, have a much broader scope. These proposed regulations are, to say the least, quite complicated and will surely continue to generate a lot of discussion. One thing is clear, however: this mess demonstrates how distortive our current system really is.

Now, before I conclude my opening statement, I want to address some misunderstandings that came up during our last hearing on corporate integration and the dividends paid deduction. During that hearing, some arguments and concerns were expressed in a manner that I believe mischaracterized the approach to corporate integration that I have been discussing for several months.

I did not dwell on these points last week because I did not want to disrupt the witnesses' statements or deny them a chance to answer members' questions, and I did not want the hearing to get bogged down by a protracted debate over a policy proposal that is not yet final. But I do want to briefly set the record straight on a few points.

One assertion we heard was that corporate integration favors big business at the expense of small businesses. That claim just is not accurate.

True enough, corporate tax integration would directly benefit businesses organized as C corporations. According to the most recent JCT data, while there are about 1.6 million C corporations in the U.S., only about 5,000—less than one half of 1 percent—are publicly traded. The vast majority of the remaining 99 percent of C corporations are closely held small businesses.

Like large corporations, these small businesses are subject to double taxation on earnings paid out to shareholders, but there are limitations on what they can do. So a dividends paid deduction would ensure a fairer and more efficient tax system for small businesses as well as large businesses.

You do not have to take my word for it. A large coalition of small business associations, including the National Federation of Independent Businesses and the S Corporation Association, recently sent a letter to the leaders of the Finance Committee and the House Ways and Means Committee stating, "Congress should eliminate the double tax on corporate income. The double corporate tax results in less investment, fewer jobs, and lower wages than if all American businesses were subject to a single layer of tax. A key goal of tax reform should be to continue to reduce or eliminate the incidence of the double tax and move towards taxing all business income once."

Without objection, a copy of that letter will be included in the record.

[The letter appears in the appendix on p. 45.]

The CHAIRMAN. On top of this pretty persuasive assessment from the small business community, our committee's Business Tax Reform Working Group also made clear in their report that dysfunctional tax policies affecting larger publicly traded businesses can and do have ripple effects on smaller businesses, including suppliers, service providers, and community organizations.

Another assertion we heard last week was that corporate integration would impose a double tax on retirement plans. Truth be told, I am not entirely sure what the basis is for that particular claim. However, I do want to do my best to assuage any lingering concerns that people might have about this idea.

Put simply, while we are still seeking input and crafting the specifics of our integration plan, I am not aware of any serious proposals out there that would result in two layers of tax on retirement plans, whether they are talking about income the plans receive from interest or from dividends.

Now, I do not want to spend too long discussing all of the issues raised in our last hearing. Clearly, we will have to continue this discussion in the coming weeks and months.

I look forward to a robust public discussion about these issues going forward, including here today with our distinguished panel of witnesses.

So with that, I will turn to Senator Wyden for his opening statement.

[The prepared statement of Chairman Hatch appears in the appendix.]

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you very much, Mr. Chairman. Once again, we are dealing with a very important issue. I commend you for bringing up this whole question of debt versus equity. As we joked last week, these are not exactly the kinds of issues that come up at summer picnics, but they are exceptionally important, because one of the biggest challenges in tax reform is figuring out the right ways to slash the thicket of tax rules that today have too much influence over our economy.

Democrats and Republicans, in my view, share the goal of getting the tax code out of the business of picking economic winners and losers. Towards that end, I have offered three proposals recently.

The first is a set of technology-neutral energy tax proposals that cut energy subsidies in half; second, a simpler set of depreciation rules that end the expensing headache for small businesses; and third, a proposal that closes the loopholes on financial tricksters who want to rip off the system at the expense of middle-class taxpayers.

Another major question that we deal with today is how tax reform should unwind the tax code's bias in favor of taking on debt. For business, this issue is all about how you are going to finance investment, growth, and hiring in the private sector.

Maybe you have designed a new product line and you need to build a facility to produce it. Maybe you need to put up cell towers with the latest technology, or maybe your firm is ready to launch a west coast branch and hire a new team, and you have made exactly the right decision—you have decided to locate in Oregon.

The question is whether you are going to finance those plans with debt by selling bonds, or with equity by selling stock. Today the tax code pushes business towards debt with a tax write-off for interest payments on the bonds they sell.

Without any question, that has a big influence over our economy. On one hand, it makes bonds an attractive investment tool. But on the other hand, there probably are a lot of businesses with debt that they would not have taken on if the tax code did not encourage it.

In my view, in America, to create more jobs in the private sector and make us as competitive as possible in a tough global economy, we want business decisions made for business reasons, not for tax reasons. And I believe reducing the tax code's economic distortions is a bipartisan proposition when it comes to tax reform.

So today the committee is going to continue its examination of a proposal known as corporate integration, which is one strategy that has been put forward as a way to help limit the preference for debt. It would accomplish that by offering companies a write-off for dividend payments they make to their shareholders.

And certainly as we have this discussion—we touched on it last week—I think Americans are going to have questions about how you would finance that tax cut, other than by withholding some amount from dividend and bond interest payments. So we are talking about a very complicated area of tax policy where changes could have enormous ripple effects on our economy.

So I think Chairman Hatch is absolutely right in bringing up the issue of debt versus equity today for our committee to discuss. We all know that comprehensive tax reform is going to have to be bipartisan.

Mr. Chairman, as we talked about last week, I am very much committed to working with you and our colleagues towards that end.

The CHAIRMAN. Well, thank you, Senator.

[The prepared statement of Senator Wyden appears in the appendix.]

The CHAIRMAN. Now I would like to introduce our distinguished panel of witnesses.

First, we have with us today Alvin. C. Warren, a Ropes and Gray professor of law at Harvard Law School. Professor Warren has taught tax law and policy at Harvard since 1979. He has been a member of the ABA's Counsel of the Section of Taxation and chair of its Committee on Basic Tax Structure and Simplification.

He is the author of a major study on corporate tax integration published by the American Law Institute. Professor Warren has a bachelor's degree from Yale University and a J.D. from the University of Chicago Law School. So we welcome you, Professor, here today and are glad you could take time to be with us.

Our second witness is Jody K. Lurie, who is a vice president and corporate credit analyst at Janney Montgomery Scott financial services firm. Ms. Lurie has wide-ranging experience focusing on corporate debt structures and portfolio reviews for companies across several industries.

She has published numerous pieces on industry trends and is frequently quoted by a wide range of publications as an expert in her field. Before pioneering the firm's corporate credit research efforts, Ms. Lurie worked as an investment banker in Janney's consumer and retail group, participating on a number of transactions, including IPOs, mergers and acquisitions, and private placements.

She is a graduate of Bryn Mawr College in Philadelphia with bachelor's degrees in mathematics and economics. Ms. Lurie is joined by her husband today, Michael Lurie, who is a tax attorney at Reed Smith in Philadelphia. Welcome to both of you.

Our third witness is Mr. John Buckley, a distinguished tax lawyer with nearly 3 decades of experience here on Capitol Hill, participating in the development of Federal tax legislation.

Starting in 1973, Mr. Buckley spent 20 years in the House Office of Legislative Counsel. After that, he spent 2 years serving as Chief of Staff for the Joint Committee on Taxation, which preceded his service of roughly 15 years as Chief Tax Counsel for the Democrats, both in the majority and the minority on the House Ways and Means Committee.

For much of that time, roughly 17 years, he was an adjunct tax professor at the Georgetown University Law Center. Mr. Buckley has a J.D. from the University of Wisconsin School of Law. So we welcome you, Mr. Buckley to the committee again. This is a place you understand very well. I want to thank you for being here.

Now, our final witness is John D. McDonald, who is currently a partner and leading tax lawyer at Baker and McKenzie in Chicago. Mr. McDonald is, by all accounts, well-versed in tax matters, with a focus on domestic and international acquisitions and reorganizations, foreign currency matters and subpart F, and foreign tax credit provisions.

He has been named one of Chambers USA's top tax advisors in multiple editions and has been listed as a recommended international tax lawyer in The Legal 500. Mr. McDonald has a bachelor's degree from Marquette University and a J.D. from Northwestern University School of Law. So we welcome you, Mr. McDonald, to the committee. I want to thank you for joining us here today.

We will now move forward with our witnesses' opening remarks, as is customary. We hope all of you will try to limit your statements to 5 minutes with an understanding that your full written statements will be included in the record.

So I will begin with you, Professor Warren, and go from there.

STATEMENT OF ALVIN C. WARREN, JR., ROPES AND GRAY PROFESSOR OF LAW, HARVARD LAW SCHOOL, HARVARD UNIVERSITY, CAMBRIDGE, MA

Professor WARREN. Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me today to testify on corporate tax integration, particularly with respect to the tax treatment of corporate debt and equity.

I would like to emphasize three points. First, the longstanding separate taxation of corporate entities and shareholders is in dire need of reform, because it produces deleterious financial and economic distortions.

In particular, the deductibility of interest payments, coupled with the nondeductibility of dividend payments, creates a tax incentive for corporations to issue debt rather than equity. As indicated by the chairman in his opening statement and in the pamphlet prepared for today's hearing by the staff of the Joint Committee on Taxation,* the result can even be a negative corporate income tax rate for investments that benefit from other preferences such as accelerated depreciation.

My second point is that these longstanding distortions can be eliminated or significantly reduced by moving from separate taxation of corporations and shareholders to an integrated tax on corporate and shareholder income. One approach would be to turn the corporate tax into a withholding tax that would be creditable against the shareholder tax due on dividends. The resulting integration of the two taxes would advance the goal of ultimately taxing income, from whatever source derived, at an individual's graduated tax rate.

A second approach, which the staff has been developing for the chairman, would couple a dividend deduction with withholding on corporate dividend and interest payments. In my view, the chairman's innovative approach could provide the basis for significant reform of our outdated distortionary and wasteful system for taxing corporations and investors.

My third and final point is that integration would involve numerous design issues, many of which are interrelated. I just want to mention two which are related to today's primary subject, the corporate tax preference for debt.

The first is the treatment of tax-exempt investors, including pension plans. Under current law, dividends received by exempt entities will usually have borne a tax at the corporate level, whereas interest payments will not. There is thus a discontinuity today between debt and equity, not only at the company level, but also for exempt investors, including pension plans.

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*For more information, *see also,* "Overview of the Tax Treatment of Corporate Dept and Equity," Joint Committee on Taxation staff report, May 20, 2016 (JCX–45–16), *https://www.jct.gov/publications.html?func=startdown&id=4914.*

We cannot eliminate the first discontinuity without taking into account the effects on the second. Depending on how it was implemented, integration could increase, decrease, or leave unchanged the total burden on corporate income received by tax-exempt entities.

A second important issue relating to corporate debt and equity is the effect of integration on decisions of corporate managers regarding how much of corporate earnings to distribute as dividends and how much to keep and invest at the corporate level. These are very complex decisions that depend on corporate and shareholder investment opportunities as well as on the relationship of four tax rates: the corporate rate, the shareholder rate on dividends, the shareholder rate on investment income generally, and the shareholder rate on capital gains.

Some analysts have argued for tax provisions that would favor either distributions or retentions. My own view is that the tax system should strive for neutrality in these decisions, which I think are best made in the private sector without pressure one way or the other from the tax code.

These examples indicate that corporate tax integration would have far-reaching consequences that would have to be considered carefully by the committee. Much work has already been done on these questions, and it is my firm belief that desirable, workable solutions can be found to all of these design issues, taking into account legislative goals on various dimensions.

Thank you again, Mr. Chairman, for inviting me to testify today. I look forward to responding to any questions the committee might have.

The CHAIRMAN. Thank you, Professor Warren.

[The prepared statement of Professor Warren appears in the appendix.]

The CHAIRMAN. Ms. Lurie?

STATEMENT OF JODY K. LURIE, CFA, VICE PRESIDENT AND CORPORATE BOND RESEARCH ANALYST, JANNEY MONTGOMERY SCOTT LLC, PHILADELPHIA, PA

Ms. LURIE. Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for allowing me to present today. Please note that my comments represent my views and not necessarily the views of Janney Montgomery Scott.

The current tax system promotes debt financing over equity financing due to the one layer of tax on interest payments versus the two on dividends. While corporate integration in theory could equalize treatment of debt and equity, it may cause unintended consequences and should be examined with caution.

Tax theorists have argued that there is no inherent difference between debt and equity, therefore, the two should be treated the same under the tax code. Still, the capital markets extend beyond tax implications.

Shareholders purchase equity securities for their unlimited growth potential, while most lenders buy bonds for their steady income returns, in exchange for limited up-side potential versus equity securities. Corporate management aligns with the goals of equity investors, and if it does not, activist investors may put pressure on management to increase shareholder returns.

For the debt side, increasing dividends or share buybacks are both negative events. Cash is not going towards debt repayment or long-term growth initiatives. The current tax system shifts the balances so that companies do not tend only to shareholders.

We can look at master limited partnerships, MLPs, a type of pass-through entity, as a key study for adverse effects in corporate integration. Most MLPs pay their equity unit holders all income not needed for core operations via cash distributions. MLPs are incentivized to have high CapEx—capital expenditures—because with high CapEx comes deductions that are passed on to the individual unit holder.

Before the collapse of energy prices, MLPs, like REITs, became a preferred investment for individual investors hunting for yield in the low-rate environment. Since the fall of 2014, however, most MLPs have come under pressure due to the fall in energy prices. While there have only been a handful of MLP bankruptcies, the outsized credit risk in the industry is notable, as seen by the concentration of MLPs with high-yield credit ratings.

Industry cyclicality is, perhaps, inevitable, but what is not is a tax policy that favors companies paying out most of their cash so that they do not have the cushion necessary to weather a down market. Even before energy prices fell, MLPs operated with minimal cash balances and provided sizeable returns to unit holders via distributions.

A pass-through structure does not necessarily decrease a company's appetite for an over-leveraged credit profile, but rather encourages a company to spend available earnings on short-term shareholder returns. While an equalization of debt and equity from a tax standpoint could lead to additional equity offerings over debt issuance, the dilution effect of companies would remain a deterrent, as it was for MLPs during the expansion era.

In general, corporate integration is unlikely to cause companies to view equity and debt financing equivalently. After all, as security falls further down the capital structure, investors demand an extra premium for the extra risk.

It is likely, however, that the difference between the cost of debt capital and the cost of equity capital will decrease. But benefits in debt over equity financing will remain. Further, despite record cash balances, some companies have utilized debt in recent years to finance shareholder giveback plans, as debt financing costs are below the 35-percent repatriation tax rate. Until there is parity in debt and other financing methods, companies will continue to use the debt markets to finance short-term equity returns.

That said, corporate integration will likely lead to a rise in the equity capital market valuations, because it would encourage dividend payments. Equity indices broke record highs in recent years thanks, in part, to economic stimulus and improving credit profiles at large corporations.

It is likely that the equity markets would respond positively to corporate integration. The additional cash being spent on shareholders, in theory, could reenter the economy.

Although a proposed tax change may alter certain corporate behaviors, we see a lack of long-term CapEx and domestic capital investments contribute to economic and job growth. While companies have robust cash balances currently, CapEx has lagged since the recession.

Rather than invest in new projects that may take years before realizing a return, companies are looking at share buybacks, dividends, M&As, and tax minimization to bolster shareholder returns. Corporate integration may put even more pressure on companies to pay outsized dividends to shareholders, which could lead to even less long-term capital investments. I see the discussion as timely but also see several potential unintended consequences that would stem from corporate integration.

With that, I would be happy to take any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Lurie appears in the appendix.]

The CHAIRMAN. Mr. Buckley?

STATEMENT OF JOHN L. BUCKLEY, FORMER CHIEF TAX COUNSEL, COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, WASHINGTON, DC

Mr. BUCKLEY. Thank you, Mr. Chairman, for the opportunity to speak before this committee today.

Ultimately, the question faced by this committee will not be whether there are issues under current law, but whether proposed legislation would be an improvement over current law.

In this case, the proposal involves a dividends paid deduction coupled with withholding taxes on payments of corporate interests and dividends. Clearly, current law imposes some distortions. There is a preference for debt financing. That is in addition to the fact that that financing is already the cheapest source of outside capital available to corporations because it comes with lower risk and the bondholder is willing to accept a lower rate of return. However, the evidence as to whether that has actually created overleveraging at the corporate level is, at best, ambiguous.

Clearly, it also creates a bias in favor of retained earnings. Now, to be very frank, that is a bias that I think is not bad, because that bias, coupled with investment incentives like the research credit and accelerated depreciation, creates a strong incentive for capital investment in the United States, which I think is favorable for our economy.

There are aspects of the proposal that I think should cause this committee to approach the topic with some caution and skepticism.

First, the proposal clearly would eliminate the bias for retained earnings. Instead, it would substitute a bias for distribution of those earnings. It would dramatically reduce the benefit of, and in many cases, effectively repeal incentives like accelerated depreciation and the research credit.

The proposal could dramatically increase the cost of borrowing by U.S. corporations. The overwhelming bulk of investors holding corporate debt obligations are tax-indifferent investors. And by the term "tax-indifferent investors," I mean investors whose interest income is not otherwise subject to tax.

For those investors, the new withholding tax is a direct reduction in their interest rate of return on those investments. Unless those investors, which really are required for the efficient operation of our debt markets in this country, are willing to accept rates of return 35-percent lower than the rates that they currently receive, there will be upward pressure on interest rates.

I see no reason why tax-indifferent investors will now be willing to accept lower rates of return. In particular, foreign investors have ample opportunities to invest overseas.

Finally, the proposal is, at best, inconsistent with, if not in direct violation of our tax treaties. That is more than just a technical issue here. We benefit greatly as a country because foreign investors are willing to purchase our stocks and our bonds. Approximately 26 percent of all corporate debt instruments are held by foreign investors. The proposed withholding tax could cause many of those investors to leave.

It also would invite retaliation by other countries against our companies or our citizens that invest there. It clearly could result in retaliatory action.

Again, Mr. Chairman, I thank you for the opportunity to testify today, and I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Buckley appears in the appendix.]

The CHAIRMAN. Mr. McDonald?

STATEMENT OF JOHN D. McDONALD, PARTNER, BAKER AND McKENZIE LLP, CHICAGO, IL

Mr. MCDONALD. Thank you, Mr. Chairman, Ranking Member Wyden, and members of this committee, for allowing me to testify on business tax reform.

As an international tax practitioner who represents primarily U.S.-based manufacturing companies in the Midwest, I have all too often seen how our present system of corporate taxation incentivizes companies to invert, be acquired by a foreign multinational, or produce products and services offshore instead of in the United States. Changing this incentive structure while ensuring that U.S. businesses remain competitive in the global marketplace is, admittedly, a significant challenge.

Our current corporate tax system has evolved over more than a century, and it is difficult to make sweeping changes overnight. Nevertheless, I applaud this committee's effort to think of creative solutions such as corporate integration to change the current dynamic. Integration approaches have actually moved the burden of the corporate income tax away from highly mobile corporations onto far less mobile U.S. individuals and tax-exempt entities and accounts. It is likely the only way the U.S. will be able to avoid simply copying the tax systems of other countries in an attempt to preserve the U.S. corporate tax base.

The dividends paid deduction currently being considered by this committee is one such approach. Another key advantage of the dividend paid deduction is that it should reduce the current preference that exists for corporations that have debt financing.

The tax law did not always favor debt over equity as much as it does today. Instead, the advantage of debt financing waxed and waned in the first decades of the 20th century based on interest deductibility limitations and corporate and individual tax rates.

It was really only when Congress chose to impose two levels of corporate tax in 1936 and the only limit on the shear amount of debt that a corporation could issue was established by common law, that the real tax preference for debt was firmly established.

Today, the code creates a disconnect, whereby a significant amount of debt-financed business profits do not bear any U.S. income tax, while a significant amount of equity-financed business profits bear two levels of income tax, and in certain cases, even more. This distinction does not make any sense.

A dividends paid deduction allows Congress the chance to revisit this issue in a holistic fashion and create more balance in the code between debt and equity financing. The precise extent to which debt and equity parity is achieved, however, depends on a number of correlative decisions that have to be made at both the holder and issuer levels. I expand on those correlative issues in my written testimony, and I look forward to discussing them further during today's hearing.

The CHAIRMAN. Well, thank you.

[The prepared statement of Mr. McDonald appears in the appendix.]

The CHAIRMAN. This has been very interesting, as all of these hearings have been. Now this is a question that any of you can answer, but I am going to start with you, Professor Warren, and just go down the line if we can.

Please consider the following statement. "Outsized reliance on debt financing can increase the risk of financial distress and, thus, raise the likelihood of bankruptcy. Unlike equity financing, which can flexibly absorb losses, debt requires fixed payments of interest and principal and allows creditors to force a firm into bankruptcy."

Do you agree or disagree with that particular statement, and would you tell us what your feelings are about that?

Professor WARREN. Well, I agree. I think it is an accurate description of one of the problems with having an incentive for debt finance. That debt finance then creates a series of mandatory payments for the company, not discretionary payments as with respect to dividends. And therefore, when you come into a period of financial difficulty, a company that is over-leveraged can get into even worse financial difficulty because it cannot make those mandatory payments.

The CHAIRMAN. Ms. Lurie?

Ms. LURIE. So the way I think about it is that debt financing is something that can be necessary for a company to build their business. Equity financing or equity distributions are not necessary; it is only if the company is doing well and wants to give back to its shareholders in such a way.

While yes, of course, an outsized amount of debt financing would contribute to over-leveraging and would, therefore, contribute to financial distress, a lot of the companies that you see making the largest debt issuance this year are the companies that have an outsized amount of cash on hand. So I think more the question is, how do you get these companies to utilize the cash that they have on hand, versus issuing $20-billion debt offerings to make an acquisition?

The CHAIRMAN. Okay. Mr. Buckley, do you agree or disagree with that statement?

Mr. BUCKLEY. I agree that the current law has an incentive for debt financing, a tax benefit for debt financing. That is in addition to, really, the natural bias to debt financing that a businessman would have. He does not want to give up a share of his company in order to acquire capital. Issuing stock means you, essentially, have to give up part of your company to another party.

The other thing I would say is, the evidence, in my mind, has shown that companies outside of the financial sector—and let us just set the financial sector aside—have been fairly conservative in their use of debt financing in this country. So they understand the risks that you talk about, and they have been fairly cautious in their use of debt financing.

The CHAIRMAN. Okay.

Mr. McDonald?

Mr. MCDONALD. In my opinion, the objective of any tax reform proposal should not be to incentivize equity financing or debt financing. The objective should be to ensure that we get at least one level of tax on U.S. source business profits.

As I said in my opening statement, if you are a foreign investor that is lending money to a U.S. company and you take advantage of the portfolio interest exemption, you are getting a deduction in the United States. You get an inclusion offshore. You do not even have to be in a treaty jurisdiction, and there is no U.S. tax imposed, and no withholding tax imposed on that investment. Whereas, a U.S. individual has two levels of tax imposed on them.

The CHAIRMAN. The reason I quoted that is, that quote is from President Obama's updated framework for business tax reform. I think it is interesting. I think he is right on what he said. I just thought I would bring that up in that way.

Now, in December 2014, my staff issued a 340-page report on comprehensive tax reform with 100 pages devoted to corporate integration. Shortly after issuance of the report, we began to hear from private-sector academics, practitioners, and economists. There was near unanimous agreement that corporate integration should be achieved.

The uncertainty arose in what method should be adopted in achieving corporate integration. Many of these groups and individuals pointed out exactly what Mr. Buckley stated, that there is a graveyard near the White House full of prior integration proposals.

However, as we know, there are a lot of important issues today of bipartisan concern, such as base erosion, earnings stripping, lock-out, a large disparity between the marginal and effective tax rate on equity financing and debt financing, and the inefficient high corporate tax rate—all issues that corporate integration could help us to address.

So circumstances today are dramatically different than in prior periods when corporate integration was seriously considered. Now to me, the important question is not whether corporate integration should be implemented—of course it should, in my eyes—but rather what method of corporate integration should be utilized.

Mr. Warren, and, Mr. McDonald, it is obvious that both of you have spent an enormous amount of time focusing on corporate integration. Now, Mr. Warren, you published a 250-page report on corporate integration for the American Law Institute. Mr. McDonald, you recently published a 100-plus page article on corporate integration that you presented at the University of Chicago Tax Conference.

Now, Mr. Warren, what method of corporate integration should be adopted, and how did you decide upon that particular method?

Professor WARREN. Mr. Chairman, I think there are various possibilities. In the report that you alluded to for the American Law Institute, our mission was to try to work out what we thought would be a framework that had the greatest possibility for solving all of the technical issues.

That is a very different question than the one that is before the committee, which is what is a workable framework that could be enacted. The framework that the ALI came up with was turning the corporate tax into a withholding tax that would be credited against the shareholders' progressive tax rate. I continue to think that would be an important way to go.

Alternatively, the approach that you have been developing of having a dividend deduction with withholding, I think, is another approach that would be appropriate.

The CHAIRMAN. Mr. McDonald, the same question to you.

Mr. MCDONALD. Yes, I firmly believe that if you are going to do integration, it is important that you move the income tax off of the corporate P&L and onto the shareholder. There are a couple of ways to do that, and one of them is the dividends paid deduction. The other approach is a shareholder mark-to-market regime.

The problem with a shareholder mark-to-market regime is, it is not entirely clear that it is administrable in all cases. The dividends paid deduction is far more administrable than the shareholder mark-to-market regime. So, therefore, I think a dividends paid deduction is clearly superior over, for example, a shareholder imputation credit.

The CHAIRMAN. Okay. I have gone over.

Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman. I think this has been an excellent panel. Let me see if I can pose several questions as part of this discussion.

Now, Ms. Lurie, in your testimony you describe today's business environment where corporations are making short-term decisions to, "keep shareholders happy. Rather than expanding a new product line or building a new plant that may take years before realizing a return, companies look at share buybacks and dividend payments."

It seems to me that you and Mr. Buckley are both saying, in some fashion, that for businesses to grow, it is important to retain earnings for long-term planning and investment. What in your view—and we can pose this to you, Ms. Lurie, and to you, Mr. Buckley—what happens to these companies under a corporate integration proposal?

Ms. LURIE. Thank you, Senator. I think the question is a little hard to determine because there are only so many examples that we have of some form of corporate integration. We have REITs. We have MLPs. We have a few other examples that we can, sort of, look at.

The reason why I spoke to MLPs is because that was an example of an industry that does not have a steady flow of income. Unlike REITs, you cannot really count on that rental income. So, if you look at these companies that are devoting a lot of the money that they do raise—either through equity or debt financing—to CapEx, you can see the erosion that could occur if you allow companies or incentivize companies to give back their retained earnings to shareholders.

So I think, at the end of the day, it is a fine balance between letting companies do what they need to do to run their businesses, and getting out of the way—as the chairman mentioned—but also making sure that companies do not have too much of a leash to do whatever it is they want to do in the event that, over the long term, the economy goes bad or there is some sort of down market that causes these companies to be over-leveraged.

Senator WYDEN. Mr. Buckley, do you want to add to that?

Mr. BUCKLEY. I think retained earnings for many corporations are necessary to finance future growth. And it is particularly true among the new companies and growing industries. They do not have really good access to the credit markets. They do not want to issue more stock and dilute their interests in the business that they created. So it is retained earnings that they need to finance future growth.

In a very bizarre way, a dividends paid deduction would result in those corporations paying a much higher level of corporate tax than anybody else, because a mature——

Senator WYDEN. Let the record show that Ms. Lurie nodded her head in the affirmative.

Mr. BUCKLEY. Yes. A mature company can afford to increase dividends and, therefore, eliminate corporate tax liability. A growing company needs to retain those earnings to fund future growth, and thus, it would be one of the few companies that would actually have significant corporate tax liability. I think it is just kind of a bizarre set of incentives that you are creating here.

Senator WYDEN. Now, the tax code provides a number of important incentives for companies to invest: in research and development for example, infrastructure, hard-to-employ workers, a variety of priorities that, on a bipartisan basis, have been designated as important.

Some of the corporate integration proposals would allow corporations to reduce corporate tax by the amount of earnings paid to shareholders. Now obviously, under today's system, a number of corporations pay significantly below the 35-percent statutory rate.

Is there reason to be concerned that providing corporations the ability to fully wipe out their corporate tax liability by paying all of their earnings as dividends could diminish the positive effects on some of these important tax incentives where there has been bipartisan support? We can have any of you take it on. In fact, why don't we—just for the heck of it, we will start with you, Mr. McDonald, and go right down the row.

Mr. MCDONALD. Well, the answer is, I do not think so. I mean, those growth companies that Mr. Buckley and Ms. Lurie are referring to can still take advantage of those incentives. I think another thing to keep in mind is the ability of the net operating loss deduction. That can be carried back or carried forward so that, if a company is in a particular position whereby in some years they are going to be in a position to pay dividends and in some years they cannot, then that deduction can be carried backwards or carried forwards.

The answer is, I think that companies will still take advantage of those incentives.

Senator WYDEN. I think the kind of concern I would have is, if a company has already eliminated its tax liability, what incentive would it have to hire disadvantaged workers or invest in low-income communities? Why don't we just keep going with you, Mr. Buckley and Ms. Lurie, and get all of you on this point, because this is, as we have indicated, complicated stuff. That is why I think we want to take the time to get everybody's opinion on the record.

Mr. Buckley?

Mr. BUCKLEY. The answer is that it would effectively repeal most of those incentives for the large bulk of corporations, because they could just simply convert stock buyback programs into increased dividends and, therefore, eliminate all corporate income tax.

I believe that our tax laws should be neutral, but I believe that our tax laws should be neutral only so long as that neutrality tilts in favor of investment in the United States. Incentives like the R&D credit and accelerated depreciation tilt the playing field in favor of investment in the United States, and I think you should be very cautious about the impact of a shareholder dividend deduction on those incentives.

Senator WYDEN. Ms. Lurie, Mr. Warren?

Ms. LURIE. Thank you, Senator. Just to build on what Mr. Buckley said, I was thinking of the bonus depreciation that some companies received a few years ago and the benefits that they received because of that and the amount of money that was going towards infrastructure in the country through water utilities and what have you. I think that is a more effective use of cash than allowing companies to give back to shareholders and effectively eliminate their tax liabilities through that method.

Finding a way to eliminate their tax liabilities through long-term CapEx plans, I think, makes a little bit more sense. Thank you.

Senator WYDEN. Mr. Warren?

Professor WARREN. Senator Wyden, the question you raise is a very important and central one. If Congress went to this kind of integration and it was worried about elimination of certain corporate tax preferences, there are ways in which the proposal could be adjusted for that. I think it is an extremely important question.

Senator WYDEN. Mr. Chairman, I again want to commend you for taking on this debt and equity issue. This is extraordinarily important, and I just pass on that when our former colleague, Senator Gregg, and I worked on our bipartisan tax reform bill and sat on a sofa every week for 2 years, this was one of the issues—debt and equity—that was front and center in trying to come up with a bipartisan proposal. Senator Gregg, to his credit, had a very good idea, where he just took a little nip from the debt, in effect, the sort of escalator, the automatic escalator, in an effort to strike a balance. So I think you are absolutely right to take on this issue, and I look forward to working closely with you on it.

The CHAIRMAN. Well, thank you, sir.

Senator Heller?

Senator HELLER. Mr. Chairman, thank you, and I want to thank our witnesses for being here today. I apologize that I missed your opening statements. I had two other committees. Three committees going on at the same time, Mr. Chairman, so I am glad I was able to make it back, and I am certainly pleased that you and the ranking member are holding this hearing today, as important as it is.

I want to, kind of, take this from the 30,000-foot level to make sure we are all doing this for all of the right reasons. There was a *Wall Street Journal* poll that came out today that said that the President's approval rating is at 51 percent. Now, I am trying to figure out how a President's approval rating of 51 percent can be attained when we only had ½ of 1 percent growth in the first quarter. I mean, any other president at any other time, you would probably see approval ratings be much less.

So what I am assuming is that the administration has done a great job talking about this being the new normal. This is where we are, and people are tired of it. After 8 to 10 years seeing no growth, perhaps this is where we are in America today.

We can talk about global competitiveness. We can talk about inversions. We can talk about integration. We can talk about all of these issues, but if the American people believe that ½ of 1 percent is the new normal, how do we push back?

So I guess my question to the panel here today—I know, maybe, it is a little off topic, but I would certainly like to get your input. One, is this a new normal; and two, if you do not believe it is, what can we do? What can we do to expand our global competitiveness?

We will start with you, Mr. Warren.

Professor WARREN. I certainly hope it is not the new normal. It is a little off the subject, but nonetheless, I would say a couple of things. I think one of the things we have to think about is rates, particularly rates for U.S. companies as compared to companies abroad. I think we have to think about the comparison of rates between individuals and companies. Finally, I think we have to think about the tax base and whether or not we need some additional revenue source.

Senator HELLER. Ms. Lurie?

Ms. LURIE. Thank you very much, Senator. I am, sort of, looking at this from more of an economic standpoint and thinking about the fact that we have been operating in a low interest rate environment for so long.

Now, the short end of the curve—we saw a bump in December with the Fed raising rates—but yet the long end still remains depressed. The real question is, why is that?

My colleagues and I have written—particularly, one colleague of mine has written many articles on that, describing that, while the short-term rate is rising through measures that the Fed is using, at the end of the day, there is no long-term growth that we see in the economy. We do not see any sort of dot-com growth or any sort of tech bubble that is occurring or real estate bubble that is occurring. So as a result, we are not seeing this amount of growth that we need to see to jumpstart the economy.

Thank you.

Mr. BUCKLEY. I will join the other witnesses in hoping that this is not the new normal. I think what I would suggest is comprehensive business tax reform with a reduction in the corporate rate, financed by elimination of what people might consider to be distortive tax incentives, and a revision of our international rules to make our companies more competitive overseas and in the United States.

One reason why inversions occur is because foreign-based multinationals have substantial competitive advantages in the United States, compared to U.S. multinationals. Now, having said that, I think you have to be fairly realistic in your expectations. I am not certain that is going to bump up economic growth dramatically.

The experience of the 1986 act was that it improved things by getting rid of some distortions, but it was very difficult to see an impact on long-term growth. I think investments in the United States and education infrastructure, et cetera, are necessary to increase growth rates.

Mr. MCDONALD. Our U.S.-based multinationals have significant money offshore. As Ms. Lurie noted in her written testimony, a lot of U.S. companies right now—because of our current tax system—are borrowing in the United States to pay dividends to their shareholders while keeping that cash offshore.

One of the major advantages of a dividends paid deduction and the integration approach, but particularly a dividends paid deduction, is that hopefully it will have a positive effect on this so-called "lock-out" problem. Companies can bring back dividends from their low-tax offshore subsidiaries and then pay them out to their shareholders in the form of a deductible dividend that wipes out the repatriation tax that Ms. Lurie was referring to, thereby obviating the need to borrow simply to pay cash dividends.

I think that is one thing that could enhance growth.

Senator HELLER. Thank you. Mr. Buckley, I do have a follow-up question. Your effort on the Ways and Means Committee—integration is not a new topic. I think previous administrations have discussed this particular issue. Why, in the past, has it failed?

Mr. BUCKLEY. I think it has failed—and I am speaking of 40 years of discussing this issue; indeed, it goes further back than that. My law school professor was quite passionate on the issue when I went to law school.

It is largely because of opposition from the corporate community, or indifference, that they do not want to have an incentive to distribute earnings. They would prefer to grow their business and retain earnings. Also, it has been because there are other alternatives that have been far more attractive to the business community, otherwise known as a corporate rate reduction.

In 1986, the United States Senate rejected a dividends paid deduction that was included in the House-passed version of the 1986 reform and substituted a slightly larger reduction in the corporate

rate. That was greeted with a great deal of joy from the corporate community.

Senator HELLER. Thank you. If you will indulge me just one minute, Mr. Chairman——

The CHAIRMAN. Let me just interrupt. Mr. Warren, would you give your impression on that same question?

Professor WARREN. The last time this was seriously considered was in the 1990s. I think the corporate community was not enthusiastic about it, but I think we are in a very different world now, with competition from abroad. So I actually think that the fact that integration failed to get the political momentum behind it in the past is not a reason not to take it very seriously now, given that we are in a very different world.

Senator HELLER. Mr. Chairman, thanks for the follow-up. I just want to ask one more follow-up to Mr. Buckley, and that is, do you believe that the Treasury Department's new rules will fix these international competitiveness problems that we have?

Mr. BUCKLEY. Are you talking about the regulatory——

Senator HELLER. Section 385.

Mr. BUCKLEY. I think it slightly reduces the opportunity for income stripping out of the United States, but only slightly. I think this committee has to look at a much broader solution to the question of collecting a full corporate income tax on income that is actually earned here and not diverted through interest payments or royalty payments to low-tax jurisdictions overseas.

Senator HELLER. Mr. Buckley, thank you. Mr. Chairman, thank you, and thanks for the follow-up questions.

The CHAIRMAN. Thank you. Let the record show, however, that there was partial integration achieved in 2003. I think that is correct, is it not, Professor Warren?

Professor WARREN. By the reduced rates for dividends——

The CHAIRMAN. Right.

Professor WARREN. Yes.

The CHAIRMAN. Okay.

Let us see—let me double-check my list. Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. Thank you for convening this hearing, and I thank the panelists. Senator Thune and I cochaired the Business Tax Working Group, and corporate integration was one of the issues that we thought deserved the attention of the United States Senate and our committee. You should not be steered towards a particular structure as you make your decision how to organize.

There is a great deal of interest in how we can deal with the inequities of a double taxation system. The concern is that if you try to do it in the current tax structure, within the walls of our current tax code, there are going to be consequences to that that may not be what you desire.

I know there has been a great deal of discussion on the fact that most businesses in America do not use the C rate, so therefore, relative tax burdens are going to be changed, which will have an impact on pass-throughs. I am concerned about the impact it is going to have on tax credits for economic growth.

I represent an urban State, where the New Market Tax Credits are particularly important to economic growth, where historic tax credits are important. I would be interested, if we just did the proposal in regards to the corporate integration, what impact could that have on a city like Baltimore that utilizes these tax credits for economic growth, or other areas that depend upon the incentives that are currently in the tax code, if all we do is deal with this one issue?

Mr. Buckley, any thoughts?

Mr. BUCKLEY. All of those provisions require corporate tax liability to be effective. A dividends paid deduction for many companies—typically, for the companies that would be in the position of, essentially, buying those credits, the result would be elimination of all corporate tax liability. So I think, as Professor Warren said, you would have to develop a different mechanism of delivering those subsidies.

Senator CARDIN. The concern you have in today's political environment is, we are going to have a hard enough time making this proposal revenue-neutral, and with the budget caps, where do you get the resources to invest in economic growth for challenged communities?

Mr. BUCKLEY. What I was going to say is, the only realistic alternative—one alternative that I think this committee would not like—is a refundable credit. If there is not corporate liability, the only other alternative would be a direct spending program. And given the current environment, I do not think there is a realistic prospect of that either.

Senator CARDIN. Professor Warren?

Professor WARREN. I think the issue raised is extremely important and should be carefully considered in any integration program, but I believe it is a design issue. And if the kind of credits that you talk about are credits that the committee and the Congress decided should not be eliminated by the integration program, I think that could be accomplished.

But I think you are exactly right to say that if you are going to take this seriously, you have to think through all of these far-reaching consequences. I just believe that these are problems that are soluble.

Senator CARDIN. I agree with you. You can design it to deal with the concerns. The problem is, in the current political environment, working solely within the C corporate integration issue, you have limited options on trying to design a way to deal with the multitude of policies that are affected by this proposal.

I know my colleagues on the committee would be disappointed if I did not raise the obvious issue, and that is, why are we having this debate in America where we, among the industrial nations, rely less on government? Why do we not have a competitive advantage in our tax code as far as marginal rates go? Of course, the reason is that we restrict to basically income taxes, whereas the rest of the industrial world uses consumption taxes along with income taxes.

If we were to harmonize with the international community, we could have lower tax rates. If the C rate was somewhere around 17 percent, I do not think we would be having this debate today. I do not think that would be an issue.

So I hope, by design—and I agree, Professor Warren, we can design this. I hope, by design, we recognize the need to harmonize with the international community and design a code that is, I hope, more progressive than our current code in helping the low-income families, is revenue-neutral so we are not using it to grow government, but also friendlier towards the area where America historically has not been in this tax code, and that is savings—friendlier towards savings and investment, friendlier towards the problems that we have tried to deal with through the tax code but have not been successful in doing.

The CHAIRMAN. Okay.

Senator Casey?

Senator CASEY. Mr. Chairman, thank you very much, and thank you for allocating this time to this issue. It is critical that we dedicate this kind of time on consequential and complicated issues that involve tax reform. We appreciate the scholarship and the contribution of the panel that is here today.

Ms. Lurie, I am going to start with you for a number of reasons, but principally because of your Pennsylvania roots and your distinguished record, not only in business but as a Bryn Mawr graduate. Your husband is here? Can he put his hand up there? Right there? Oh, okay. I want to make sure—and he is a Reed Smith lawyer?

Well, this is really impressive that a Reed Smith lawyer is staffing you today. I appreciate you doing that. The chairman knows from his early days as a lawyer how significant that is, because he was a Pittsburg lawyer in days gone by. But we are grateful you are here.

I want to start with you on kind of a broad question. When I talk to businesses in Pennsylvania and I bring up the issue of tax reform, they become very animated, for a good reason. They hope we will confront it and deal with it and come to a conclusion. But they also usually list a number of aspirations, but also a number of cautionary flags. They want us to tackle tax reform for all of the reasons that are obvious, but they also caution us to not change the code in a way that would adversely impact innovation or would adversely impact investment.

So I want to start with you and Mr. Buckley on a question that I think is not only central to firms in Pennsylvania, manufacturing firms especially, but a whole range of folks across the business sector. One is the potentially adverse impact that this proposal could have on both accelerated depreciation and the R&D tax credit or similar provisions that are in place now. What is your sense of that?

Ms. LURIE. Thank you, Senator. I think what we have to look at when we are tackling this idea is how it is going to affect different businesses and different industries, because I think different businesses and different industries are going to have incentives to do one plan over another, and they are either going to benefit from a dividends paid deduction or not. There are companies that do depend on the R&D credit, that do depend on having that, and then having that structure where they are incentivized to give more dividends out would certainly offset that a little bit.

So I think there are a lot of hurdles that we will have to cross in order to figure out what industries are going to get negatively affected versus those that might be positively affected by some sort of change in the tax code.

Senator CASEY. Mr. Buckley, especially on accelerated depreciation, what is the point you are making on that?

Mr. BUCKLEY. Well, under current law, a corporate manager is actually neutral as to whether he distributes earnings or retains earnings. That decision does not impact his corporate tax liability.

If he distributes, there is the potential of a shareholder tax, but for him making a decision, it is neutral if he is focused at the corporate level.

In that context, accelerated depreciation is a robust incentive to keep the money, invest the money, grow the company. In the future, it may no longer be a neutral choice at the corporate level. If he distributes the earnings, he gets an immediate reduction in tax, far more robust than what he would get if he invested those earnings and used accelerated depreciation.

I think it dramatically reduces the incentive effect, and that, I think, should be of concern to this committee. I admit accelerated depreciation is not neutral, but in my opinion it is not neutral in favor of investment in the United States, and that is the type of non-neutrality that I am more than happy to support.

Senator CASEY. I know we do not have a lot of time. Maybe I will submit this for the record, but other issues where there may be potentially adverse impact—I mentioned investment. I also mentioned having the tools to respond to a recession, but in the interest of time——

So thank you very much. I appreciate your time.

The CHAIRMAN. Senator Warner, we will turn to you.

Senator WARNER. Well, thank you, Mr. Chairman. I get, I hope, an extra minute for waiting for the last.

Let me start, because I have a number of things—I would like to make a couple of comments and take it in a slightly different direction.

One, I really appreciate the fact that you are digging into this. This is not easy. I think regardless of where we sit—which side of the aisle—I think most of us would, at least, privately acknowledge you could not create a more complicated, messy tax code than we have in America.

Yet, with this complexity also comes the problem that, out of the 34 OECD nations, we are 31st in terms of total revenue. So we have complexity, and yet vis-à-vis our competitors, we are at an extraordinarily low revenue rate.

So the fact that you are willing to take this on—I commend you. The absurdity of the, kind of, double taxation that has to be addressed, and the lock-out of the $2.4 trillion of earnings caught abroad that need to be repatriated, are important questions.

I, personally, am someone who has spent a bunch of time fighting for the Simpson-Bowles-type approach that is based, Mr. Buckley, on the old idea of, let us lower the rate and get rid of some of the exclusions. So I intellectually believe that, but I find some caution on that.

One, when we used to think that we could lower the rate from 35 to say 28 or 25 percent when the rest of the world has moved now with patent boxes and other tools to rates that are even substantially lower, I am not sure we are going to be able to chase that rate down low enough to stay competitive, when just taking into account—and I voted for this at the end of last year—that we just added another $680 billion of unpaid tax exclusions that we made permanent. So if anything, we are going the opposite direction.

I give Professor Warren credit for acknowledging the fact that it may be time for us to look at new revenue sources so we can bring down the rate to a level that will keep us competitive. I also think that some of my colleagues have raised this issue. There are preferences about a pro-American investment around R&D and accelerated depreciation.

Senator Heller's comments about what the new normal is—I worry that we also have a tax code that, even with all of its components, frankly, so favors investment in plant and equipment over human capital that we have this combination of globalization, technology, and activist investors that makes it so the first thing that businesses eliminate, particularly for short-term returns, is any kind of investment in human capital.

The terminology—we think, if you invest in plant and equipment, that is an asset. If you invest in training a human being, that is a cost.

So, I guess where I would like to go in my question—since I have used up 3 minutes of my time already—I want to hear from everyone. Ms. Lurie, you touched on this in your testimony. Even with all of these distortions, we have seen, I think, a reluctance among American businesses to make long-term capital investments, whether it is in human capital or plant and equipment. I fundamentally believe we have a problem in modern American capitalism around "short-termism" versus long-term value creation. I fear that as a 20-year capitalist and someone who has spent more time on the business side than on the political side, that short-termism will destroy long-term value creation and really undermine our country.

I would actually like to hear from all of you. Even if we can try to make sure that we try to keep some of the incentives right in this modified system that we have moved to, is this problem of short-termism real, number one? And number two, in even a well-designed corporate integration system, will that not accelerate distribution of profits rather than the kind of long-term capital investment, both in plant and equipment and in human capital, that would move us past these ½-percent growth rates that we have seen?

Considering the fact that I went last, can I get an extra 30 or 40 seconds to have all of the witnesses respond, Mr. Chairman?

The CHAIRMAN. Sure.

Professor WARREN. My own view is a little different from some other members of the panel about an incentive to distribute earnings under an integrated system. I think the missing element is the relationship between the rates. That is to say, a lot of the discussion has been on the assumption that retained earnings were great in a period in which individual rates were very high, 70 percent at one point. Corporate rates were 30 percent.

Of course under those circumstances, there is definitely an incentive to retain earnings, but it is primarily due to the difference in those tax rates. You want your money compounding in an after-tax rate of 35 percent, rather than an after-tax rate of 70 percent.

An important element of all of this—and responding to your question—I think, is that the committee has to think about not just the structure, whether we have separate taxes or integrated taxes, but also the rate relationships. You could imagine rate relationships where there would be an incentive to distribute earnings: a very low shareholder tax rate and a very high corporate tax rate.

But you can adjust those rates. Obviously, there are all sorts of other constraints, but those rates would have enormous impact on whether or not there is going to be a distribution, and whether or not we stay with a separate tax system or go to an integrated system.

Senator WARNER. Thank you.

Ms. Lurie?

Ms. LURIE. Thank you, Senator. So I think shareholders are inherently impatient, whereas bondholders—not to favor the bondholder side—are a little bit long-term driven, just because they know that there is a life of a bond and it matures over that life of the bond, and they get their principal back.

I think with that concept of being impatient, if you allow companies to be able to more readily push money out the door to the shareholders, then I think you will have more short-termism, as you described, and less of that long-term viewpoint.

Now, one question I did want to bring up—and this speaks to the chairman's write-up in 2014—is the discussion about how many companies are actually corporations versus alternative structures, and to compound on that, how many companies that have that C corp structure have shareholders that are actually being affected by a change in the double taxation to a single structure, versus how many debtholders would be affected, and if that would then negate any benefit you are seeing on the shareholder side from putting back money into the economy.

Senator WARNER. Thanks.

Mr. BUCKLEY. You know, Senator, I share your concern about short-term thinking among corporate management. In part, it may be due to the rise of activist investors and other factors. Their focus, increasingly, is on increasing earnings per share in the short run. That is the reason why you see these big stock buybacks. It is the easiest way to increase earnings per share to report to shareholders, rather than investing the income for the long-term.

You know, I do not see the dividends paid deduction changing that, other than changing the form in which they return the income to shareholders. Increasing the dividend will have a much more dramatic impact on current earnings per share than a stock buyback. For every dollar per share you increase a dividend, with a dividends paid deduction, you would increase earnings per share by 35 cents for disinvesting your corporate assets.

I think you raise a tremendously important point. On human capital, the only slight quibble I would have is, it is very difficult for corporations to robustly invest in human capital, because human capital is mobile; therefore, I think the response to that has to be greater involvement with government education programs, job training programs, et cetera.

Mr. McDONALD. I think the reason that the companies are chasing earnings per share is because there is not another reliable metric. I think if companies were more inclined to distribute their dividends and shareholders were, therefore, able to invest in companies based on long-term dividend streams, you would have more long-term thinking.

I think the other thing that we should take a step back on and ask ourselves is, what are these companies growing for? They are growing for the shareholders. They are the owners of the company. So rather than penalizing companies that pay dividends to shareholders—it is, after all, their company—I think we should be, at best, neutral between debt and equity financing and just not penalize companies for distributing dividends out to those who are the owners of the company.

Senator WARNER. Mr. Chairman, I just would like to, again, say thanks for being willing to take this on. I do think if we want to move beyond whatever this new normal is, the idea of how we simplify our system but incent long-term value creation has to be part of this ongoing discussion. I think there is a lot of bipartisan agreement on that. Thank you, Mr. Chairman, for the extra time.

The CHAIRMAN. Well, thank you. I appreciate you being here.

Let me just say, there has been some talk about corporate integration and tax preferences during this hearing. I want to clarify that the dividends paid deduction is not mandatory. In other words, companies will not be forced to pay out their taxable income in the form of dividends. Some companies, I think, would decide to retain some or all of their taxable income. Those companies can use these tax preferences to reduce or eliminate their tax liability. I expect that companies that already have these tax preferences will use them to reduce or eliminate their tax liability rather than let them go to waste.

Let me just ask a question for both Professor Warren and Mr. McDonald. I would like you both to answer this. Let us start with you, Professor Warren. Should the tax system encourage corporations to retain earnings? As I view it, Ms. Lurie and Mr. McDonald have both said "yes."

Professor WARREN. So my view is different. My view is that this is a dimension on which the tax system should be neutral.

The CHAIRMAN. All right. Let me ask you, do you feel the same way, Mr. McDonald?

Mr. McDONALD. I also think the tax law should be neutral. I agree. It should be neutral. We should not incentivize companies to hoard cash.

The CHAIRMAN. Well, let me just say this: corporations like Apple have lots of cash, exceeding $100 billion as I understand it. Yet, Ms. Lurie points out they are issuing a large amount of debt. Why is that?

Ms. LURIE. Thank you, Mr. Chairman. I think, at the end of the day, companies are not going to pay that repatriation tax unless they really feel like they have to. If the cost of debt is significantly below the repatriation tax, they are going to borrow, because they do have the cash there, it is just not necessarily accessible.

So I think companies are sitting on the cash in hopes that there is going to be a repeal of the repatriation tax sometime down the road.

The CHAIRMAN. Mr. McDonald, would you take a crack at that?

Mr. MCDONALD. Well, that is one of the advantages, as I mentioned before, of a dividends paid deduction, that currently the company that you mentioned is penalized if they bring that cash back to pay out a dividend to their shareholders. Whereas, if we were to enact a dividends paid deduction, that cash could come back. There would be a tentative tax computed, but then the dividends could be paid out to the shareholders and eradicate the tax. So that is one of the big advantages of a dividends paid deduction.

The CHAIRMAN. Again for Professor Warren and Mr. McDonald, if shareholders receive more dividends as a result of the dividends paid deduction, is that bad?

Professor WARREN. In my view, no.

Just to back up a moment. These are the kinds of decisions that should be made in the private sector based on market conditions without pressure one way or the other from the tax system.

The CHAIRMAN. Does this mean less investment in the economy?

Professor WARREN. I know of no reason to think it would mean less investment in the economy.

The CHAIRMAN. Well, shareholders tend to put such money towards its highest and best use, which might be current consumption, or it might be reinvesting in the corporation that paid the dividend, or it might be putting the money into another investment. Is the money somehow wasted because it is paid as a dividend?

Professor WARREN. Not in my view.

The CHAIRMAN. Mr. McDonald?

Mr. MCDONALD. I totally agree.

The CHAIRMAN. See, where I am having some difficulty is, I cannot see why anybody would be against what we are trying to do here. I can see where you would want to mold it and make sure you get it the very best you can.

Ms. Lurie, in Mr. Buckley's written testimony, he wrote, "In my opinion, tax reform should be designed with the goal of increasing economic growth, expanding employment in the United States. Our tax system should be based on principles of economic neutrality as long as that neutrality tilts the playing field in favor of investment and job growth in the U.S." Do you agree with Mr. Buckley's statement?

Ms. LURIE. I do.

The CHAIRMAN. All right. A well-respected economist, Martin Sullivan, recently published a cover story for *Tax Notes* magazine in which he concluded that corporate integration would tilt investment to the United States. This is what he came up with. I am sure you are familiar with that.

Dr. Sullivan wrote that, "Integration of the corporate and individual tax would eliminate the disparity between debt and equity and between pass-through entities and C corporations." He then provides a number of examples that show that, "In addition to reducing distortions in the domestic economy, integration disproportionately benefits domestic investment."

Do you have any problems with that?

Mr. BUCKLEY. Mr. Chairman, the only thing I would ask is whether he contemplates withholding taxes on dividends and interest payments made by U.S. corporations. I think that will be a bar to foreign investment in the United States, particularly an investment in debt securities, because you are reducing the yield that a foreign investor will get when he purchases a debt obligation of the United States corporation.

That foreign investor will not face a similar reduction in yield if he simply keeps his money overseas and invests in high-quality bonds issued by foreign corporations.

So I think there is potential here for decreasing foreign investment in the United States, particularly in our debt market.

The CHAIRMAN. Mr. McDonald, do you agree with that?

Mr. MCDONALD. Well, I would revisit the opening question I started with, which is, is it right that certain portions of debt-financed U.S.-sourced business profits bear no U.S. income tax? It is one thing if the lender happens to be in a treaty jurisdiction where at least there is an assumption that the lender is bearing a full rate of tax in their host country, but that does not apply to portfolio interest exemption. The individual is not paying any tax in the United States. They may not be paying any tax in the foreign jurisdiction. So no tax is applied.

The CHAIRMAN. Professor Warren, do you have a comment?

Professor WARREN. This is—as with respect to almost everything we have talked about today—a complicated issue. In this case, it would depend on how the markets would react, whether or not there would be other sources of interest that would not be subject to withholding, and whether American issuers would gross up the interest paid to lenders. If so, that would put a burden at the corporate level rather than at the lender level. So I think this is a very complicated question.

I do not think it undermines the basic analysis in the Sullivan article that you talked about.

The CHAIRMAN. Look. What I am concerned about is that we have a lousy tax system in this country. We are losing internationally. Our companies are inverting, many of them. The administration's approach is to penalize the companies rather than incentivize them.

We are causing our country all kinds of problems here because we want to do the whole tax code. I would love to do that, but we are not going to do it this year in this time frame. I see this as a way of stopping some of the inversions and also putting incentives where they ought to be. No matter what you do, somebody is going to find fault with it, but the fact of the matter is, our current system is broken and not working. And our country is in dire jeopardy if we do not start doing some things that might work. We cannot keep spending and running up national debt. So it is important that we get this tax system right. To be honest with you, I am very, very concerned about it.

Let me just ask one more question. I have stipulated that the corporate integration discussion draft will be revenue-neutral. Right now—from what I have been told—it is revenue-positive, but we want it to be revenue-neutral and maintain the progressivity of the tax system.

Those two stipulations which irritate some on my side, by the way, have seemed to have been ignored by the other side. Suppose, in addition to meeting those goals, the discussion draft has revenue-neutral options to resolve the lion's share of the objections, for instance, that Mr. Buckley has raised.

If the discussion draft cleared those hurdles, Mr. Buckley, would there be a policy reason remaining to maintain the double taxation of dividends? Then let me ask Professor Warren and Mr. McDonald to feel free to comment as well.

Mr. BUCKLEY. If the discussion draft is successful in addressing a whole range of issues, I see no policy objection. Now, if it creates a set of new distortions and new dislocations, then I think there is reason for caution.

The CHAIRMAN. Well then, we should never do anything, because we are going to have some new distortions and new dislocations, perhaps. I do not know. I do not particularly think that is what is going to happen here.

Professor Warren and then Mr. McDonald.

Professor WARREN. I would just say here—pretty much on the same comparison, I think, that Mr. Buckley just made—that at the end of the day, one has to compare the final version of the proposal with current law. My view is that the path that the committee is on in developing a proposal is a very positive path, but we have to wait and see the final version.

The CHAIRMAN. That is great.

Mr. McDonald?

Mr. MCDONALD. Aside from a dividends paid deduction, there is only one other door to walk through, which is to basically copy the system of our trading partners. There are a lot of features of that system that people on the other side of the aisle are not going to like either, like a territorial system. A dividends paid deduction gives people more optionality as to what they are going to do with international tax reform.

The CHAIRMAN. Let me ask you this, Professor Warren: regarding debt and equity, our tax system has a bias against financing a C corporation with equity. Should we get rid of that bias against equity and instead create a level playing field?

Professor WARREN. Yes, I believe we should. I think one of the really telling points is the demonstration in the pamphlet prepared by the Joint Committee on Taxation for this hearing, that you can end up with—and we have today in many companies—an effective negative corporate tax rate on tax-preferred investments that are financed by debt. I do not know of any policy reason why we would want to have a negative corporate tax rate.

The CHAIRMAN. Well, in other words, should we let the business decide how it should raise the money it needs to operate without the tax code influencing that choice?

Professor WARREN. That would be my position.

The CHAIRMAN. Does anybody disagree with that position?

[No response.]

The CHAIRMAN. Now is your chance.

[No response.]

The CHAIRMAN. Well, let me ask Mr. Buckley this question. Professor Warren and Mr. McDonald have shown the link between corporate integration and the responses to many of the problems with the U.S. business tax system, including inversion transactions. Now, I appreciate the cautionary counsel that you are providing us as members today: pursuing integration means dealing with political barriers that will not be easy to clear. If we take your advice and discard the dividends paid deduction and any efforts to balance debt and equity, what do we do to counter the problems of the business tax system that Professor Warren and Mr. McDonald are trying to remedy?

Mr. BUCKLEY. Again, Mr. Chairman, I will answer it like I did to Senator Heller. I think the best approach going forward is broad-based reform with corporate rate reductions.

The CHAIRMAN. We all agree with that, but have you noticed how inept the Congress is in approaching that? We do not have the time this year to do that, and even if we did, we could not get it through because of the political year.

I guarantee you that if we can get through this year, and we are still in the majority——

Mr. BUCKLEY. But you have to be very——

The CHAIRMAN. Let me finish.

Mr. BUCKLEY. Okay.

The CHAIRMAN. If we are still in the majority, we are going to do it in the next couple of years. We will do that full tax reform, and I do not care who puts up a roadblock, we are going to roll right over it, because we have to have it. We have to be competitive in this world. Right now, just throwing that up as a block does not mean anything.

Now, what I am trying to do is get us somewhere with corporate integration, and I would like to have your genius, and you two as well. Help us to know how to write this if that is the problem. Help us to know what to do. Let us talk in terms of positiveness, because I think you can see that this is an idea that has some merit. The question is, how do we write it? How do we make it work?

I am challenging both Mr. McDonald and Professor Warren to help us too.

Mr. BUCKLEY. Mr. Chairman, I think one of the aspects of this proposal that has to be addressed is its impact on corporate bond rates. I mean, Professor Warren essentially alluded to the fact that U.S. companies may have to gross up their interest payments to reflect the new withholding tax.

Let me say I disagree with Mr. McDonald. That burden of that withholding tax will not be borne by the foreign investor. It will be borne by U.S. companies who, for legitimate business reasons, are debt financing their business expansion. They will be facing a cost increase that their foreign competitors overseas will not.

So my suggestion—if you are going ahead—is, you have to figure out some way of making sure you do not negatively impact the economy by increasing the interest rates that corporations have to pay to finance——

The CHAIRMAN. I have the same concern.

Mr. McDonald?

Mr. MCDONALD. Yes. So that foreign lender is, presumably, in competition with U.S. lenders who are going to be subject to tax. Now, I have not seen the proposal and I do not exactly know how this withholding tax is going to work, but presumably this withholding tax is not designed to create a double tax. It is presumed to be creditable against that U.S. lender's tax liability.

If that is the case, then you have foreign lenders and you have U.S. lenders competing to lend money to those corporations. I do not exactly accept the notion that the corporation is automatically going to bear the burden of that higher interest rate.

Mr. BUCKLEY. Let me, again, slightly differ. Most—it is almost all—U.S. investors in corporate debt securities are tax-indifferent investors; they face no U.S. tax on their interest income. So they are in the same position that the foreign investor is, that that withholding tax is a reduction in their interest yield.

The question this committee has to ask is, are they willing to accept a lower interest yield and continue to make the same level of investments? I see no reason why they would do that.

The CHAIRMAN. Professor Warren, it is up to you to resolve this conflict. [Laughter.]

Professor WARREN. The facts here are very interesting. I am looking at the pamphlet issued by the Joint Committee on Taxation for today's hearing. I was actually surprised to learn the very high percentage of U.S. corporate bonds that are held today by regulated investment companies and by insurance companies, which is an additional dimension on this debate.

If the regulated insurance companies are passing their attributes through to the investors, then those investors may well be taxable, depending on their position. As we all know, insurance companies are taxed under an incredibly complicated scheme. So I have not even started to think about how you would think about integration with the withholding on debt where the interest goes to insurance companies.

So my view is that this is an important issue that needs to be worked on and considered, but I do not regard it as being something that would so clearly be detrimental to U.S. interest that we should not try to figure it out.

The CHAIRMAN. Well, I agree with that statement. You know, the interest withholding proposal is designed to deal with the bias toward debt, in general, and earnings stripping of the U.S. tax base in particular. The withholding proposal attacks the biggest form of earnings stripping, and that is excessive interest deductions.

What is more, many tax reform proposals fully or partially deny this deductibility of interest. Now, denying the deduction is the economic equivalent, in my opinion, of the interest withholding proposal with respect to tax-exempts and, of course, foreigners.

Am I wrong in making that statement?

Professor WARREN. No. I do not think so. What I would say is that the interest withholding proposal has an advantage over the denial of deduction proposals in that there would be a possibility of portfolio shifts so that taxable shareholders might purchase bonds on which interest had been withheld to use the credit. Therefore, if there had to be any gross up, it would be less.

The CHAIRMAN. All right. Ms. Lurie, I think one of your main points is this, that many firms are over-leveraged; that is, they have too much debt. Now your concern is that if there were not incentives to retain earnings, then firms with high debt would not have adequate cash reserves on hand to pay their regular debt payment should there be a downturn in the firm's business fortunes.

So my question is, if you think that firms are over-leveraged, then would not at least one partial solution to that problem be to stop giving debt such favorable tax treatment as compared with equity?

Ms. LURIE. I think you have to look at a couple of different pieces that we have in real life, where we have seen it proved out where companies do not have as favorable a treatment towards debt as they do have to equity. In those scenarios, we did see that companies still did, in fact, over-leverage, and, in fact, they will continue to do so if the cost of debt is cheaper than the cost of equity. So if there is always going to be that margin, then they are going to lever up with debt and give away equity, and they do not want to dilute their equity shares.

The CHAIRMAN. Mr. McDonald, let me have your views on that. It seems to me—maybe you could give us the benefit of your feelings.

Mr. MCDONALD. Yes, well, Ms. Lurie references MLPs. Except with a very narrow class of publicly traded partnerships, they are subject to two levels of tax, because what they are invested in is C corps. The fact that you enact a dividends paid deduction is not automatically going to cause people to issue a bunch of common equity in order to pay down their debt. It is going to have a dilutive effect. I agree with that.

But I do think—and it is a guess—that if you had a dividends paid deduction that equalized the playing field a little bit, you would see greater reliance on nonparticipating preferred stock as a greater option by issuers than you see today, instead of debt.

The CHAIRMAN. Now, Mr. McDonald, you wrote—sorry to keep you so long, but this is extremely interesting to me, as you can imagine. This has been a particularly good panel, I believe.

You wrote, "The committee should consider how far it wants to tip the scales in favor of equity financing." Would the dividends paid deduction proposal tip the scales in equity's favor or merely make the tax code neutral as to whether a corporation finances with equity or debt?

Mr. MCDONALD. Yes. It entirely depends—this is what I was trying to stress in my written testimony. It entirely depends on a series of second- and third-order decisions you are going to have to make. Interest is not always up-side to a corporation. It has a deleterious effect on their foreign tax credit limit, for example, that is probably the biggest negative impact, and there are a whole host of others.

So you are going to have to decide, as a committee, which one of those provisions that have negative connotations to a corporation are equally going to apply to a dividends paid deduction, and that is a policy decision.

The CHAIRMAN. Professor Warren, would you give us your thoughts on this?

Professor WARREN. Well, again, my view is that we should look for a structure where the tax law is as neutral as it can be between retaining earnings and making distributions. I think that should be the basic policy decision with respect to that issue.

The CHAIRMAN. Does this approach help us that way?

Professor WARREN. Again, depending on some other decisions that you make, I think this approach is on a pathway to do that.

The CHAIRMAN. Well, let me ask this question of Mr. McDonald. The Treasury and IRS promulgated some proposed regulations under section 385 just last month. Now those regulations tend to draw a line between what instruments should be regarded as debt and what instruments should be regarded as equity.

So my question is, are you hearing from your clients about these proposed regulations, and if we assume that the dividends paid deductions were generally coupled with a withholding tax on dividends and interest, what might the implications of that be for the section 385 proposed regulations and the ongoing controversy over whether a given instrument is debt or equity?

Mr. MCDONALD. Yes. With respect to your first question, we are hearing from all of our clients. These regulations were billed as an anti-inversion tool, but they are far, far broader. They apply to companies that are not inverted but foreign-based, and they apply to U.S.-based multinationals that have never even thought of inverting. And they are going to have a lot of second- and third-order deleterious effects on legitimate business activity, which is probably the subject of a whole separate hearing.

But with respect to your second point, I think the dividends paid deduction, if coupled with the withholding tax so that we seek to get at least one level of tax, not two, not zero, but one across the board on all U.S.-sourced business profits, it does more or less obviate the need for these regulations, because you are not trying to prevent people from getting impermissible debt. It does not matter as much whether you are funding with debt or equity.

The CHAIRMAN. Your feelings, Professor Warren?

Professor WARREN. My reaction is similar. That is to say, we have a big difference today between debt and equity. There are different ways you can approach it. The integration proposal approaches it by making the treatment the same. The proposed 385 regulations approach the discrepancy by moving the line between what is debt and what is equity, so that fewer things would be considered debt.

Where that line is located and the pressure on the line would be less of a problem if we had less differential taxation of debt and equity.

The CHAIRMAN. My personal view is, it is a stupid approach towards trying to solve this problem.

This question is for you, Mr. McDonald. You have worked extensively in the field of international tax law. Can you briefly tell us the interrelationship between earnings stripping and the phenomenon of inversions, and can you please tell us how this proposal, a dividends paid deduction coupled with a withholding tax on dividends and interest, might address that issue?

Mr. MCDONALD. Yes. Well, earnings stripping—there are a couple of different ways that you can do earnings stripping, but earnings stripping through a debt issuance is one of the ways that companies that are inverted can get an immediate reduction in their effective tax rate over a very short period of time. So the favorable treatment that the code currently gives debt over equity actually incentivizes that short-term benefit from inversions. I think, again, the dividends paid deduction, not in isolation, but coupled with a withholding tax so that we ensure all business profits are subject to one level of tax, would, in fact, reduce the incentive to invert.

The CHAIRMAN. Thank you.

Professor Warren?

Professor WARREN. I basically agree with that.

The CHAIRMAN. Okay. Well, this question is for Ms. Lurie, and I invite Mr. McDonald to share his thoughts also.

Now you have expressed concern that the new policy could encourage "lumpy" dividends as the corporation's profits fluctuate. Do you think this concern would be alleviated by allowing a dividends paid deduction to generate an NOL that can be carried back or carried forward to reduce taxable income in other years?

Ms. LURIE. Thank you, Mr. Chairman. I think it would really depend on how the actual structure would work. I think really more than anything, figuring out what the withholding tax and the dividends paid deduction, versus an interest withholding, would look like, I think, will really sort of dictate whether or not a company sees themselves as benefitting from giving to shareholders in 1 quarter, 1 year, an outsized amount or not.

I think companies already utilize NOLs to their full potential if they can when they have them, either through acquisitions or through looking at years to take advantage of them. So I think that would just further that issue, but it would really sort of beg the question of looking at this situation further.

The CHAIRMAN. Okay. This question is for Mr. Buckley, but if Professor Warren or Mr. McDonald has any thoughts on this matter to share, I would welcome those.

Almost a decade ago, then Ways and Means chairman and a friend of mine, Charlie Rangel, had a tax reform proposal that, among other things, would have allocated certain interest expense deductions to foreign income enjoying tax deferral. Would the effect of that have been to significantly delay or even sometimes effectively disallow such interest deductions?

Mr. BUCKLEY. Well, it obviously would have delayed the interest deductions until the related foreign income was repatriated. Now, that is obvious, its impact.

The CHAIRMAN. All right. Mr. McDonald, do you have any comments?

Mr. MCDONALD. No, other than it is kind of the other side of the coin. Instead of taxing the tax-exempt shareholder who is receiving the interest income, we are simply deferring, potentially indefinitely, the interest deduction to the corporation.

The CHAIRMAN. Professor Warren?

Professor WARREN. I agree with Mr. Buckley.

The CHAIRMAN. You are getting off easy, Professor Warren. Let me ask this of Mr. Buckley.

In your written testimony, you favorably cite Mr. Talisman's article a couple of times, which focused on keeping corporate interest fully deductible. It appears the article was written—at least in part—in response to Senator Wyden's tax plan, which would disallow the interest deduction related to the inflation component.

I want to focus on part of Mr. Talisman's conclusion. He writes, "Also, as proponents for a limitation readily admit, the real culprit for any debt bias is a double-level tax on C corporations, leading to the conclusion that it would be far better to eliminate double taxation than to expand it to an elimination of interest deductions."

Do you agree with Mr. Talisman's conclusion that (1) the real culprit for the debt is the double-level tax on C corporations and (2) that it would be far better to eliminate double taxation than to expand it to an elimination of interest deductions?

Mr. BUCKLEY. I think I agree with Mr. Talisman's article. The only thing I would say is, it never occurred to me that a corporate integration proposal would couple a dividends paid deduction with essentially a withholding tax that, as you point out, is equivalent to denial of the business deduction for interest. I just think the two of them are a little bit too much to respond to what, let me concede, is a problem. But again, this is where I keep disagreeing with Mr. McDonald. That withholding tax will not be paid by the investor. It will be paid by the company, and it will have an impact on the company equivalent to what you would get from a disallowance of the interest deduction. I just find it surprising to see the two of those items combined in a corporate integration proposal.

The CHAIRMAN. Mr. McDonald?

Mr. MCDONALD. I keep coming back to the fact that there was never in our Internal Revenue Code, as far as I am aware, a conscious decision to have a certain slice of business profits that were simply subject to no tax at all. So I get that moving to a situation where we have one level of tax on interest held by tax-exempts is a change. The question is, whether it is a change for the better or a change for the worse.

The CHAIRMAN. All right. Mr. Buckley, you list in your written testimony several non-tax reasons for a corporation to finance itself with debt rather than with equity. But do any of those reasons mean the tax law should create a bias in favor of debt over equity? In fact, if the reasons for debt financing are sufficiently strong, might this not suggest that debt financing would be less elastic in response to tax and thus, if anything, might be a more suitable object for heavier taxation than equity financing? I would invite Professor Warren and Mr. McDonald to comment as well.

Mr. BUCKLEY. I believe that, even with a fairly robust increase in the corporate interest rate that could occur due to the withholding tax, for many companies, debt financing will still be very, very attractive. It is a lower cost, because the bondholder has less risk and, therefore, demands a lower rate of return. It also does not involve diluting the stock ownership in the company.

However, what you are doing then is increasing the after-tax cost of a financing mechanism that is chosen by corporations for good and valid business reasons. That can only lead to less business investment in the United States or—let me leave it at that. It can only lead to companies reducing their investment plans, because you have increased the cost of external capital to the company through external withholding tax.

The CHAIRMAN. Professor Warren?

Professor WARREN. I disagree somewhat. That is to say, I disagree with the premise of Mr. Buckley's statement that the debt financing is necessarily for good business reasons. People debt finance today to get the advantage of a negative tax rate. I do not regard that as an appropriate use of the tax system.

So I think you have to think about the interaction of the interest deduction with the other tax preferences that are in the code.

The CHAIRMAN. Mr. McDonald?

Mr. MCDONALD. I agree.

The CHAIRMAN. All right. Professor Warren, in your testimony—are you getting too tired? Are you okay?

It is very seldom I get to ask a lot of questions. I can take my 5 minutes, and then we have 20 others who do it. So this is a field day for me, and it has been a wonderful panel, as far as I am concerned.

Professor Warren, in your written testimony, you note that, with respect to tax-exempt shareholders and debtholders, "One approach would be to determine the corporate taxes paid on dividends to exempt entities and then to enact an explicit tax on their income from corporate investments, against which corporate taxes or withholding would be creditable and refundable. The level of the new tax could be set to maintain, decrease, or increase the current tax burden on corporate income received by exempt entities. In 1992, the Treasury estimated that such a tax in the range of 6 to 8 percent would approximate the then-current corporate tax on dividends paid to exempt entities. This general approach, which was recommended in the 1993 American Law Institute study, has the advantage of minimizing tax differentials. Some would say it has the disadvantage of recognizing explicitly the rate of tax at which tax-exempts are taxed on their investment income."

Now some have suggested, under a corporate integration proposal, tax-exempts would bear the same tax burden on corporate earnings as taxable shareholders and bondholders. Would a modest tax on the investment income of tax-exempts alleviate such concerns?

Professor WARREN. Well, I think it depends on how you actually structure it. So if you take the example of a dividend deduction with withholding where the dividend is paid out of corporate taxable income, say at 35 percent—which is the example given in the committee's materials—if that were nonrefundable, the exempt investor would end up having a burden on that kind of dividend that is exactly the same as is levied today under the corporate tax. It would not be called a corporate tax. It would be called a withholding tax.

Individual taxable investors would be subject to the same rate if the credit were nonrefundable, except for people whose marginal rate was greater than 35 percent. So one way to think about a nonrefundable withholding tax is that it sets a flat rate for that kind of income, and then is subject to an additional tax for higher-rate taxable investors.

Again, everything is in the details, but I do not think it is generally true that tax-exempt organizations would pay taxes at a higher rate than taxable investors.

The CHAIRMAN. In your written testimony, you note that, with respect to retirement plans, "The fact that an integration structure could reduce taxes for investments outside qualified accounts, while holding constant the absolute tax burden inside retirement accounts, should not be considered a defect. The policy of encouraging retirement saving through tax-preferred accounts should not require opposition to reducing taxes on other forms of saving."

Could you please elaborate a little bit on that statement?

Professor WARREN. The basic benefit of either of our two forms of tax-preferred retirement vehicle is the same. In either a Roth IRA or qualified accounts such as a traditional IRA, the basic benefit is being able to compound the income at a zero rate of tax.

If you are outside a qualified account and your marginal tax rate is, say, 30 percent, the advantage of saving for retirement is reducing your tax rate from 30 percent to zero.

If we kept the absolute tax burden on exempts the same, there would be no reduction in the benefit from retirement savings as compared to current law. On the other hand, if we also reduced the marginal rate of tax on investment outside of qualified accounts—say that went from 30 percent to 20 percent—then the relative advantage of saving through a qualified account or Roth IRA would necessarily go down.

In my view, it is important to think about what we want to do about the absolute burden on savings outside qualified accounts and Roth IRAs. We may want to keep it the same. We may want to raise it or lower it. I think that is all totally appropriate.

Being in favor of a strong policy to encourage people to save for retirement—which I am—should not entail opposition to reduction of other tax rates for investments that are held in other forms of savings.

The CHAIRMAN. Well, Professor Warren, you have been involved with corporate integration for many years, having authored a 1993—I think it was—ALI study on this subject. Now, there has been very little disagreement as to whether corporate integration is the right policy. But could corporate integration help with some of the problems we are seeing today, such as base erosion, inversions, the lock-out effect, the high corporate tax rate, and earnings stripping? Would you care to comment?

Mr. McDonald, if you would care to comment after Professor Warren, I would appreciate it.

Professor WARREN. I think the article by Dr. Sullivan in *Tax Notes* that you referred to earlier goes through the arguments, and I basically agree with his analysis. I think it could be a big plus in our current environment, which was not the environment in the 1990s when we last talked about this kind of integration.

Mr. MCDONALD. I would agree. I would just add that interest is not the only way to base-erode. But as it relates to interest, I think that the proposal that is currently being considered would go a long way towards minimizing the impact of base erosion, in the United States at least.

The CHAIRMAN. All right. I am going to ask just one more question, but for you, Professor Warren, you, Ms. Lurie, and you, Mr. McDonald.

One of the justifications for utilizing either the shareholder credit method or dividends paid deduction method of corporate integration is the idea that corporations are mobile today, as evidenced by inversions, and of course, the income of corporations is extremely mobile, as evidenced by BEPS and stateless income. Shareholders, however, are much less mobile. So maybe it makes more sense to tax the corporate earnings at the shareholder level rather than at the corporate level.

I would really appreciate it if you would comment.

Professor WARREN. I agree with that. The world has changed significantly in that regard since the 1990s. I do think it shows that the Congress made a mistake in the 2003 legislation which reduced taxes at the shareholder level and kept them high at the corporate level. I think it puts our companies in a disadvantageous competitive position.

The CHAIRMAN. Ms. Lurie?

Ms. LURIE. I think that while I am no expert in State tax, I think it does bring up that question of interstate commerce and how it would affect what each State is receiving from the companies that are incorporated there, versus what they are receiving from shareholders in each of those States.

The CHAIRMAN. Mr. McDonald?

Mr. MCDONALD. Yes. I think we can all look towards our personal experiences. When we had extraordinarily high marginal rates, people did not suddenly expatriate out of the United States just to avoid taxes. There are a lot of things that keep us rooted where we are as individuals. Those factors just do not play into corporate business decisions, nor can they. So I am absolutely in favor of moving the burden of the tax squarely onto the shoulders of the shareholder.

The CHAIRMAN. Well, let me just make this statement. The allegation of a treaty override—in substance, any withholding on dividends would not be a treaty override. In fact, in the lion's share of cases, those claiming treaty benefits would be better off as to dividends.

As to interest, there is broad agreement that interest payments are facilitating earnings stripping. We need to attack earnings stripping if we want to stop inversions.

Now, 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.

I just wanted to make those comments to set the record straight.

I want to personally thank all of you witnesses here today. I have kept you here longer than I, perhaps, should have.

Professor Warren and Mr. McDonald, you laid out the case for dealing with the primary distortion in our business tax system. Favoring debt over equity does matter.

Ms. Lurie and Mr. Buckley, we also very much appreciated your comments on the issue of debt versus equity.

I would ask everybody—members, staff, policymakers, tax professionals, and our friends in the media—to step back for a moment and reflect on what we have heard today in the context of the big picture. The American business tax system is migrating offshore, whether by foreign takeovers, American management's defensive tactic of inversions, or the formation of businesses overseas. New business that, but for our out-of-date tax system, would be formed here are now being formed offshore.

The European Union and other trading partners are aggressively luring U.S. businesses through tax incentives like patent boxes. At the same time, foreign companies are harassing the leading edge of U.S. firms through changes in their tax and administration. Foreign companies are favored in debt-based acquisitions under our tax policy.

We can respond with targeted, complex regimes like the section 385 regulations, or we can tinker around the edges with anti-earnings stripping proposals. But why not end the gamesmanship? Why not use simple mechanisms instead of complex rules? Why not respond by leading in a different direction, like this committee did in 1986? Why not have the U.S. lead the world in a new direction? Why not have our trading partners respond to the U.S. system, instead of the other way around? While we are at it, why not tilt the U.S. tax system towards retaining U.S. investment and luring more from overseas?

Now, that is where I am trying to go with the dividends paid deduction and parity between debt and equity. My vision is a simpler system: balance between debt and equity financing, which cuts out incentives to shift income overseas, rewards investors for businesses in the United States, and attracts foreign investment.

So I want to thank my friends on both sides of the aisle for their participation in this process. I look forward to exploring the discussion draft with all of you when it is completed.

In concluding, all of this reminds me of a story told by the late Martin Ginsburg who taught tax law at Georgetown for many years, the husband of our Supreme Court Justice. After giving a lengthy lecture about the difficulties in distinguishing interest from dividends, a student raised his hand and said, "Professor Ginsburg, aren't you making this a lot more difficult than it needs to be. It is easy to distinguish interest payments from dividends. If it is deductible, then it must be interest. If it isn't, then it must be a dividend."

Of course, it is not really that simple, but it could be. That is what we are trying to get to with our corporate tax integration proposal.

I appreciate all of you for adding to our understanding and knowledge here today. This is an important hearing, and I take it very seriously. I am trying to solve some problems without the politics involved. I would like to bring both sides together as we did last year with 37 bipartisan bills that this committee passed out—already this year, with a number of bipartisan bills. This could be a bipartisan approach to help deter the inversions and at the same time put us into a better tax system than we currently have today, at least with regard to these issues that we are trying to resolve with this corporate inversion approach.

I would appreciate each of you thinking about that and sending us your best ideas on how we might accomplish this without a lot of difficulties and problems that could arise otherwise. We are very grateful for you being here. We are very grateful for you being willing to stay this extra time.

With that, we will recess until further notice.

[Whereupon, at 12:20 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of John L. Buckley, Former Chief Tax Counsel, Committee on Ways and Means, House of Representatives

INTRODUCTION

Chairman Hatch, Ranking Member Wyden, I want to thank you and the other members of the committee for the opportunity to appear before you today.

Mr. Chairman, I believe that you should be commended for the way in which this committee has approached the issue of tax reform. Bipartisan working groups foster understanding across party lines, a necessary component of a successful tax reform effort. The hearings that you are conducting reflect a commitment to a careful examination of the issues. As you continue the process of developing tax reform legislation, you may want to take into account comments once made by a former chairman of this committee, Senator Moynihan. "The idea of a new set of simple rules is always appealing. However, any time a change of this magnitude is under consideration with huge potential risks to the economy and shifts of fortune in the balance, we must approach proponents' claims with caution and healthy skepticism."

The subject of today's hearing, the double taxation of corporate income, has been the subject of debate for an extremely long time. Based on my experience, interest in the topic has been much greater within the academic community than the corporate community. Indifference or outright opposition from the corporate community played a large role in the defeat of the corporate integration proposals made by the Reagan, George H.W. Bush and George W. Bush administrations. During my career as a congressional staffer, the only lobbying that I experienced on this issue occurred when individuals representing several large corporations came in to express opposition to the George W. Bush administration proposal.

I have to acknowledge that details matter and that the opposition to the Bush administration proposal was based on opposition to its method of delivering the relief, a shareholder exemption for dividends paid out of fully taxed earnings. Press reports indicate that a quite different proposal is now being considered. That proposal would provide a deduction for corporate dividend payments similar to the current deduction for corporate interest payments. The cost of the new dividends-paid deduction would be offset by the imposition of a 35%, nonrefundable, withholding tax on the payment of corporate dividends and interest. The proposal could effectively repeal the corporate income tax for most corporations, as they shift funds allocated for stock buybacks to increased dividend distributions. It is likely the only corporations that would continue to have significant liability would be corporations which need to retain earnings to fund future growth or which for regulatory purposes are required to increase their equity capital (banks and other financial institutions are an example). The proposal promises far greater benefits to corporations than previous ones and it is possible that it may receive a different reaction from the corporate community. But, details matter and I believe that the new withholding taxes will be problematic for many corporations and their shareholders.

I believe that politics will, and more importantly should, play a large role in the development of tax reform legislation. I mean to include both the politics necessary to assemble the congressional majorities required for enactment and the more difficult task of assessing the potential for negative public response after enactment. Tax proposals enacted without regard to politics can have a fairly short life span. For example, in 1982 the Congress enacted a withholding tax on dividends and interest. It was a small withholding tax with a 10% rate. It was fully refundable and only applied to payments made to individuals, exempting payments to corporations, individual retirement funds, pension funds, other tax-exempt organizations, and foreign investors. It was repealed before it took effect as a result of the public outcry.

The proposal being discussed today includes a far greater and more expansive withholding tax of 35% on all corporate dividend and interest payments, without regard to whether the recipient is tax-exempt. It would be nonrefundable. As a result, individuals would face at least a 35% rate on dividend and interest income, even if they were in a lower marginal tax rate bracket. Tax-exempt entities, including pension funds and individual retirement plans, would effectively pay tax notwithstanding their exempt status.

If the proposal were enacted, individuals with individual retirement or 401(k) plans would receive statements showing a reduction in their investment income due to the withholding tax, but no corresponding benefit, as is the case with other withholding taxes. In the case of dividend income, you could argue that the proposal merely substitutes direct tax liability for the indirect burden of the corporate tax. No such argument would be available in the case of interest payments due to the current deduction for interest at the corporate level. The merits of the argument probably would not matter; I doubt that you will be successful in convincing angry constituents. I believe that the holders of Roth IRAs will be particularly incensed since they essentially waived an immediate tax reduction for contributions to the account in return for the promise of no taxation of the account's earnings in the future.

Essentially, the proposal would impose taxes directly on your constituents and a long list of tax-exempt entities in lieu of the indirect burdens of the current corporate tax. Before legislating, you should consider whether that approach would be able to withstand the attacks that may follow enactment.

Finally, the potential disruptions and distortions that could result from the proposal could dwarf the problems caused by the current double taxation of corporate earnings. For example, corporations may use costly and less efficient leasing transactions involving a non-corporate lessor to avoid the withholding tax on corporate interest payments. The fact that dividends received by tax-exempt entities would be subject to tax at a 35% rate, but capital gains would remain exempt, could create a new set of distortions in the case of the growing number of corporations with dividend distributions in excess of their fully taxed income. For you, the question is not whether there are issues under current law. The more important question is whether the cure is worse than the disease.

CRITIQUES OF CURRENT CORPORATE TAX

In the past, proponents of corporate integration have focused on two economic distortions arguably caused by the double taxation of corporate income: the incentive to operate in pass-through form rather than as a taxable corporation and the bias for debt financing that could result in over-leveraging at the corporate level.

Incentive for Pass-Through Organizations

I have to admit that I have always been puzzled by the focus on increased use of pass-through entities like partnerships, limited liability companies, and subchapter S corporations. If you think that the double taxation of corporate earnings is a serious problem, why would you object to the use of a business structure that avoids the double tax?

I recognize that there has been a steady increase in the use of pass-through entities over the past 30 years. That increase has occurred even though there has been a large reduction in the level of double taxation due to large individual and corporate rate reductions in 1986 and the special dividend rates enacted in 2003 and the sharp decline in the portion of stock ownership representing taxable accounts. Clearly, factors other the double taxation of corporate income have played a role.

Again, the question is whether the proposal being discussed would increase or decrease the use of pass-through entities. There are two aspects of the proposal that would substantially increase incentives to operate in a non-corporate form. First, small businesses, without access to the public equity markets, often rely on debt financing for their capital needs. As explained below, the proposal could increase the cost of debt financing for corporate borrowers, eliminating any temptation for a small business to use the corporate form even with an unlimited dividend-paid deduction. Second, a pass-through entity can make tax-free distributions of cash flow sheltered from tax by reason of accelerated depreciation or other tax benefits. Under the proposal, investors in a taxable corporation would face a 35% withholding tax on dividends funded with similar cash flows, even though the corporation received no benefit from the new dividend-paid deduction.

Bias for Debt Financing

Many proponents of corporate integration argue that the current favorable tax treatment for corporate debt financing leads to excess use of debt at the corporate level and greater risk of bankruptcy or other financial distress among corporations. An article by Jonathan Talisman, former Treasury Assistant Secretary for Tax Policy, makes the important, but often ignored, point that there are substantial nontax reasons for using debt rather than equity to raise investment capital and thus they are not pure substitutes for each other. Debt does not dilute the interests of existing shareholders. Debt is a less risky investment than stock, which means that debt generally has a lower cost. Also, issuing stock can involve much larger underwriting fees than debt financing provided by a bank or other financial institution. In short, corporations will continue to have significant debt levels and it is very unlikely that they will issue additional stock to reduce current levels of debt.[1]

The Talisman article also cites several well-respected academics to support the proposition that "any tax-driven bias for debt may be exaggerated and, to the extent it exists, it does not contribute substantially to overleveraging or distress." I am not in the position to judge whether the experts cited in the Talisman article or other experts on the issue are correct. But, I am confident that a dividend-paid deduction is the wrong approach if you are concerned about excess debt in the corporate sector.

Retained earnings are one of the largest sources of capital available to corporations for purposes of investment and debt reduction. That is not surprising; there are no fees for retaining earnings and no tax at the shareholder level. The dividend-paid deduction will create enormous pressure to increase corporate dividend distributions and fund future investments with debt. That pressure could be irresistible since some academic studies indicate that corporations have been conservative in using debt and have the capacity to increase borrowing.

Originally, I thought that the withholding tax on interest was without justification and a mere "money grab." Now, I think that it may be a necessary component of the proposal designed to counteract the incentive to debt finance caused by the dividend-paid deduction. Also, a withholding tax on dividends, but not on interest, could create a new set of distortions. Hybrid debt securities that have both debt and equity features could be used to create deductible returns on equity without being subject to withholding tax liability.

Increased Cost of Corporate Borrowing

Withholding taxes are often compliance tools forcing both reporting and prepayment of the tax. If the amount withheld exceeds the actual liability, the excess is refunded. The withholding tax in this proposal is quite different; it is nonrefundable and bears little relationship to the tax that would actually be imposed on the recipient.

For individuals with marginal rates of 35% or higher and corporations that are not financial intermediaries, the proposed withholding tax on interest has the same effect as a traditional withholding tax and would not cause those investors to demand a higher interest rate. However, those investors are a very small part of the corporate bond market.

The bulk of investors in the corporate bond market are tax-indifferent investors, investors whose interest income is otherwise exempt from tax. Tax-indifferent investors include retirement plans; pension funds; religious, charitable, and other tax-exempt organizations; life insurance companies using corporate bonds to fund life reserves; and foreign investors. Banks and other financial intermediaries also could be included in this group because a 35% withholding tax on their gross interest income normally would be dramatically larger than the tax on their net interest income, namely the spread between the interest income and their cost of funds. Tax-indifferent investors are the group whose demand for corporate bonds is necessary to clear the market, that means having a willing buyer for all bonds being offered for sale in the market. The interest rate demanded by that group of investors will set the rate for the entire market. For those investors, the withholding tax is simply a reduction in their yield on the bonds. The withholding tax will increase corporate

[1] Jonathan Talisman, "Do No Harm: Keep Corporate Interest Fully Deductible," *Tax Notes,* 2013.

bond rates unless that group is willing to accept yields 35% lower than they currently receive.

Currently, interest rates on corporate bonds reflect the sum of the risk-free interest rate (the rate on Treasury bonds) plus a risk premium. In the future, a new element will be added, the amount of the new withholding tax. There is no reason to believe that the withholding tax will cause tax-indifferent investors to accept a lower risk premium because they have alternatives to U.S. corporate bonds if they are seeking an interest rate return. They could simply invest in Treasury bonds, rather than receiving little additional income for accepting the higher risk of corporate bonds. The withholding tax would make the United States an "outlier" in world capital markets causing foreign investors simply to avoid the United States and domestic investors to invest in overseas markets. As a result, I believe market rates will increase to reflect the withholding tax in order to keep tax-indifferent investors in the U.S. corporate bond market. With the current level of corporate debt issuance, that implies an increase of slightly more than 50%. An example using the simplifying assumption that the withholding tax has a rate of 33% is useful. Assume that the current interest rate on the bond is 4%, the rate would have to go up to 6% to make the tax-indifferent investor whole for the withholding tax (6 minus the withholding tax of 2).

Clearly, there would be a market response to the prospect of increased interest rates. Corporations could reduce the issuance of bonds by reducing planned investments, using alternative financing arrangements like leases, or replacing debt with equity. The reduced supply would tend to reduce the otherwise large increase in rates. Offsetting the reduced supply, there could be reduced demand as tax-indifferent investors unwilling to accept lower returns decide to make their interest-bearing investments in overseas markets or through structures like leasing. In summary, it seems clear that there will be an increase in rates due to the withholding tax; the amount of the increase could be as much as 50%, and there will be a period of volatility in the credit markets as market participants attempt to measure the respective sizes of changes in the supply of, and demand for, corporate bonds.

Some economic models may assume that the corporate bond market will adjust, with no increase in interest rates as fully taxable investors replace tax-indifferent investors. I do not believe that there are enough taxable investors to replace tax-indifferent investors and believe that many market participants would agree.

Lessons from 2003

In 2003, the George W. Bush administration proposed a version of corporate integration. Under that proposal, a corporation would establish an exempt dividend account to which the corporation would add its fully taxable income for each year. Dividends paid out of that account would be exempt from tax at the shareholder level. The proposal was greeted with opposition from the corporate community and was not enacted. The opposition came from a group of corporations whose dividends exceeded their fully taxed income. That group included capital-intensive companies whose income was sheltered from tax by accelerated depreciation and other benefits like the research credit, multinationals not repatriating the income from large operations overseas, and multinational energy companies repatriating income on which there was no U.S. tax because of foreign tax credits. If anything, the number of those corporations has grown as companies have expanded their operations overseas since 2003 and the Congress has provided larger depreciation and other benefits.

Those companies had two concerns. First, they felt that the value of their shares in the market would suffer if their shareholders only received a partial exclusion while shareholders of other companies enjoyed a full exclusion. Second, they argued that the value of tax incentives was reduced due to the fact that the use of those incentives would result in increased tax at the shareholder level. The impact of the corporate integration proposal being discussed today on those companies and their shareholders would be far worse.

That proposal would substantially increase taxes at the shareholder level, seemingly based on the assumption that all dividends are paid out of corporate earnings that would otherwise be taxed at the full 35% rate and the assumption that shareholders would not be harmed because corporations would pass on the value of the dividend-paid deduction by increasing dividends. Those assumptions are simply incorrect in many instances and where they are incorrect the total tax on dividends will be substantially greater than under current law. Corporations that currently distribute dividends in excess of their fully taxed income would do their shareholders a favor by reducing the dividend rate. Any attempt by those corporations to pass on the benefit of the dividend-paid deduction through increased dividends would result in more over taxation at the shareholder level.

Just like the Bush administration proposal, any distribution out of tax-favored income would result in a recapture of the tax benefit by increased tax at the shareholder level. For example, if the United States adopted a territorial system of international taxation, any distribution out of exempt foreign income would be recaptured by a 35% tax at the shareholder level.

CONCLUSION

In my opinion, tax reform should be designed with the goal of increasing economic growth and expanding employment in the United States. Our tax system should be based on principles of economic neutrality as long as that neutrality tilts the playing field in favor of investment and job growth in the United States.

I am not an economist so I am not going to offer an opinion concerning the impact of double taxation on the economy, but there is no question that it, combined with incentives like accelerated depreciation and the research credit, create a bias for retention of corporate earnings and reinvestment in our domestic economy. I would note that unprecedented period of economic growth and expansion of the middle-class in the 1950s and 1960s occurred when the level of double taxation was dramatically greater than today due to corporate rates in excess of 50% and a maximum tax rate of 70% on dividends.

However, you do not need to be an economist to conclude that the corporate integration proposal being discussed today could have large, negative implications for our economy.

- The proposal would eliminate the bias for retention of corporate earnings and substitute a bias for distribution of those earnings. It would dramatically reduce the benefit of, if not effectively repeal, incentives like accelerated depreciation and the research credit. Simply increasing dividend distributions would provide a larger tax reduction than accelerated depreciation would provide for an investment in plant and equipment. The research credit would be effectively repealed for many corporations that could simply eliminate all corporate tax liability by converting stock buybacks into dividend distributions.
- The proposal could dramatically increase the interest cost of corporate borrowing. You do not have to "love" debt to recognize that debt financing is the lowest-cost and most flexible source of external capital for corporate investment. U.S. companies, but not their foreign competitors, would face that cost increase.
- The proposal could result in complex and inefficient financial transactions designed to take advantage of the fact that the rate on non-corporate debt could be substantially lower than the rate on corporate debt and the fact that the capital gain income of tax-indifferent investors would remain tax-exempt while dividends received by those investors would be subject to a 35% tax rate.
- The imposition of new withholding taxes on foreign investors is at best inconsistent with, if not in direct violation of, tax treaties, perhaps inviting retaliatory action affecting U.S. investment overseas.

In short, the cure would be worse than the disease. Again, thank you for the opportunity to testify today. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R–Utah) today delivered the following opening statement at a hearing to explore how corporate integration could make the tax code neutral in regards to financing with debt or with equity:

Welcome, everyone, to this morning's hearing, which is our second hearing on the topic of corporate tax integration. Last week we had a hearing to examine the potential benefits of a dividends paid deduction. Today, we will focus on the differing tax treatment of debt and equity under the current system and the distortions that are created as a result.

As a number of studies have shown, U.S. businesses pay an effective tax rate of about 37 percent on equity financing, while the effective tax rate on debt financing is negative. That's right: negative. The tax code actually gives a subsidy to corporations for debt financing. Experts and policymakers across the ideological spectrum have acknowledged that this is a problem.

For example, President Obama's Updated Framework for Business Tax Reform, which he released last month, makes this observation: "[T]he current corporate tax code encourages corporations to finance themselves with debt rather than with equity. Specifically, under the current tax code, corporate dividends are not deductible in computing corporate taxable income, but interest payments are. This disparity creates a sizable wedge in the effective tax rates applied to returns from investments financed with equity versus debt."

The Congressional Budget Office and the Joint Committee on Taxation, along with Treasury Departments of past administrations, agree. The George W. Bush administration's Mack-Breaux tax reform panel and the Obama administration's Volcker tax reform panel came to the same conclusion: Our tax code's bias in favor of debt financing causes significant distortions in the economy.

We'll talk about a number of these distortions today, but I want to mention just a few here at the outset.

Most obviously, the bias in favor of debt under our tax system incentivizes businesses to base financing decisions, not necessarily on market conditions or their specific situations, but on relative tax consequences.

In addition, while debt isn't inherently an inferior option, businesses and economic sectors that are over-leveraged are, broadly speaking, more vulnerable to losses in the event of an economic downturn. This puts consumers at greater risk for things like higher interest rates due to bankruptcies, taxpayer bailouts, and the like. Our system, which puts a premium on debt in the form of a tax preference, adds to these risks.

Finally, the favored tax status of debt incentivizes the use of complicated and often wasteful tax-planning strategies that redirect resources away from projects and ventures that will lead to growth. This includes, for example, the use financing instruments that will be regarded as debt by the IRS, even though they resemble equity in a lot of ways. This was apparently the focus of the administration's newly proposed section 385 regulations, which were ostensibly promulgated to prevent inversions, but, as we're finding out, have a much broader scope. These proposed regulations are, to say the least, quite complicated and will surely continue to generate a lot of discussion. One thing is clear, however: This mess demonstrates how distortive our current system really is.

Now, before I conclude my opening statement, I want to address some misunderstandings that came up during our last hearing on corporate integration and the dividends paid deduction. During that hearing, some arguments and concerns were expressed in a manner that I believe mischaracterized the approach to corporate integration that I've been discussing for several months.

I didn't dwell on these points last week because I didn't want to disrupt the witnesses' statements or deny them a chance to answer members' questions, and I didn't want the hearing to get bogged down by a prolonged debate over a policy proposal that is not yet final. But I do want to briefly set the record straight on a few points.

One assertion we heard was that corporate integration favors big business at the expense of small business. That claim just isn't accurate.

True enough, corporate tax integration would directly benefit businesses organized as C corporations. According to the most recent JCT data, while there are about 1.6 million C corporations in the U.S., only about 5,000—less than ½ of 1 percent—are publicly traded. The vast majority of the remaining 99.7 percent of C corporations are closely held small businesses.

Like large corporations, these small businesses are subject to double taxation on earnings paid out to shareholders, but there are limitations on what they can do. So a dividends paid deduction would ensure a fairer and more efficient tax system for small businesses as well as large businesses.

You don't have to take my word for it. A large coalition of small business associations, including the National Federation of Independent Businesses and the S Corporation Association, recently sent a letter to the leaders of the Finance Committee and the House Ways Means Committee stating:

"Congress should eliminate the double tax on corporate income. . . . The double corporate tax results in less investment, fewer jobs, and lower wages than if all American businesses were subject to a single layer of tax. A key goal of tax reform should be to continue to reduce or eliminate the incidence of the double tax and move towards taxing all business income once."

Without objection, a copy of that letter will be included in the record.

On top of this pretty persuasive assessment from the small business community, our committee's Business Tax Reform Working Group also made clear in their report that dysfunctional tax policies affecting larger publicly traded businesses can and do have ripple effects on smaller businesses, including suppliers, service providers, and community organizations.

Another assertion we heard last week was that corporate integration would impose a double tax on retirement plans. Truth be told, I'm not entirely sure what the basis is for this particular claim. However, I do want to do my best to assuage any lingering concerns that people might have about this idea.

Put simply, while we're still seeking input and crafting the specifics of our integration plan, I am not aware of any serious proposals out there that would result in two layers of tax on retirement plans, whether we're talking about income the plans receive from interest or from dividends.

Now, I don't want to spend too long discussing all of the issues raised in our last hearing.

Clearly, we'll have to continue this discussion in the coming weeks and months. I look forward to a robust public discussion about these issues going forward, including here today with our distinguished panel of witnesses.

LETTER SUBMITTED FOR THE RECORD BY HON. ORRIN G. HATCH

Parity for Main Street Employers

The Honorable Orrin G. Hatch
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219 Dirksen Senate Office Building
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The Honorable Kevin Brady
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U.S. House of Representatives
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The Honorable Ron Wyden
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The Honorable Sander Levin
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U.S. House of Representatives
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March 17, 2016

Dear Chairmen and Ranking Members:

As Congress debates tax reform to make American businesses more competitive, the undersigned organizations representing employers organized as S corporations, partnerships and sole proprietorships offer the following three principles to help guide your efforts.

First, tax reform needs to be comprehensive. Jobs in the United States are evenly divided between corporate and pass-through employers, with nearly 70 million private-sector workers employed at S corporations, partnerships and sole proprietorships. To ensure that we avoid harming these critical employers, tax reform needs to be comprehensive and improve the tax code for corporations and pass-through businesses alike.

Second, Congress needs to restore rate parity by reducing the tax rates paid by pass through businesses and corporations to similar, low levels. The 2012 fiscal cliff negotiations resulted in pass-through businesses paying, for the first time in a decade, a significantly higher top marginal tax rate than C corporations. Taxing business income at different rates penalizes pass-through businesses and encourages planning to circumvent the higher rates, ultimately resulting in wasted resources and lower growth. To ensure that tax reform results in a simpler, fairer and more competitive tax code, Congress needs to reduce the top tax rates to similar levels for all taxpayers.

Third, Congress should eliminate the double tax on corporate income by integrating the corporate and individual tax codes. A study by Ernst and Young made clear that the double corporate tax results in less investment, fewer jobs, and lower wages than if all American businesses were subject to a single layer of tax. A key goal of tax reform should be to continue to reduce or eliminate the incidence of the double tax and move towards taxing all business income once.

By embracing these broad concepts, Congress can move the taxation of business income in a direction that helps all employers, regardless of how they are organized, to invest and create jobs here in America.

We appreciate your consideration of these priorities.

Sincerely,

Aeronautical Repair Station Association; ACCA—The Indoor Environment and Energy Efficiency Association; Agricultural Retailers Association; American Architectural Manufacturers Association; American Beverage Licensees; American Business Conference; American Composites Manufacturers Association; American Council of Engineering Companies; American Feed Industry Association; American Foundry Society; American Horticulture Industry Association; American Hotel and Lodging Association; American Institute of Architects; American Rental Association; American Subcontractors Association; Inc.; American Supply Association; American Trucking Associations; AMT—The Association for Manufacturing Technology; Associated Builders and Contractors; Associated Builders and Contractors Florida East Coast Chapter; Inc.; Associated Equipment Distributors; Associated General Contractors of America; Association of Independent Manufacturers'/Representatives (AIM/R); Association of RV Parks and Campgrounds; Auto Care Association; Aviation Suppliers Association; Building Owners and Managers Association International; Construction Industry Round Table; Design Professionals Coalition; Direct Selling Association; Door and Hardware Institute; Electronics Representatives Association; Family Business Coalition; Financial Executives International; Financial Services Institute; Food Marketing Institute; Foodservice Equipment Distributors Association; Greater Tennessee Chapter, Associated Builders and Contractors, Inc.; Hearth, Patio and Barbecue Association; Heating, Air-Conditioning and Refrigeration Distributors International; Independent Community Bankers of America; Independent Electrical Contractors; Independent Insurance Agents and Brokers of America; Independent Lubricant Manufacturers Association; Industrial Minerals Association—North America; Industrial Supply Association; International Association of Plastics Distribution; International Foodservice Distributors Association; International Franchise Association; International Housewares Association; International Warehouse Logistics Association; ISSA, The Worldwide Cleaning Industry Association; Land Improvement Contractors of America; Metal Treating Institute; Metals Service Center Institute; Modification and Replacement Parts Association; Motor and Equipment Manufacturers Association; National Association of Chemical Distributors; National Association of Convenience Stores; National Association of Electrical Distributors; National Association of Landscape Professionals; National Association of Shell Marketers; National Association of the Remodeling Industry; National Association of Truck Stop Operators; National Association of Wholesaler-Distributors; National Automobile Dealers Association; National Beer Wholesalers Association; National Christmas Tree Association; National Club Association; National Electrical Contractors Association; National Federation of Independent Business; National Funeral Directors Association; National Grocers Association; National Industrial Sand Association; National Insulation Association; National Lumber and Building Material Dealers Association; National Marine Distributors Association; National Marine Manufacturers Association; National Newspaper Association; National Propane Gas Association; National Ready Mixed Concrete Association; National Restaurant Association; National Roofing Contractors Association; National Small Business Association; National Stone, Sand and Gravel Association; National Tooling and Machining Association; National Utility Contractors Association; NEMRA—National Electrical Manufacturers Representatives Association; Non-Ferrous Founders' Society; North American Association of Food Equipment Manufacturers; North American Equipment Dealers Association; NPES The Association for Suppliers of Printing, Publishing, and Converting Technologies; Outdoor Power Equipment and Engine Service Association; Pacific-West Fastener Association; Pet

Industry Distributors Association; Petroleum Marketers Association of America; Precision Machined Products Association; Precision Metalforming Association; Printing Industries of America; Professional Beauty Association; S Corporation Association; Secondary Materials and Recycled Textiles Association; Service Station Dealers of America and Allied Trades; Small Business and Entrepreneurship Council; Small Business Legislative Council; Society of American Florists; Specialty Equipment Market Association; Tire Industry Association; Tree Care Industry Association; Truck Renting and Leasing Association; Water and Sewer Distributors of America; Western Equipment Dealers Association; Wichita Independent Business Association; Wine and Spirits Wholesalers of America; and Wisconsin Grocers Association.

PREPARED STATEMENT OF JODY K. LURIE, CFA,[1] VICE PRESIDENT AND CORPORATE BOND RESEARCH ANALYST, JANNEY MONTGOMERY SCOTT LLC

To Chairman Hatch, Ranking Member Wyden, and the other members of the committee, thank you for allowing me to present my thoughts on the potential effects to the capital markets with the implementation of corporate integration.

- Recent events have highlighted issues related to the double taxation of corporate income.
- At the same time, the current structure appropriately promotes debt repayment over dividend distribution.
- As a positive, corporate integration could result in a rally in the equity markets.
- Further review of some of the unintended consequences from corporate integration may be warranted.

INTRODUCTION

For decades, the American tax system has grappled with issues related to the double taxation of corporation income. While most of the witnesses today and in last Tuesday's hearing testified on retirement accounts, international tax law, and specific issues around stocks and dividends, the focus of my testimony is the effect of corporate integration on bonds and interest.

Under the current tax system, corporations receive a deduction for interest payments on debt securities (such as bonds), resulting in only one layer of tax on the debt side. Since a corporation does not receive a deduction for dividend payments, the system promotes debt financing over equity financing, all else equal. While corporate integration in theory could equalize the treatment between equity and debt, it may also cause unintended consequences and should be examined with caution.

I have identified seven outcomes that are likely to occur from corporate integration. First, the equalization of the tax treatment of debt and equity may create an increased incentive for companies to return cash to shareholders over alternatives, such as debt repayment. Second, equity market valuations may rise, though companies may alter their dividend policies. Third, corporate integration would have diverse effects on companies in different industries. Fourth, the potential reduction in the debt markets may lead to job cuts. Fifth, corporate integration would likely encourage corporations to create complex organizations and financing instruments. Sixth, corporate integration may be impractical for the current corporate bond trading system, and could impose substantial compliance costs from an execution standpoint. Seventh, corporate integration may not address the real issue at hand, which is whether comprehensive entity tax reform would help the economy.

DEBT AND EQUITY ARE DIFFERENT

Many tax theorists have argued that there is no inherent difference between debt and equity; therefore, the two types of securities should be treated the same under the tax code. Even if this were true from a tax perspective, the capital markets extend beyond tax implications. The basic distinctions between debt and equity are widely known throughout the capital markets. In Finance 101, we learn that shareholders and lenders have different goals.

A shareholder purchases an equity security with the potential of unlimited growth and returns on his investment at the cost of higher risk. In contrast, a lender who

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[1] Please note that my written and oral comments today represent my views, and not necessarily the views of Janney Montgomery Scott LLC. I would like to acknowledge the help of my supervisors, colleagues, and friends.

buys a straight bond has limited upside potential, but with lower risk versus an equity. While some lenders invest for capital appreciation (*i.e.,* the price of the bond rising), many seek income returns equal to the market rate and their principal repaid in full at maturity.

Corporate management typically aligns with the goals of the equity investors. Executive compensation is usually tied to equity performance via stock options and warrants, so management has a personal interest in increasing the equity value and, with that, paying dividends. Additionally, activist equity investors can seize control of a corporation's board of directors and institute policies that quickly bolster returns. Increasing dividends or share buybacks are both negative events for lenders, particularly when financed with debt.

Since the cards are already stacked against lenders, I see it as reasonable for the tax system to incentivize companies to repay their lenders before making discretionary dividends to their shareholders. The current tax system, which favors interest payments over dividends, does this. Equalizing the tax treatment of debt and equity may incentivize corporations to pay large dividends rather than save cash for other purposes, like debt repayment or long-term capital investments.

SHAREHOLDER RETURNS

Corporate integration has similarities in taxation of pass-through entities, which are not taxed at the corporate level, but at the shareholder level. Recent events related to pass-through entities can provide a case study for corporate integration in practice. In particular, these events suggest that a withholding tax and dividend paid deduction may encourage companies to distribute, rather than retain, earnings to their shareholders.

MLPs as an Example

The formation of businesses as alternative structures (such as partnerships, RICs, REITs, S corporations, and LLCs) to avoid double taxation is well known, and speaks to inefficiencies of the current tax system. That being said, recent events suggest that a move towards corporate integration may result in adverse effects.

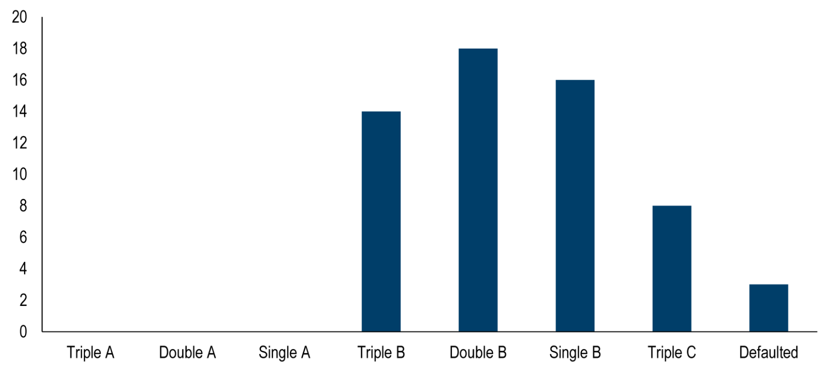
Master limited partnerships ("MLPs"), as an example, are a type of publicly traded partnerships ("PTPs"). As background, MLPs are required to generate 90% of their income through a qualified source, such as natural resources-related activities, so the majority of MLPs are involved in the energy sector. Most MLPs pay out to equity unitholders all income not needed for core businesses via cash distributions (*i.e.,* dividends). As pass-through entities, MLPs pay no taxes, but rather the individual partners pay taxes on the entity's income. As a result, MLPs are incentivized to have high capital expenditures because with high capital expenditures come deductions that are passed on to the individual unitholders.[2]

As I will explain in more detail shortly, we can learn many lessons from recent events in the MLP space. Before the collapse in energy prices, MLPs, like REITs, became a preferred alternative for individual investors looking for income in the current low interest rate environment. Since fall 2014, however, most MLPs and their oil, gas, metals, and mining peers have come under pressure due to the fall in energy and commodity prices. While there have only been a handful of MLP bankruptcies—two prominent firms filed for Chapter 11 bankruptcy protection this month—the outsized credit risk in the industry is notable.

Industry cyclicality is perhaps inevitable, but what is not is a tax policy that favors companies paying out a substantial portion of their cash so that they do not have the necessary cushion during a down market. Years of feast are often followed by years of famine, and tax policy should not encourage gorging during feast only to be followed by starvation during famine. During the years after the 2008–2009 recession and before the 2014 erosion in energy prices, MLPs benefited from sectorwide expansion with technological advancements in the United States and heightened demand for domestic oil, natural gas, and liquids. Market participants utilized the debt and, to a lesser extent, equity markets to finance capital expenditures, while at the same time promising unitholders distributions with yields that were competitive with high-yield corporate bonds. Even before the drop in energy prices less than 2 years ago, these companies operated with minimal cash balances, providing sizable returns to their equity unitholders via distributions.

[2] Jody Lurie, *Janney Fixed Income Weekly,* "Credit: Masters of Their Own Design (MLP Overview)," *http://www.janney.com/File%20Library/Fixed%20Income%20Weekly/April-30-2012.pdf,* (April 30, 2012).

Ratings of MLPs Are Skewed Towards the Lower End of the Ratings Spectrum[3]



When the energy market crashed, MLPs began to cut back on capital expenditures, but only reduced or eliminated their equity distributions as a last resort due to market perception related to dividend cuts. Several MLPs experienced credit ratings downgrades, and the current landscape of MLPs is skewed towards the lower end of the ratings spectrum. Of the 114 MLPs and energy-related publicly traded partnerships, about half are not rated, and over a third are high yield (*i.e.,* double B or lower) rated by Moody's and/or S&P. Many MLPs operated before the fall in energy prices with minimal cash on hand and high levels of debt and leverage, so when the fall in prices occurred these MLPs had few financing options. Two prominent MLPs filed for Chapter 11 bankruptcy protection this month. It is likely the bankruptcy tally among MLPs will rise, as predicted by both Moody's and S&P.[4]

A pass-through structure does not necessarily decrease a company's appetite for an overleveraged credit profile, but rather encourages a company to spend all available earnings on short-term shareholder returns as opposed to saving some cash to ensure the long-term viability of the entity. While an equalization of debt and equity taxation could lead to additional equity offerings over debt issuance, the dilution effect for the company would remain a deterrent, as it was for MLPs during their expansion era, so debt issuance would stay the preferred method coupled with a focus on shareholder returns. MLPs are an example of a publicly traded entity that is taxed only once—at the unitholder level—so the recent history of MLPs serves as a cautionary tale on corporate integration.

Favoring Shareholders, While Ignoring Long-Term Investments

Since the 2008–2009 recession, corporate cash balances have reached record levels. At year-end 2015, non-financial corporate liquid assets totaled $1.95 trillion.[5] The low rate environment has encouraged borrowing, though many companies have shifted their debt profiles away from less short-term debt like commercial paper and towards long-term debt like corporate bonds. I have published multiple articles on the corporate cash balance topic, noting that the largest companies in the United States represent an outsized portion of corporate cash, and that a notable amount is locked up overseas due to high repatriation costs. Companies have utilized the debt markets to finance robust shareholder remuneration plans, as debt financing costs are significantly below the 35% tax rate on repatriating deferred foreign income. Unless the cost to issue debt equals the repatriation cost or until there is a way for companies to access the cash through a less costly method, companies will continue to use the debt markets to finance short-term equity returns.

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[3] Bloomberg (May 17, 2016); does not include non-rated companies; classification based off the lower of Moody's and S&P's ratings when available; triple C includes double C as well; some companies are PTPs and not MLPs, per Bloomberg classifications, but are viewed as such from a market perspective

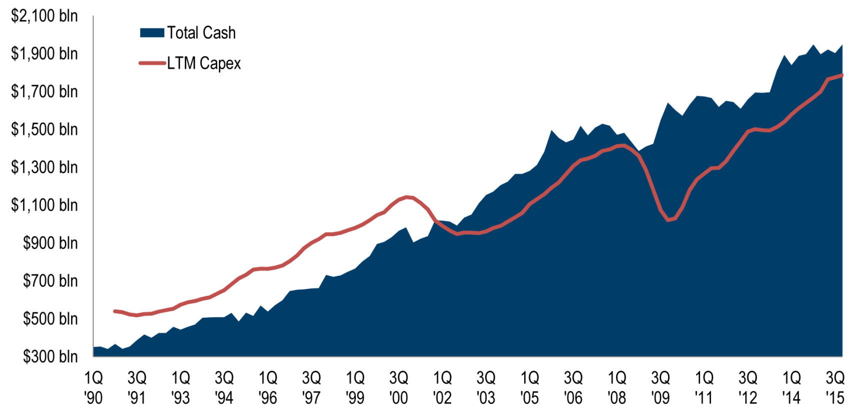
[4] Moody's Investors Service, *April Default Report* (May 9, 2016), and Standard and Poor's Financial Services, *Default, Transition, and Recovery: The Global Corporate Default Tally Climbs to 62 Issuers So Far in 2016,* (May 12, 2016).

[5] Board of Governors of the Federal Reserve System, "Financial Accounts of the United States," *http://www.federalreserve.gov/releases/z1/current/z1.pdf* (March 10, 2016).

When reviewing corporate liquidity trends, another issue that arises is the reduced amount of capital expenditures relative to available cash. While non-financial corporate liquidity peaked at year-end 2015, the trailing 12 month amount of capital expenditures has not kept pace. In fact, since the recession, capital expenditures have been tracking well below corporate cash levels. Companies are not investing in organic growth projects, but rather opting for short-term measures to keep shareholders happy. Part and parcel to this issue is the increase in mergers and acquisitions, through which some companies have pursued tax inversions. Rather than invest in a new project (such as expanding a product line or building a new plant) that may take years before realizing a return, companies are looking at share buybacks, dividends, mergers and acquisitions, and tax minimization to bolster shareholder returns.

Although the proposed tax changes may alter certain corporate behavior, it is likely we will continue to see a lack of long-term capital investments, and domestic capital investments are significant contributors to economic and job growth. Corporate integration may put even more pressure on corporations to pay outsized dividends to shareholders, which could lead to even less long-term capital investment.

In Recent Years, Companies Have Kept More Cash on Hand than Spent on Capital Expenditures[6]



A RISE IN EQUITY CAPITAL MARKETS

Corporate integration would likely lead to a rise in equity capital market valuations because it would encourage dividend payments. As I commented previously, equity indices broke record highs in recent years, thanks in part to economic stimulus and improving credit profiles at large corporations. It is likely that, with a decreased cost of equity capital through a change in the tax treatment of equity, the equity markets would respond positively. The more cash being spent on shareholders, in theory, could reenter the economy. Empirical studies have shown that companies with consistent and increasing dividend plans see greater total returns over the long run than companies that do not pay or that cut their dividends. Part of this trend is the result of perceived company stability by investors. That said, it is unclear as to whether the new policy would encourage consistent or lumpy dividends, as the return amount would ultimately be based on the optimal rate to benefit from a dividend paid deduction and could vary with income levels each quarter.

COST OF CAPITAL

An equalized treatment of equity and debt from a tax perspective is unlikely to cause companies to view equity and debt financing equivalently. After all, as a security falls further down the capital structure, investors demand an additional premium to take on the security's risk. It is likely, however, that the difference between cost of debt capital and cost of equity capital will decrease, companies will still see the benefit in debt- over equity-financing. What's more, certain industries may ben-

[6] Board of Governors of the Federal Reserve System, "Financial Accounts of the United States," *http://www.federalreserve.gov/releases/z1/current/z1.pdf* (March 10, 2016); data pulled from Bloomberg.

efit more or less from the new regulation. Banks, for example, will likely benefit as lenders underlying the bank loans through the withholding tax and credit system. At the same time, it is unlikely banks would dramatically change their financing profile due to their desire to borrow cheaply and charge a spread on lending. Moreover, banks have regulatory requirements, and try to optimize the capital structure based on such guidelines. Regulated utilities, however, which operate with consistent cash flow streams, may look at the policy favoring dividends as a positive. Like REITs, they may see the dilution effect as less of a factor because they can increase their dividends with each equity issuance. At the same time, a higher cost of debt capital, though potentially marginal, could be the determinant between whether a capital project will meet the required return on investment or not.

SHRINKING FIXED-INCOME CAPITAL MARKET

The U.S. capital markets are the largest in the world, offering some of the most complex and diversified solutions for financing and investing. Debt capital markets, more affectionately known as “fixed-income” capital markets, represent 60% of the $66.5 trillion total U.S. capital markets, while equity capital markets represent the remaining 40%, as of year-end 2015.[7] Corporate debt, including bonds, bank loans, and commercial paper, represents 20% of the U.S. fixed-income capital markets.[8] The Federal Reserve’s monetary policy since the recession resulted in a rise in both equity and debt market valuations. Stock indices set new highs, and the low interest rate environment led to a yield-grabbing mentality by investors. In terms of corporate debt, a handful of companies broke records in terms of issuance size with their bond offerings in recent years, and an increased number of issuers entered into the primary market to capture the low rates. Both domestic and international companies seized the opportunity, and we saw a record number of issues and issuance amount by international companies enter into the U.S. corporate bond market. A change in the tax policy could lessen the appeal of issuing debt in the U.S. markets, especially now that interest rates are lower overseas.

As experts suggest, it is possible that the debt markets could shrink due to the equalizing of debt and equity with the proposed tax system. Per the Bureau of Labor Statistics, over 900,000 people work in the securities industry, and the headcount has risen in the post-recession era.[9] Anecdotally, however, we have witnessed shrinking headcount in the equity markets with the advent of electronic trading platforms and regulatory changes. While technological advancements have also affected the fixed-income markets, the heterogeneity of debt securities has prevented the wholesale industry change that is occurring in the equity markets. What’s more, the low rate and low growth environment in which we operate has led to further headcount reduction by industry participants looking to cut costs and bolster margins. A less profitable or less active fixed-income market could add further job losses to a challenged situation.

CREATIVE ENGINEERING AND FURTHER TAX AVOIDANCE

As history shows, companies always look for ways to minimize taxes. A corporate integration system, while improving certain issues facing C corporations and their constituents today, may not prevent companies from pursuing creative structures to limit tax liabilities. Companies may create complex structures, including commercial mortgages, sale leaseback transactions, or various other formats, to avoid paying withholding tax on debt and equity. These unintentional outcomes are inherently hard to predict.

COSTLY EXECUTION

My firm and other broker-dealers and financial institutions already face the hurdle of complex and costly trading platforms. Adding an equivalent to a shareholder credit or dividend paid deduction system on the debt side will likely translate to additional expenses and implementation challenges. The proposed tax changes are not as straight-forward and easy to administer as one might think.

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[7] Securities Industry and Financial Markets Association. Data sourced from Federal Reserve, Bloomberg, Federal Agencies, NYSE, and NASDAQ (May 19, 2016).

[8] Securities Industry and Financial Markets Association, “U.S. Bond Market Issuance and Outstanding,” *http://www.sifma.org/research/statistics.aspx* (May 3, 2016).

[9] Bureau of Labor Statistics, “Securities, Commodity Contracts, and Other Financial Investments and Related Activities: NAICS523,” *http://www.bls.gov/iag/tgs/iag523.htm* (May 19, 2016).

CONCLUSION

Given recent events around corporate inversions, I view this discussion as timely and notable. Among the many challenges that may be created by the potential new tax regime are the incentives that would arise for companies to give back to shareholders over creditors or long-term capital investments, as the latter use of cash would have a better economic multiplier on job creation and long-term expansion. Identifying a way to encourage companies to invest longterm in domestic projects would likely better support the economy than would providing inroads into dividend distribution. Recent events related to MLPs provides a good case study when considering how companies may change their behavior through the equalized tax treatment of debt and equity. Further, relative to other fixed-income securities, corporate debt may provide more attractive yields for certain investors, so the combination of reduced attentiveness to balance sheets and higher yields could cause an imbalance in individual investors' portfolio allocation and could expose them to unforeseen credit risk.

Prepared Statement of John D. McDonald, Partner, Baker and McKenzie LLP

I. INTRODUCTION

Mr. Chairman, Ranking Member Wyden, and members of this distinguished committee, it is an honor to participate in these hearings on business tax reform.[1] I have been a tax practitioner specializing in international taxation for 20 years. I have authored or co-authored over 100 articles on domestic and international taxation, including one focusing on the merits of corporate integration.[2] I have coauthored one treatise focusing on U.S. corporations doing business abroad. I also had the privilege for a brief period during my career to assist the Islamic Republic of Afghanistan with various legal issues including tax regulation and sovereign debt restructuring in Kabul. I am here today in my own capacity and not on behalf of my firm. My views do not represent those of any client or other organization.

II. BUSINESSES ARE MOBILE AND SEEK THE LOWEST TAX JURISDICTIONS TO PRODUCE THEIR PRODUCTS AND SERVICES

Given that my practice tends to focus on U.S.-based publicly traded multinationals organized as corporations, my testimony focuses on businesses doing business in corporate form. As this committee is well aware, corporations, and the businesses they conduct, are highly mobile. Innovation will make them even more mobile. This committee has already witnessed the way the Internet has transformed the sale of software, music and videos. One can imagine that, in the decades to come, many companies we think of today as manufacturing "tangible" products will simply design the product (presumably in multiple locations), store the digital designs on servers owned by a 3rd party maintained in multiple locations, and sell the "product" via digital download over the Internet to a consumer anywhere in the world who happens to have a 3–D printer in their home or office who can then "print" the product. In this environment, it simply does not matter whether you are a "U.S.-based" or "non-U.S.-based" multinational. Nor does it matter if the "manufacturing" and "marketing" staff are physically proximate to the customer.

While these changes are happening, corporate managers are incentivized to reduce costs. U.S. Federal, State and foreign taxes are a cost. They are no different from raw material costs or labor costs. U.S. Federal corporate income taxes are, in fact, one of the most significant costs U.S. based multinationals have to reduce. To put it in perspective, a corporation's treasury function may spend significant time and energy to reduce a company's borrowing cost by 30 basis points. Yet, a multinational's decision to invert or produce products outside of the United States can save up to 3,500 basis points in U.S. Federal taxes alone on the profit derived from that activity.

So long as tax costs are imposed on corporations and reflected on income statements that, in turn, impact the compensation of corporate managers, those man-

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[1] Unless otherwise noted, all code, section, and Treas. Reg. § references are to the United States Internal Revenue Code of 1986, as amended, or regulations issued pursuant thereto.

[2] The article on integration is *A Taxing History: Why Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer,* 94 *Taxes* 3 (March 2016).

agers will be under incredible pressure to reduce those costs. It is, after all, their job.

III. THE PERILS OF RETAINING OUR CURRENT SYSTEM

As this committee is well aware, our current tax structure incentivizes corporate managers to produce products or services offshore instead of the United States even though, on a pre-Federal tax basis, that may not be the most efficient place to produce. The U.S. tax system incentives corporate managers to migrate intangibles to offshore jurisdictions. It then incentivizes those corporations to use those offshore funds to acquire more assets offshore rather than repatriate them to the United States (the so-called "lock-out effect"). The U.S. system also incentivizes corporations to invert. Although recent attempts have been made to curtail inversions, the U.S. Government cannot prevent corporations from simply being acquired by larger foreign corporations headquartered in countries with more favorable tax regimes.

IV. IF YOU CAN'T BEAT THEM, JOIN THEM

One approach would be to retain the current U.S. corporate tax structure but lower the corporate tax rate and develop an innovation box regime. These changes would make the United States more attractive relative to its peers.

The difficulty with this approach is that it is unclear how much this will truly impact the incentives of corporate managers. The U.S. Federal corporate income tax will still show up on corporate income statements. Corporate managers will still be tasked with reducing that line item. Congress can make it harder to invert, but it cannot prevent companies from being acquired, and it cannot prevent tomorrow's breakthrough company from being formed offshore today.

Thus, if the current corporate tax system is retained, the United States will be forced via tax competition to make other changes, like a territorial system, that put it on par with other countries. Yet, any territorial system that is designed to be appealing enough to make the United States competitive will likely enhance (rather than reduce) the incentive companies already have to own intangibles and produce their products and services offshore.

Most importantly, however, other countries will not simply stand pat. Any reform that makes the U.S. look better to corporate managers making investment decisions will almost certainly be countered by other countries that will make their corporate regimes even more attractive vis-à-vis the United States than they currently are. The Organization for Economic Cooperation and Development's ("OECD's") and G–20's base erosion and profit shifting ("BEPS") initiative attempts to put some additional guardrails around the manner in which many countries and the United States compete with one other. Yet, not all countries are OECD or G–20 members. Not all issues are governed by the OECD guidelines. The member countries have broad discretion about how they interpret the OECD guidelines that do apply. Moreover, it is not clear how the OECD can ensure compliance by those G–20 countries that are not OECD members. Last, but not least, even the OECD guidelines do not prevent countries from simply lowering their tax rates across the board.

The bottom line is that it is not easy to eliminate (or even reduce) tax competition. If it were easy to eliminate tax-competition, the members of the European Union would already have their consolidated corporate tax base, and the States within the United States would have done something similar long ago.

V. INTEGRATION PROVIDES A BETTER PATH FORWARD

A far better approach is to revamp the current corporate tax system so that the corporate tax burden is shifted away from the corporation (which is highly mobile) to the shareholders (who are not).[3] The goal should be to design a system that allows corporate managers of U.S.-based multinationals to manage their business, as much as possible, on a pre-U.S. Federal tax basis.

Starting in 1936, the U.S. tax system has explicitly sought two (2) levels of tax on corporate profits—one at the corporate level and again at the shareholder level. Since then, there have been multiple attempts to eliminate this "double-taxation"

[3] I use a defined term here, because obviously "shareholders" could, in turn, be U.S. or foreign corporations or non-resident aliens, etc. . . . By shareholders I mean to include U.S. individuals, tax-deferred accounts of those individuals, and U.S. tax-exempt entities. Foreign individuals and entities will have to be addressed through a withholding tax mechanism, with due consideration of any treaty concerns.

of corporate profits through various "integration" approaches that have been studied and analyzed over the years. I discuss the merits of these systems briefly below in reference to their impact on corporate manager incentives.

A. The Limits of An Imputation Credit Approach

One integration approach is to enact a shareholder imputation credit similar to that used in Australia and New Zealand. In this approach, corporations continue to pay tax, but domestic shareholders are allowed to credit those taxes against their own tax liability that they would otherwise have on the dividend. This has the effect of reducing or eliminating the second level of tax on corporate profits.

Some have argued that a shareholder imputation credit would reduce the incentive corporate managers have to migrate intangibles abroad and produce products and services abroad. The argument is that since the shareholder credit is only available with respect to distributions of profits that have been subjected to home-country taxation, corporate managers will have less incentive to avoid paying those home-country taxes.

There are a number of responses to this argument.

First, the extent to which the imputation credit is even helpful or relevant depends on the corporation's shareholder base. Australia, for example, allows dividends sourced from foreign (*i.e.,* non-Australian) profits to be paid to non-Australian shareholders without withholding tax, regardless whether the income has been subjected to Australian tax and regardless whether a treaty applies. Moreover, non-Australians do not receive any imputation credit. Thus, if the shareholder base is largely non-Australian, a corporate manager has no desire to pay Australian corporate tax in order to pass along a shareholder imputation credit. There is no upside for them. One could argue that the United States does not necessarily have to have the same system as Australia and could, for example, impose a withholding tax on distributions of foreign untaxed earnings to non-domestic shareholders. The U.S.'s flexibility is constrained by tax-competition, however. This leads to my next point below.

Second, the corporate tax is still reflected on the income statements of the multinational. Thus, corporate managers will still be incentivized (all other things being equal) to locate in jurisdictions that have other attractive features beyond simply a shareholder imputation credit. The United States will be compelled by tax competition to have similar features or lose investment. Perhaps the most significant example is a taxpayer favorable territorial system.[4] In this regard, it is important to point out that Australia effectively has a territorial system. Moreover, as noted above, Australia allows those repatriated profits from CFCs that have not been subjected to Australian tax to be distributed to non-Australians without any withholding tax. Thus, this committee should not assume that moving to a shareholder imputation credit approach will somehow reduce the pressure on Congress to enact other features, such as a territorial system, that further incentivize intangibles migration and offshore production. The United States will still have to engage in tax-competition with other countries, even if it enacts a shareholder imputation credit.

Third, corporate managers would only be incentivized to pay home-country tax during those periods when the company is paying dividends. Even then, they would only be incentivized to pay that amount of home-country taxes that are sufficient to support the dividends paid.

Fourth, it does not reduce the incentive corporate managers currently have to finance their business operations with debt.

B. Other Integration Approaches Would Change Incentives for the Better but Possess Serious Administrative Issues

Other integration approaches would completely shift the burden of the corporate tax on to the shareholder. These approaches would have the advantage of allowing corporate managers to plan entirely on a pre-tax basis. They would also focus the imposition of the business tax on individuals or U.S. tax exempt entities that are far less mobile than multinational corporations.

For example, one approach, which is only applicable for publicly traded corporations, involves eliminating the corporate income tax entirely and forcing shareholders of publicly traded companies to mark their shares to market (an "MTM" ap-

[4] As the committee is aware, there are a wide variety of "territorial" systems. Some systems exempt virtually all types of profits from the entire home country corporate tax, whereas others only exempt certain types of profits from most (but not all) home country corporate tax.

proach). Another approach involves treating all corporations like partnerships (a "pass-through" approach).

Both approaches involve significant administrative issues, however. For example, it is not at all clear how an MTM approach would be collected on a MTM basis (or even a realization basis) from non-resident aliens and foreign corporations if the U.S. issuer's stock is traded between two foreign persons on a foreign exchange. Similarly, the difficulty of allocating income of publicly traded entities on a pass-through basis has been addressed in a number of studies on integration.

C. The DPD Represents a More Administrable Integration Approach that Also Favorably Impacts Corporate Manager Incentives

An administrable integration approach that would also have a more positive impact on corporate manager incentives than the shareholder imputation credit is the so-called "dividends paid deduction" or "DPD" being considered by this committee. The DPD has been considered by Congress over the years (starting at least as early as 1946) as a method for eliminating the double-taxation of corporate profits.

Unlike the shareholder imputation credit, however, the DPD does more than mitigate double-taxation. It should reduce (albeit not eliminate) the incentive that corporate managers have to make investments on a post-U.S. Federal income tax basis. This, then, reduces the need for the U.S. Federal Government to engage in tax competition with other countries to have the best suite of tax features for multinationals.

First, the DPD ought to reduce (albeit not eliminate) the tax incentive that U.S.-based multinationals have to produce products or services offshore. I say "reduce" because it is still possible that a corporation would have taxable income in excess of "free" cash flow (the cash flow existing after reinvestment in the business) that cannot be eliminated on a present basis through a DPD.[5]

EXAMPLE: USCO, a publicly traded U.S. multinational, needs to decide whether to build a plant in the U.S. or offshore. The pre-tax projections of cash flow and taxable income are as follows:

	2017	2018	2019	2020	2021
Revenue	$0	$30	$100	$105	$111
COGS	$0	($18)	($30)	($30)	($30)
Operating Expenses	$0	($10)	($10)	($10)	($10)
Depreciation	($10)	($12)	($16)	($20)	($24)
Taxable Income	($10)	($10)	$44	$45	$47
Cash Flow From Operations	$0	$2	$60	$65	$71
CAPEX	($100)	($20)	($40)	($40)	($40)
"Free Cash Flow" [6]	($100)	($18)	$20	$25	$31

Beginning in 2019, the net operating loss carryforwards will have been used, and taxable income will be generated, but there will not be enough "free" cash flow to pay a sufficiently large dividend to wipe out the entire corporate tax through a DPD. Depending on the U.S. corporate rate, the foreign tax rate and the length of time taxable income is expected to exceed free cash flow, USCO may still conceivably have an incentive to engage in deferral. Nevertheless, the differential between the U.S. and foreign tax rate would have to be significant, and the time frame during which taxable income exceeds cash flow would also have to be lengthy for the prospect of deferral to motivate offshore production.

[5] Most businesses (and investments made by those businesses) move through different stages during which they have different income and cash flow profiles. *See e.g.,* Donald L. Lester, John A. Parnell, and Shawn Carraher, "Organizational Life Cycle: A Five-Stage Empirical Scale," 11 *International Journal of Organizational Analysis* 339 (2003).

[6] I am assuming the negative free cash flow is funded either by issuing equity or debt.

Second, the DPD should substantially reduce the so-called "lock-out" effect that currently plagues many U.S.-based multinationals, without necessitating a switch to a territorial regime.[7] Presently, if earnings are retained offshore, and not repatriated, no U.S. tax is paid and no tax is accrued on the U.S. financial statements.[8] This creates a tremendous incentive to keep cash in non-productive passive investments, reinvest cash offshore, and borrow in the United States to fund dividends and stock buy-backs. With a DPD, to the extent that the repatriated cash will be used to pay dividends,[9] there is no Federal tax reason for the multinational to keep cash offshore.[10]

Third, the DPD would either substantially reduce (or possibly even eliminate) the preference that currently exists in the U.S. tax system for debt financing corporate operations. The precise extent to which parity is achieved, however, depends on a number of specific policy choices that Congress will have to make if it proceeds with a DPD. I address this issue specifically in the remainder of my written testimony.

VI. THE IMPACT OF A DPD ON DEBT-EQUITY PARITY

The committee is keenly interested in the extent to which allowing corporations a DPD would eliminate the preference for debt financing in the United States. The tax law did not always favor debt over equity financing as much as it does today. In fact, there is little to suggest that the current preference for debt financing was ever fully considered as an affirmative policy choice by Congress. Instead, the advantage of using debt financing instead of equity financing waxed and waned in the first decades of the 20th century based on interest deductibility limitations and corporate and individual rates. It was only when Congress chose to impose two levels of tax on corporate profits in 1936 and the only limit on the sheer amount of debt a corporation could issue was established by common law that the tax preference for debt was firmly established. Again, this does not appear to be a considered policy decision taken by Congress, but instead is a state of affairs that evolved over time based on other changes in the code.

The importance of the distinction is illustrated in stark relief with the issuance of the proposed section 385 regulations. As this committee will likely hear from others over the coming months, the new proposed section 385 regulations will have a profoundly negative impact on ordinary non-tax motivated transactions and investment in this country. Thus, it would be good for the government and the taxpayer community if the tax treatment of debt and equity were brought into greater balance, thereby obviating the need for punitive rules, like the proposed section 385 regulations, that hinder legitimate economic activity such as cash-pooling, acquisitions of foreign companies that will not be compliant with section 385 and post-closing integration.

Clearly, allowing a DPD will eliminate the biggest tax difference between debt and equity financing. Yet, there are a lot of second- and third-order effects that this committee should consider in connection with granting a DPD. The committee should consider how far it wants to tip the scales in favor of equity financing.

One threshold issue, for example, is the "base" out of which the DPD may be claimed. A "dividend" represents property distributed out of a corporation's earnings and profits ("E&P") which will not necessarily be the same as a corporation's "taxable income." A basic example would be interest on a tax-exempt bond, which would be included in E&P but not included in taxable income. Interest expense reduces a corporation's earnings and profits ("E&P") but may only be deducted against taxable income. Thus, a decision will need to be made as to whether a distribution of property creates a DPD if it is made out of E&P[11] or whether it will be limited to distributions made out of "taxable income." This will then have certain cascading effects which I refer to below.

There are also more bespoke issues that are unique to specific holders and specific issuers. In the interest of simplification, Congress should also reconsider a number

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[7] To be clear, enactment of a DPD does not preclude the enactment of some form of territorial regime.

[8] The financial statement presentation is driven by Accounting Principles Board Standard 23 which has since been codified as ASC 740–10–25–3.

[9] I address stock buy-backs below.

[10] The corporate taxpayer would still be incentivized to keep cash offshore if the cash is being brought back to repay principal on debt (which would not be deductible) or invest in assets with long class lives that will depreciate slowly.

[11] To the extent the DPD exceeds taxable income, it would then presumably create a net operating loss that could be carried backwards or forwards.

of anti-abuse provisions the code contains that will cease to have a rationale once a DPD is enacted. The DPD could also impact many common reorganization transactions. I try to highlight some of those effects the committee should consider below.

A. Issues From a Holder's Perspective

Different holders will have different concerns with respect to the DPD proposal depending on their status and how the rule is crafted.

1. U.S. Shareholder Perspective

U.S. individuals, domestic corporations and tax-exempt entities will have different concerns with respect to the DPD proposal than foreign investors. We address domestic taxpayers below.

a. Individual Holders

It is useful to think in terms of tax base, rate, and timing.

Tax Base

The DPD should not impact or create a "base" difference between debt and equity. In terms of the tax base, under current law, the rules governing debt (including but not limited to contingent debt) and the rules governing equity both allow for the tax-free return of invested capital/principal and the inclusion in gross income of return on that capital/principal. Thus, it is really the rate at which that income is taxed and the time when it is taxed that have to be considered in determining how far a DPD would tilt the scales in favor of equity financing.

Tax Rate

Normally, interest deducted by a corporation is included in the taxable income of individuals at ordinary income rates. Yet, individuals currently enjoy a favorable tax rate on dividends paid by domestic corporations under section 1(h)(11) if they hold the shares of the issuer for a sufficient period of time. If the DPD is enacted and there is no change to the foregoing preference, there will be an incentive (all other things being equal) for holders to own debt-like equity as opposed to equity-like debt.[12]

One additional issue the committee will need to address is the tax treatment of redemptions taxed under section 302(a). If the committee wants the DPD to mitigate the current "lock-out" effect for CFC earnings, the committee will have to consider whether the DPD applies to share repurchases governed by section 302(a) as well as property distributions governed by section 301. This is because many companies use their free cash flow to buy back stock, not just pay dividends. Stock buy-backs from public shareholders are often governed by section 302(a) of the code (governing sale-type redemptions), not section 302(d) and section 301 (governing dividend-equivalent redemptions). If the redemption is governed by section 302(a), section 312(n)(7) currently limits the amount of the E&P reduction to those earnings attributable to the shares that were redeemed. Yet, despite the E&P reduction, the shareholder recognizes "gain" (not ordinary income) equal to the dividend minus his/her basis.

> *EXAMPLE:* In 2016, A, a U.S. citizen invested $1 in USCO, a publicly traded corporation in an initial public offering for 1% of USCO's shares. A then sold those shares to B, a U.S. citizen, for $4 in 2017. In 2022, USCO has $1,000 of E&P. USCO has a stock buy-back program where it periodically goes out into the market and redeems shares from those shareholders who choose to tender their shares. In 2022, B tenders all of his shares in USCO for $10.[13]

Under current law, USCO would reduce its E&P by $10 (1% × $1,000) and not receive a deduction. A would recognize a gain of $3 in 2017, but the gain would be "capital" in nature. B would recognize gain of $6 ($10 minus $4) and, again, the gain would be "capital" in nature. If a DPD were enacted and drafted so that it applied to share-buy backs, the issuer would presumably get an ordinary deduction of $10,

[12] Congress has historically been concerned abut equity-like debt, rather than debt-like equity. *See e.g.,* §§ 163(l) and 279.

[13] The example assumes that USCO received $100 of initial equity capital, earned another $1,000, but nevertheless is only worth $1,000, which suggests USCO has $100 of assets on its balance sheet that have depreciated in value but USCO has not been able to deduct them for tax purposes.

assuming E&P equaled taxable income.[14] USCO's preference for debt financing would thus be reduced. The rates applicable to A and B's income, however, will be more favorable than they would be had A loaned money for a contingent debt instrument and sold it to B who then had it redeemed by USCO.[15] Thus, A and B would now have a tax preference for equity financing under this scenario.

Timing

Holders of instruments with original issue discount ("OID") and contingent debt instruments have to recognize income over the term of the instrument even if they do not necessarily receive cash. A holder of an equity instrument only recognizes income when there is a realization event, like a dividend or a redemption.

Unlike the rate difference described above, however, this distinction is merited by the different economic terms between debt and equity. As the committee is aware, "debt" and "equity" lie on either ends of a continuum with repayment of principal and yield on "debt" being more certain than with "equity." Thus, allowing holders of "equity" to defer income recognition does not automatically mean that holders will prefer equity over debt. To be "equity" in the first instance, the payments on the instrument would typically have to be more uncertain than those of a debt instrument, and so allowing holders to defer taxation until there is a realization event would seem appropriate.

b. Corporate Holders

There is no capital gains rate differential for corporations. But corporations do receive a dividends received deduction with respect to dividends from other corporations.[16] Presumably, if a DPD were enacted, the dividends received deduction would be removed. If so, that would bring the treatment of equity financing more in line with debt financing for corporate holders.

c. U.S. Tax-Exempt Entities

Subject to some exceptions, interest and dividends received by a tax-exempt entity are not considered Unrelated Business Taxable Income ("UBTI"). Yet, corporate tax is paid on the earnings out which corporate dividends are paid, whereas, corporate tax is not paid on interest payments made to tax-exempt entities. Thus, the tax-exempt investor gets an exclusion with debt or equity financing but only debt financing generates a corporate tax deduction.

If Congress were to enact a DPD and retain the current treatment of dividends, the DPD would equalize the treatment of debt and equity for tax-exempt entities. Yet, it would also result in lost revenue, as no business tax would be paid on earnings that were paid to tax-exempts as dividends or interest. In this committee's May 17th hearing, it heard about the tremendous growth in ownership of U.S. corporations by tax-exempt shareholders. Thus, the revenue loss would likely be significant.

If, instead, Congress were to cause dividends from domestic corporations (but not interest) to be UBTI (in order to compensate for the lost corporate tax revenue), then U.S. tax-exempt entities would presumably prefer offering debt financing. This is because even if yields on equity were adjusted to reflect the treatment of dividends as UBTI, tax-exempt entities cannot earn an unlimited amount of UBTI without endangering their tax-exempt status.[17] Thus, one approach would be to impose tax on dividends and interest paid by domestic corporations to tax-exempt entities, but not count those dividend and interest payments against the tax-exempt entity in determining its tax-exempt status.

During this committee's May 17th hearing, there was significant discussion about the impact that a withholding tax on dividends would have on retirement savings

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[14] I am assuming for purposes of this example that the committee would only permit a DPD for amounts paid out of E&P to the extent the earnings were reflected in taxable income and would not permit a deduction for E&P generated from untaxed earnings like municipal bond income, etc. . . .

[15] Had A loaned the money to USCO for a contingent debt instrument, at least a portion of A's income would be "ordinary" income that it accrued on a constant accrual basis until it sold the instrument to B. Similarly, at least a portion of B's income would be ordinary income that he accrued on a constant accrual basis prior to having the instrument redeemed.

[16] §§ 243, 245, 246, and 246A.

[17] Similarly, if both interest and dividends paid by domestic corporations were included in UBTI, one could see some tax-exempt entities preferring investments in non-dividend paying stocks or foreign entities to limit their overall amount of UBTI.

accounts, such as 401(k) plans. I would offer a couple of thoughts in this regard.[18] First, page 4 of Ms. Miller's testimony assumes that withdrawals from a 401(k) plan would still be taxable even if the withdrawal is made from income that has already been subjected to withholding tax. This may be true, but need not necessarily be true. There are a lot of correlative changes this committee needs to consider when enacting a DPD, and the taxation of amounts withdrawn from a 401(k) that have already borne shareholder level tax may be one of those changes. Possibilities would include exempting that income from tax when withdrawn or providing a refundable credit for the taxes that have been paid on that income when the income is withdrawn by the taxpayer. Second, like all taxpayers, 401(k) plan participants will adjust to any new tax system. They can shift their investment preferences (if given a sufficient transition period) from dividend paying stocks to growth stocks that are reinvesting all of their cash flow in the business.[19]

I would suggest that the real issue for tax-exempts, including but not limited to retirement accounts, is the possibility that a DPD would usher in a withholding tax on interest. Right now, as noted above, a U.S. corporation's interest payment to a tax-exempt entity is not subject to any business tax. The question for this committee is whether that is the appropriate answer from a policy perspective.

2. Foreign Shareholder's Perspective

As the committee is aware, the United States imposes a 30% withholding tax on U.S. source interest and dividend payments, but the United States has largely relinquished taxing jurisdiction on interest payments through its treaty network. In contrast, most U.S. tax treaties do not fully eliminate the withholding tax on dividends. The ones that do only do so for significant (80%+) shareholders who satisfy an enhanced limitations on benefits test. In addition, certain types of debt extended from unrelated parties can qualify for the "portfolio interest exemption"[20] and escape U.S. withholding tax without resorting to a treaty. These differences favor debt financing over equity financing.

Presumably, if Congress enacts a DPD, it will have to revisit the treatment of dividend withholding taxes under applicable treaties in order to offset the revenue loss that would otherwise occur. This, in turn, will likely require a similar reassessment of how interest is withheld upon. After all, if Congress enacts a DPD, but fails to equalize the manner in which interest and dividends are withheld upon, foreign persons will still have a significant preference for offering debt financing vs. equity financing.[21]

B. Issuer's Perspective

A corporate issuer's ability to derive an interest deduction for debt financing is obviously a significant tax advantage over equity financing. Yet, there are a number of places in the code where an interest deduction is either limited or has a negative corollary effect. Each provision has its own rationale and this committee will have to consider whether the rationale for the provision applies equally to a DPD.

1. Limitations on Interest Deductibility

The amount of interest deduction a corporate taxpayer may deduct in any given year with respect to debt issued to, or guaranteed by, a foreign related party is limited by section 163(j). Whether this limit also applies to a DPD would likely depend greatly on how Congress chooses to resolve the withholding tax issue mentioned above. For example, if dividends subject to a DPD are subject to full withholding, there may not be any reason to subject them to the section 163(j) limitation.

Some interest expense must be capitalized.[22] If similar rules are not provided for the DPD, all other things being equal, an issuer may have a preference for equity financing over debt financing.

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[18] I do not address whether, in fact, 401(k) plan participants are *already* bearing the corporate income tax through lower stock prices and dividends. This is because making that argument first requires the determination as to whether shareholders are currently bearing the economic burden of the corporate income tax, something that tax professionals have been arguing about for a very long time.

[19] Admittedly, this is easier for a younger individual who has a much longer investment horizon than an older plan participant who has transitioned his or her portfolio to income generating securities.

[20] *See* § 881(c) and Treas. Reg. § 1.871–14(g).

[21] I address the treaty override issues associated with a DPD more fully in my article cited above.

[22] *See* § 263A(f).

Interest on debt used to fund tax-exempt income is not deductible under section 265. That does not automatically mean a similar rule is required for a DPD. Given that the income generated from the investment is not taxable, a subsequent distribution of that income would presumably not be entitled a deduction.[23] Hence, it is not clear that the DPD arising from equity used to finance a tax-exempt investment would have to be subject to section 265.

The interest deduction with respect to related party debt is deferred until "paid" under sections 267(a)(2) and (3). This committee will have to consider whether it is appropriate to, for example, allow a corporate taxpayer to receive a DPD by simply issuing its own note to the shareholder, or whether payment in cash or other property will be required to crystalize the deduction.[24]

2. Correlative Effects

Interest deductions have a number of unfavorable correlative effects to U.S. corporations. The question is which of these correlative effects should apply equally to a DPD.

For example, U.S. corporations have to apportion interest expense to U.S. and foreign sources in order to compute their foreign tax credit limitation.[25] Any interest apportioned to foreign sources reduces the U.S. corporation's foreign tax credit limitation and its ability to claim foreign tax credits. The underlying theory is that money is fungible and if the taxpayer chooses to finance the business by having a U.S. corporation issue debt (instead of having its foreign subsidiaries issue the debt) then the interest expense should be apportioned. Presumably the DPD would also have to be apportioned under the same theory.

Corporations also have to apportion interest expense to gross income from activities that do, and activities that do not, qualify for the section 199 domestic production deduction. Presumably, the DPD would be similarly apportioned.

A similar issue will arise for foreign corporations that generate effectively connected income. If a foreign corporation generates effectively connected income, the code has rules that apportion its interest expenses to that effectively connected income and ensure that proper withholding tax is charged.[26] Moreover, since 2004, the United States has exempted dividends paid by foreign corporations with significant effectively connected income from U.S. withholding tax.[27] If a DPD were enacted, decisions would have to be made as to whether the DPD would be deductible against effectively connected income. If it is, a decision will have to be made as to how it is apportioned and withheld upon when distributed.

C. Enactment of a DPD will Remove the Rationale for a Number of the Code's Anti-Abuse Provisions

There are a whole host of code provisions that were enacted to prevent corporate taxpayers from issuing instruments that were characterized as debt under the common law, but nevertheless contained "equity-like" features. The underlying rationale for these provisions as that an interest deduction should not be permitted for instruments that were sufficiently "equity-like." If Congress were to enact a DPD, however, the rationale for these provisions presumably disappears. In the interest of simplifying the code, Congress may consider removing these provisions. I list some examples below.

Section 163(l) prohibits deductions on debt where a substantial portion of the principal or interest is payable in equity. Section 279, similarly, limits deductions with respect to debt issued in acquisitions that have certain equity-like features. Interestingly, section 279 was enacted at the same time as section 385 in 1969,[28] when Congress sought to better define the distinction between debt and equity. Pre-

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[23] I am assuming that the DPD would be limited to distributions out of taxed earnings and would not allow a deduction for income that had been subject to a preference. But if that is incorrect, then that could cause the committee to consider whether section 265 should also apply to deny a portion of the DPD.

[24] There is already significant case law that determines whether a corporation's issuance of an obligation is sufficient to cause a "dividend" to have been "paid." Compare, *Moser v. Commissioner,* 914 F.2d 1040 (8th Cir. 1990) and *Estate of McWhorter v. Commissioner,* 69 T.C. 650, *aff'd without opinion,* 590 F2.d 340 (8th Cir. 1978).

[25] § 864(e) and Treas. Reg. § 1.861–9T.

[26] § 884(f).

[27] § 871(i)(2)(D) enacted in § 409(a) of The American Jobs Creation Act of 2004.

[28] *See* An Act to Reform the Income Tax Laws, Pub. L. 91–172, § 411(a), 83 Stat. 487, 604–05 (1969).

sumably, the rationale for sections 163(l) and 279 would fall away if Congress were to enact a DPD. If so, Congress should consider repealing them.

Other examples are less clear-cut. For example, the applicable high yield debt obligation ("AHYDO") rules in section 163(e)(5) were enacted as an anti-abuse provision. Yet, unlike sections 163(l) and 279, it is not as obvious that the rationale for the AHYDO rules would fall away with a DPD. On the one hand, Congress enacted the AHYDO rules because they believed that high-yield instruments with significant deferred payments were very equity-like. In that sense, enactment of a DPD would eliminate the rationale for the AHYDO rules. Yet, the AHYDO rules also prevent a corporation from claiming a deduction for original issue discount accrued long before it is paid. That rationale would appear to remain intact even after the enactment of a DPD.

D. The DPD May Impact Other Common Reorganization Transactions

As a threshold matter, the code contains rules governing the movement and allocation of accumulated E&P in corporate reorganizations.[29] The rules do not address the movement and allocation of accumulated taxable income. Thus, if the DPD is only allowed for a payment out of accumulated taxable income (rather than E&P), companies will need rules to track and allocate their accumulated taxable income which they currently do not have.

In addition, the enactment of the DPD may impact the ability and desire of corporations to engage in divisive transactions. Under the code, when a corporation distributes appreciated property (including stock of a subsidiary) to its shareholders, a tax is imposed at the distributing corporate level and at the shareholder level. Section 355 provides an exception to this rule in certain specific fact patterns many of which require the taxpayer to analyze the preceding 5 years of shareholder and business activity. If section 355 applies, no gain is recognized at the corporate or shareholder level.

It is unlikely that the enactment of a DPD will incentivize corporations to engage in divisive transactions that do not satisfy the rigorous requirements of section 355. This is because the DPD will only eliminate the corporate-level gain, not the shareholder level income event. Moreover, the government will not allow distributing corporations to "withhold" on shares of a controlled subsidiary. Thus, if the distribution is taxable and withholding is required, the distributing corporation would have to come up with additional cash to pay over to the government. This would create an additional taxable event to the shareholders.[30] Thus, corporations will still need to satisfy the requirements of section 355 to do divisive transactions.

The question is whether it must comply with all of the requirements of section 355. It is possible that a divisive transaction can qualify for section 355, but corporate level tax can nevertheless be triggered under, for example, sections 355(d) and (e).

> *EXAMPLE:* USCO is a U.S. publicly traded corporation that wholly owns all of the stock of USSUB, a domestic subsidiary. USCO has a $10 tax basis in USSUB. USSUB is worth $100. USCO distributes all of the stock in USSUB to its shareholders in a transaction that satisfies section 355 in 2017. Later, in 2017, an unrelated corporation ("XYZCO") acquires all of the stock of USSUB in a transaction that runs afoul of section 355(e). The distribution remains tax-deferred to the shareholders, but USCO must recognize a $90 gain.

Presumably, a DPD would be denied in the foregoing example or else USCO would be somewhat ambivalent about complying with section 355(e).

VII. CONCLUSION

Thank you again for the opportunity to testify on tax reform and corporate integration. I am happy to answer any questions.

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[29] § 381 (governing tax-free liquidations and non-divisive asset reorganizations); and Treas. Reg. § 1.312–10 (in the case of divisive transactions).

[30] *See Old Colony Trust Co. v. Commissioner,* 279 U.S. 716 (1929) and *Enoch v. Commissioner,* 57 T.C. 781 (1972) (acq. in part).

PREPARED STATEMENT OF ALVIN C. WARREN, JR., ROPES AND GRAY PROFESSOR OF LAW, HARVARD LAW SCHOOL, HARVARD UNIVERSITY

Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me to testify today on the treatment of corporate debt and equity under proposals to integrate the individual and corporate income taxes.[1] I would like to emphasize three points: (1) current law creates significant distortions between debt and equity finance for U.S. companies, (2) integration could substantially reduce or eliminate those distortions, but (3) reduction of those distortions requires careful attention to other discontinuities under current law, such as the taxation of investment income of exempt entities, including retirement plans.

1. CURRENT LAW

The United States has long had a "classical" income tax system, under which income is taxed to corporations and to shareholders as distinct taxpayers. Interest paid to suppliers of corporate debt capital is deductible by the corporation, but dividends paid to shareholders are not. Taxable income earned by a corporation and then distributed to individual shareholders as a dividend is thus taxed twice, once to the corporation, and again to the shareholder on receipt of the dividend. As a result, the current regime is often characterized as a "double tax" system.

The actual U.S. tax system is considerably more complex. For example, some income earned through corporate enterprise is taxed only once, at the corporate level. This is the result for corporate taxable income distributed as dividends to tax-exempt shareholders, such as pension funds and charitable endowments. Other income earned through corporate enterprise is taxed only once, at the investor level. This occurs when corporate earnings are distributed as deductible interest payments to taxable debtholders. Finally, some income earned through corporate enterprise is not taxed in the United States at either the corporate or investor level. This is the result for deductible interest paid to certain foreign and tax-exempt holders of U.S. corporate debt. Accordingly, domestic corporate income is sometimes taxed twice in the United States, sometimes once, and sometimes not at all.

This system creates many financial and economic distortions, which can include (1) a disincentive for investment in new corporate capital, (2) an incentive for corporate financing by debt or retained earnings, (3) an incentive to retain (or distribute) corporate earnings, and (4) an incentive to distribute corporate earnings in tax-preferred forms. The extent and direction of these distortions depend on the relationship of four tax rates: the rate on corporate income, the rate on individual investment income, the rate on dividend receipts, and the rate on the sale of corporate shares. The U.S. rate of tax on corporate income is currently significantly higher than in many other major economies, which creates incentives to shift income abroad, including by converting U.S. companies into foreign entities.

This hearing is focused on distortion, particularly the tax preference for corporate debt over equity. Economists tend to emphasize the deleterious economic consequences of the distortion, such as the difficulties faced by highly leveraged companies in economic downturns. Lawyers tend to emphasize the wasteful transactional costs of designing complex financial instruments to fall on one side or the other of the fuzzy border between debt and equity.

2. INTEGRATION BY SHAREHOLDER CREDIT

How would integration of the individual and corporate taxes reduce or eliminate the tax preference for corporate debt? Consider first shareholder-credit integration. Under this approach, the corporate tax would be converted into a withholding tax that is creditable against the shareholder tax due on dividends.

By way of example, assume that the corporate tax rate is 35% and dividends are taxed as ordinary income. A company that earns $100 of income would pay $35 in corporate tax, leaving $65 for distribution as a dividend. Assume now that the $65 cash dividend is paid to a domestic shareholder whose individual tax rate is 20%, 25% or 40%. Individual shareholders would include $100 in their taxable income (just as employees include pre-withholding wages in income), apply their normal tax rate, and, assuming that the credit is refundable, offset the resulting tax by a credit

[1] I appear on my own behalf. This statement does not purport to represent the views of any institution with which I am affiliated. In preparing this testimony, I have drawn freely on my previous writings on the subject.

for the $35 corporate tax (just as employees receive a credit for taxes withheld by their employers).

As shown in Table 1 below,[2] the ultimate tax burden would be the same as if the shareholders had earned the business income directly.

Table 1. Shareholder-Credit Integration
$65 Cash Dividend Out of $100 Corporate Income After $35 Corporate Tax Payment

Shareholder tax rate	20%	25%	40%
1. Shareholders' taxable income	100	100	100
2. Initial tax	20	25	40
3. Tax credit (35% × line 1)	35	35	35
4. Final tax or refund (line 2 − line 3)	−15	−10	5
5. Net shareholder cash ($65 − line 4)	80	75	60

As this example illustrates, a refundable shareholder credit would incorporate the entity-level business tax into the graduated individual income tax. The resulting integration of the two taxes would advance the goal of ultimately taxing income, from whatever source derived, at an individual's personal tax rate. As corporate interest payments are currently so taxed, shareholder-credit integration could reduce or eliminate the differential treatment of corporate debt and equity under current law.

The system illustrated in Table 1 has been used in many major economies and was recommended for the U.S. in a 1993 study of the American Law Institute.[3]

3. INTEGRATION BY DIVIDEND DEDUCTION AND WITHHOLDING

The committee staff has been developing a related proposal for the chairman.[4] Under this approach, corporations would deduct dividend payments and withhold a shareholder tax on those payments. The result can be similar or identical to shareholder-credit integration, because the withholding tax and credit function similarly to a shareholder credit for corporate taxes. Table 2 provides an example of identical cash flows under the two approaches, assuming a corporate and withholding tax rate of 35%.[5]

[2] Example 1 is taken from Michael J. Graetz and Alvin C. Warren, Integration of Corporate and Shareholder Taxes, *National Tax Journal* (forthcoming, 2016), current version: *http://ssrn.com/abstract=2780490.*

[3] Alvin C. Warren, "Reporter's Study of Corporate Tax Integration" (American Law Institute), reprinted in Michael J. Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (*Tax Analysts,* 1998; Amazon.com e-book, 2014).

[4] U.S. Senate, Committee on Finance, *The Business Income Tax—Bipartisan Tax Working Group Report* (July 2015); U.S. Senate, Committee on Finance, Republican Staff, *Comprehensive Tax Reform for 2015 and Beyond* (December 2014).

[5] Example 2 is taken from Graetz and Warren, *supra* note 2. For similar examples, see Warren, *supra* note 2 at 54–55; U.S. Senate, Committee on Finance (2014), *supra* note 4 at 202–203.

Table 2. Comparison of Present Law, Shareholder Credit, and Dividend Deduction With Withholding Cash Dividend of $30

Assumptions: Corporate and withholding tax rates are 35%. Shareholder tax rate is 20% under current law and 40% with a shareholder credit or dividend deduction. The corporation receives $100 in taxable income and pays a cash dividend of $30 (*i.e.,* a dividend that reduces corporate cash by $30 and increases shareholder cash by $30).

Taxpayer	Present Law	Imputation credit	Dividend deduction and withholding tax
CORPORATION			
1. Taxable income before dividend	$100.00	$100.00	$100.00
2. Corporate tax before dividend	$35.00	$35.00	$35.00
3. Corporate cash before dividend	$65.00	$65.00	$65.00
4. Declared dividend	$30.00	$30.00	$46.15
5. Corporate tax to be imputed to shareholder (35/65 × line 4)	NA	$16.15	NA
6. Dividend withholding (35% × line 4)	NA	NA	$16.15
7. Tax reduction due to dividend deduction (35% × line 4)	NA	NA	$16.15
8. Total corporate tax (line 2 − line 7)	$35.00	$35.00	$18.85
9. Remaining corporate cash (line 3 − line 4 + line 7)	$35.00	$35.00	$35.00
10. Reduction in corporate cash (line 3 − line 9)	$30.00	$30.00	$30.00
11. Effective corporate tax rate* (line 8/line 1)	35%	35%	18.85%
U.S. SHAREHOLDER			
12. Cash dividend (line 4 − line 6)	$30.00	$30.00	$30.00
13. Taxable dividend (line 4 + line 5)	$30.00	$46.15	$46.15
14. Shareholder tax before imputation or withholding credit	$6.00	$18.46	$18.46
15. Imputation or withholding credit (line 5 or 6)	0	$16.15	$16.15
16. Net shareholder tax (line 14 − line 15)	$6.00	$2.31	$2.31
17. Net shareholder cash (line 12 − line 16)	$24.00	$27.69	$27.69
COMBINED CORPORATE AND SHAREHOLDER TAXES			
18. Total tax (line 6 + line 8 + line 16)	$41.00	$37.31	$37.31
19. Corporate tax on distributed income [(35/65 x line 10) − line 7]	$16.15	$16.15	0
20. Shareholder tax on distributed income (line 16 + line 6)	$6.00	$2.31	$18.46
21. Total tax on distributed income (line 19 + line 20)	$22.15	$18.46	$18.46
22. Pre-tax distributed income (line 10/.65)	$46.15	$46.15	$46.15
23. Total effective tax rate on distributed income* (line 21/line 22)	48%	40%	40%

*Assumes book and taxable income are the same

As Table 2 illustrates, identical cash flows can be reached under a shareholder credit and a dividend deduction with withholding. There are, however, important differences in the characterization of those results. The declared dividend under the deduction in Table 2 is higher, because it includes the withholding tax of $16.15. As compared to the shareholder credit, the dividend deduction reduces the "corporate" tax to $18.85. If the accounting authorities agreed with that characterization, the company's effective tax rate would be 18.85% (assuming that book income also equals $100), rather than 35% under the shareholder credit. In both cases, the government receives total payments from the corporation of $35 and a total 40% tax on the distributed earnings, but, as shown in lines 6, 16 and 19, those amounts are classified differently, as among corporate, withholding, and shareholder taxes.

This example shows that a corporation may achieve results equivalent to a shareholder credit if it increases its declared dividend by the amount of withheld taxes. Most importantly for our subject today, a dividend deduction would eliminate the current preference for corporate debt due to the deduction for interest payments. Given the proposed withholding tax on dividends, a new distinction between debt and equity could be eliminated by extending withholding to payments of interest.

4. INTERRELATED DESIGN ISSUES, PARTICULARLY WITH RESPECT TO EXEMPT ENTITIES

As illustrated in the foregoing examples, the tax preference for debt over equity finance could be eliminated or substantially reduced under integration. The real world is, of course, much more complicated than these examples, so a number of important design issues would have to be addressed, including the treatment of corporate income that has not borne U.S. corporate tax, retained earnings, tax-exempt shareholders (including retirement accounts), foreign income, foreign shareholders, and distributions other than dividends (such as share repurchases). Substantial work has already been done on these issues, many of which are interrelated.

Given its importance, I want to focus here on the relationship between eliminating the corporate debt bias of current law and the taxation of exempt entities, particularly retirement accounts. To clarify the discussion, I would like to make a distinction between the absolute tax burden and the relative tax advantage of exempt entities relating to their corporate investments.

a. Absolute Tax Burden

By absolute tax burden, I mean simply the total taxes due on income ultimately realized by an exempt entity from its corporate investments. As indicated above, current law imposes a tax at the company level on dividends out of corporate taxable income, but no tax on interest payments out of corporate income. As exempt investors pay no tax in either case, the result is a discontinuity not only at the corporate level, but also at the investor level. We cannot eliminate the first discontinuity without affecting the second.

Suppose, for example, we adopted a shareholder credit (as in Table 1) that was refundable to exempt shareholders. That form of integration would *decrease* the absolute tax burden on corporate income distributed to exempt investors, because dividends would now be burdened by a tax at neither the corporate nor the investor level. Now suppose we adopted a dividend deduction with withholding at the corporate tax rate (as in Table 2). If the dividend withholding were nonrefundable, the amount an exempt entity would receive from a dividend out of corporate taxable income *would neither increase nor decrease.* Further suppose that we adopted nonrefundable withholding on corporate payments of interest as well as dividends. Assuming first that such interest payments were not increased to reflect the new withholding tax, that tax would *increase* the absolute burden on corporate income distributed to exempts. Now assume that competitive pressure from other sources of interest on which there was no withholding induced corporations to increase interest payments, so that investors received the same net amount they had received without the withholding tax. That result would effectively increase corporate-level taxes, while leaving unchanged the amount of interest received by exempt entities

Finally, suppose that we wanted to eliminate the debt-equity distortions of current law without increasing or decreasing the overall absolute tax burden on exempt entities. Nearly 40 years ago, the Assistant Secretary of the Treasury for Tax Policy raised this issue using a paradoxical question: "at what rate of tax are tax-exempts tax exempt?" [6]

One approach would be to determine the corporate taxes paid on dividends to exempt entities and then to enact an explicit tax on their income from corporate investments, against which corporate taxes (or withholding) would be creditable and refundable. The level of the new tax could be set to maintain, decrease or increase the current tax burden on corporate income received by exempt entities. In 1992, the Treasury estimated that such a tax in the range of 6% to 8% would approximate the then current corporate tax on dividends paid to exempt entities.[7] This general approach, which was recommended in the 1993 American Law Institute study, has the advantage of minimizing tax differentials. Some would say it has the disadvantage of recognizing explicitly the rate of tax at which tax-exempts are taxed on their investment income.

The foregoing discussion suggests that the method chosen to reduce the corporate-level distortion between debt and equity could have significant effects on the taxation of exempt entities, including tax-preferred retirement accounts. Given the important role played by tax-preferred accounts in the Nation's savings, it is therefore crucial that careful attention be paid to the effects of integration on the absolute tax burden on retirement savings to achieve whatever results are considered appropriate for such savings.

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[6] Statement of Acting Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick, *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Committee on Ways and Means,* 95th Congress, 2d Session at 6254 (1978).

[7] U.S. Treasury Department, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once," at 71 (1992), reprinted in Michael J. Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (*Tax Analysts,* 1998; Amazon.com e-book, 2014).

b. Relative Tax Advantage

Even if there is no increase in the absolute tax burden of exempts, integration might affect their relative tax advantage. Consider again a dividend deduction with nonrefundable withholding at the corporate tax rate. Cash dividends paid out of corporate taxable income to a qualified retirement account would neither decrease or increase if dividends were grossed-up to reflect the deduction (as shown in Table 2). On the other hand, after-tax amounts from dividends received by taxable shareholders could increase, because the credit could eliminate or reduce the additional investor-level tax due under current law. For example, a shareholder whose tax rate on dividends did not exceed the corporate rate would no longer owe any investor-level tax.

Should the resulting reduction in the relative advantage of investing through a qualified account be considered a defect of integration in such a case? Assuming tax rates do not change, the key advantage of qualified retirement accounts is that investment income compounds at a zero rate of tax. (This is the well-known present-value equivalence of qualified accounts and Roth IRAs).[8] The relative advantage of compounding at a zero rate of tax (or any other preferred rate) necessarily declines if the tax burden on investments outside qualified accounts goes down. In my view, the resulting decline in the relative tax advantage of tax-preferred accounts should not be regarded as a reason to oppose a reduction in taxes on other forms of saving. The logic of such opposition would lead to supporting the highest possible tax rate for investment income outside qualified retirement accounts.

By the same token, the fact that an integration structure could reduce taxes for investments outside qualified accounts, while holding constant the absolute tax burden inside retirement accounts, should not be considered a defect. The policy of encouraging retirement saving through tax-preferred accounts should not require opposition to reducing taxes on other forms of saving.

5. CONCLUSIONS

Integration, whether by shareholder credit or a dividend deduction with withholding, could substantially reduce many distortions and problems of current law (including certain international problems, which are not the subject of today's hearing). In particular, integration could reduce or eliminate important distortions caused by differences in the taxation of corporate debt and equity. Any integration proposal should, however, be carefully crafted to achieve the desired results regarding the absolute tax burden on income earned by exempt entities (including retirement accounts) from their investment in corporate debt and equity.

PREPARED STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON

One of the biggest challenges in tax reform is figuring out the right ways to slash the thicket of tax rules that today have too much influence over our economy.

Democrats and Republicans, in my view, share the goal of getting the tax code out of the businesses of picking economic winners and losers.

That's why I've put forward proposals for a technology-neutral energy tax policy that cuts energy subsidies in half, a simpler set of depreciation rules that ends the expensing headaches for small businesses, and closing the loopholes on financial tricksters who want to rip off the system at the expense of middle-class taxpayers.

Another major question is how tax reform should unwind the code's bias in favor of taking on debt. For businesses, this issue is all about how you're going to finance investment, growth, and hiring.

Maybe you've designed a new product line and you need to build a facility to produce it. Maybe you need to put up new cell towers with the latest technology. Or maybe your firm is ready to launch a west-coast branch and hire a new team, and you've made just the right decision: you're setting up shop in Oregon.

The question is whether you're going to finance those plans with debt by selling bonds, or with equity by selling stock. Today the tax code pushes businesses toward debt with a tax write-off for interest payments on the bonds they sell.

[8] *See e.g.,* Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 275–281, 696 (7th edition, 2013).

Without any question, that has a big influence over our economy. On one hand, it makes bonds an attractive investment tool. But on the other hand, there are probably a lot of businesses with debt that they wouldn't have taken on if the tax code didn't encourage it.

In my view, business decisions should be made for business reasons, not tax reasons. And I believe reducing the tax code's economic distortions is a bipartisan proposition when it comes to tax reform.

Today the committee is continuing its examination of a proposal known as corporate integration, which is one strategy that has been put forward as a way to help limit the preference for debt. It would accomplish that by offering companies a write-off for dividend payments they make to their shareholders. Americans have questions about how you'd finance that tax cut, other than by withholding some amount from dividend and bond interest payments.

This is a complicated area of tax policy, and any change would no doubt have big effects on our economy, so it's an important issue for the committee to dissect.

I want to thank our witnesses for joining the committee here today, and I look forward to your testimony.

COMMUNICATION

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Comments for the Record by Michael Bindner

Senate Committee on Finance
Debt Versus Equity: Corporate Integration Considerations
Tuesday, May 24, 2016

Chairman Hatch and Ranking Member Wyden, thank you for the opportunity to submit my comments on this topic, which are largely a restatement of our submission to a Joint Committee Hearing on July 13, 2011.

The main change to our comments is to our four-part tax reform proposal, which is as follows:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement, and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old-Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We preface our analysis by noting that debt and equity are not taxed, per se. Instead, the interest on debt is taxed as income to the lender and their depositors or investors and is considered an expense to those who incur it for the purchase of capital or for home financing while dividends are taxed rather than equity. Indeed, equity cannot be federally taxed—only the dividend income earned as a result of holding such equity. State governments can, of course, tax equity under personal property tax provisions and it could potentially be taxed under a state level Equity Value Tax, which would operate on the same principal as a Land Value Tax on economic rent.

Two perspectives on taxing interest and dividends are important to note—the perspective of the producer/business owner and the perspective of the consumer. Identifying both points of view is essential to any analysis of the economic and equity impacts of tax reform on interest and dividend taxation.

Under the VAT and NBRT elements of our proposal, interest paid would continue to be an expense while increases to equity would be considered a result of adding value and therefore subject to tax, whether paid out in dividends or not. The equity itself, however, is not taxed—rather the income which grows income is.

Under VAT and NBRT regimes, labor is also taxed while interest paid is not, however the return on equity and labor would ideally be taxed at the same rate—rather than taxing dividends at either a higher or lower rate than income, depending on the tax bracket of the taxpayer and their primary source of income.

An advantage to both VAT and NERT is that they are potentially much simpler with regard to the tax treatment of interest expenses than the current personal and corporate income tax systems, although that simplicity is as much a function of how the tax laws are written as the inherent nature of these taxes.

Under our proposals, wages, interest income, and dividend income for most households would not be taxed directly. In order to facilitate the payment of VAT, net income would increase by the same percentage as the VAT plus any adjustment due to receipt of refundable Child Tax Credits through NBRT, while gross income would decline to Net Income plus OASI taxes and for high income individuals and families, continued income surtax withholding.

For most families, taxation would occur through consumption rather than through wages. The loss of gross income would be for wages which were never paid anyway, as the responsibility for being an object of taxation shifts from the employee to the employer. Of course, economically, the consumer is the already the ultimate funder of all income taxes currently paid by both labor and capital under the current system.

There is extensive literature already in existence on the tax treatment of interest income to financial services firms. We will leave review and comment of this highly technical literature to those who are expert in it, as we believe it is beyond the purposes of this hearing. Such issues are important to consider when implementing legislation and regulation are in the drafting stage—and we surmise that this debate is nowhere near that point.

OASI contributions have no impact on the question of interest and dividends unless personal accounts are included as a feature. Whether such accounts are on the Cato Institute model, with diversified investment, or our model with insured investment in the employing company, equity would largely replace debt and value added to equity would be taxed as income under VAT and NBRT rather than as interest income to the financial institution making the loan.

High-income individuals are more likely to be taxed both as consumers and as producers; however, their greater propensity to consume less of a percentage of income in any current period requires a separate surtax, especially if dividends are reinvested rather than spent and capital gains remain unrealized. In the short term, reinvestment or holding investments leaves this potential income outside the reach of taxation, creating real vertical equity issues that can only be resolved with the adoption of surtaxes on all income above a certain level.

Under our proposal, there would be no separate rate for interest, dividends, disbursements from inheritance or sale of inherited assets (unless the sale is to a qualified Employee Stock Ownership Plan), capital gains or wages. All income would be taxed at the same rate. For high income tax payers, all income is fungible. It matters not whether it comes from dividends or from interest on deposits loaned out to firms who pursue debt finance rather than equity finance.

We propose graduated rates from the $100,000 per year income level to the $550,000 per year level, as it is no more complicated to look up tax due on a tax table for graduated rates than for a single rate, so tax simplification concerns provide no justification for abandoning graduated tax rates. Indeed, such rates are necessary to compensate for the fact that at higher levels, families are more likely to defer spending for decades, if not generations, and may attempt to avoid taxation permanently. While in the long term, all income must eventually be spent to have any value, in the short term there are serious equity concerns from not taxing high income individuals at a higher rate because they are less likely to consume within a given period.

Without high-income surtaxes, the pool of potential investment becomes more and more concentrated until the vast majority of the population is reduced to wage slavery alone. Indeed, the lowering of tax rates in the last three decades has produced such a result, with productivity gains going to an ever shrinking high income population at the top of the income distribution, while most workers see income levels rise only by the rate of inflation, even when they are the source of the increased productivity that is growing the economy.

Drawing this distinction is much more important than the impact of tax reform on debt finance versus equity finance.

Thank you for this opportunity to share these ideas with the committee.