

## **INTEGRATING THE CORPORATE AND INDIVIDUAL TAX SYSTEMS: THE DIVIDENDS PAID DEDUCTION CONSIDERED**

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Chairman Hatch, Ranking Member Wyden, and members of the committee. Thank you for inviting me to appear today to discuss integrating the corporate and individual tax systems.

In my testimony, I first describe how taxes on corporate earnings have dropped because of corporate moves to avoid taxes and because of shareholder shifts from taxable to nontaxable accounts. Both trends are important to thinking about corporate tax integration—particularly in the form of a dividends paid deduction. The shareholder shift is less obvious because the published data are hard to parse, leading even sophisticated analysts to overstate the taxable share of US stock.

Second, I describe how a lower estimate of the taxable share of US stock complicates attempts to integrate corporate and individual taxes further. Finally, I suggest some areas for further research on the competitiveness of US corporate taxes.

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<sup>1</sup> The views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders. I would like to acknowledge the suggestions of Alan Auerbach, Lydia Austin, Richard Auxier, Len Burman, Frank Clemente, Howard Gleckman, Joe Rosenberg, Frank Sammartino, Steve Shay, Eric Toder, and Bob Williams.

## US STOCK OWNERSHIP TRENDS

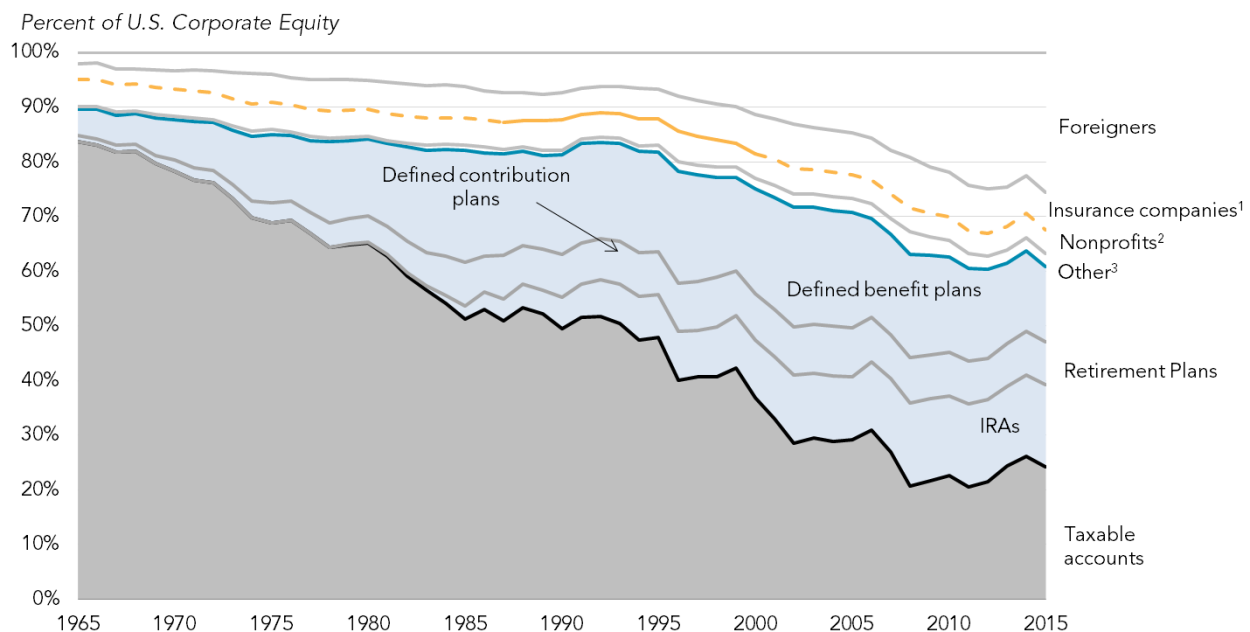
The usual story we tell is that corporate earnings are generally subject to two levels of tax: first, the company pays the corporate income tax; second, the shareholders pay individual income tax on dividends and realized capital gains. Yet reality may differ from that simple story.

Many commentators have noted the sharp decline at the first level: corporate tax receipts fell from 3.6 percent of gross domestic product in 1965 to 1.9 percent in 2015. However, observers have overlooked the substantial erosion at the second level of taxation of corporate income. Over the same 50-year period, US retirement accounts and foreigners have largely displaced taxable accounts as the owners of stock issued by US corporations (figure 1).<sup>2</sup> As a result, corporate earnings are largely exempt at this level.

**FIGURE 1**

### Ownership of U.S. Corporate Stock, 1965-2015

Direct and Indirect Holdings



**Source:** Board of Governors of the Federal Reserve System, "Financial Accounts of the United States;" Investment Company Institute. 2016, "The U.S. Retirement Market, Fourth Quarter 2015;" Barclay Hedge; Preqin; Tax Policy Center calculations.

(1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance.

(2) Dashed lines indicate TPC estimates

(3) Primarily government holdings, but includes equities in 529 savings plans.

<sup>2</sup> For a complete discussion, see Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of US Corporate Stock," *Tax Notes* (May 16, 2016). I attach this article for the record.

My colleague Lydia Austin and I estimate that the share of corporate stock issued by US corporations that is held in taxable accounts fell more than two-thirds over the past 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015.<sup>3</sup> Our estimates are based on data from the Federal Reserve Board's Financial Accounts of the United States (often called the Flow of Funds Accounts) and other sources. The Flow of Funds Accounts, which go back to 1965, are the most common source used to measure US stock ownership.

## US STOCK OWNERSHIP HIGHLIGHTS

There are two major factors for the decline in the share of corporate stock held in taxable US accounts. The first is the increase held in tax-favored retirement accounts such as IRAs, 401(k) plans, and traditional defined-benefit pension plans. We estimate that share is now about 37 percent of US corporate stock. The second is the increase in portfolio investment by foreigners; that share is about 26 percent of corporate stock (the foreign share would be greater if we included foreign direct investment, which is a controlling interest in a US corporation, 10 percent or more). Foreigners generally pay no US tax on capital gains from the sale of US corporate stock, and the US withholding taxes they pay on dividends are often reduced greatly by treaty.

### *Retirement Account/Plan Holdings*

Retirement accounts and plans held about 37 percent of US stock in 2015, worth roughly \$8.4 trillion. Over the past 30 years, IRAs grew faster than other components, largely because of rollovers of assets from defined contribution plans (figure 2).

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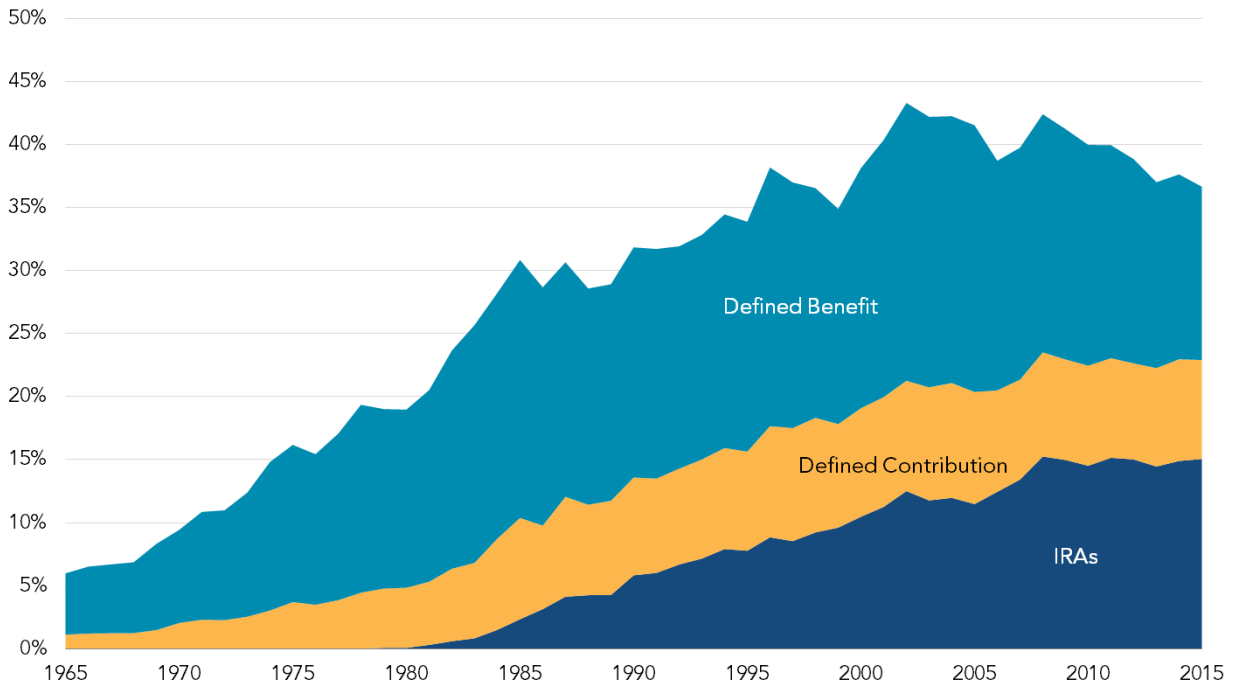
<sup>3</sup> In constant (2015) dollars, we estimate that total household ownership increased slightly from \$4.5 trillion to \$5.5 trillion from 1965 to 2015, while total outstanding stock increased more than fourfold from \$5.4 trillion to \$22.8 trillion. I am attaching this paper for the record.

FIGURE 2

## Pension Plans' Holdings of U.S. Corporate Stock, 1965-2015

Direct and Indirect Holdings

Percent of US Corporate Equity



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States."

Income accrued within retirement accounts, including both (i) Roth and traditional IRAs and (ii) defined-contribution and defined-benefit retirement plans, is effectively tax-free. In general, investment returns in these retirement accounts are tax-free in two different manners. Contributions to Roth IRAs and Roth 401(k) are nondeductible, and withdrawals are nontaxable. Alternatively, contributions to traditional IRAs or 401(k) plans are deductible and earnings are taxable upon withdrawal. If account owners face the same tax rate when they contribute to or withdraw from their accounts, the two forms of retirement savings are economically equivalent to the individual (given the same after-tax contribution); the benefit of a Roth plan's full tax exclusion for withdrawals equals the benefit of a traditional IRA or 401(k) plan's tax deduction for contributions.

### Foreign Holdings

Foreigners owned about 26 percent of US stock in 2015, worth about \$5.8 trillion (figure 3). Foreign multinational corporations own another \$4.6 trillion of "direct" investments in US companies. Like the Fed, we counted portfolio stock in corporate equity but not

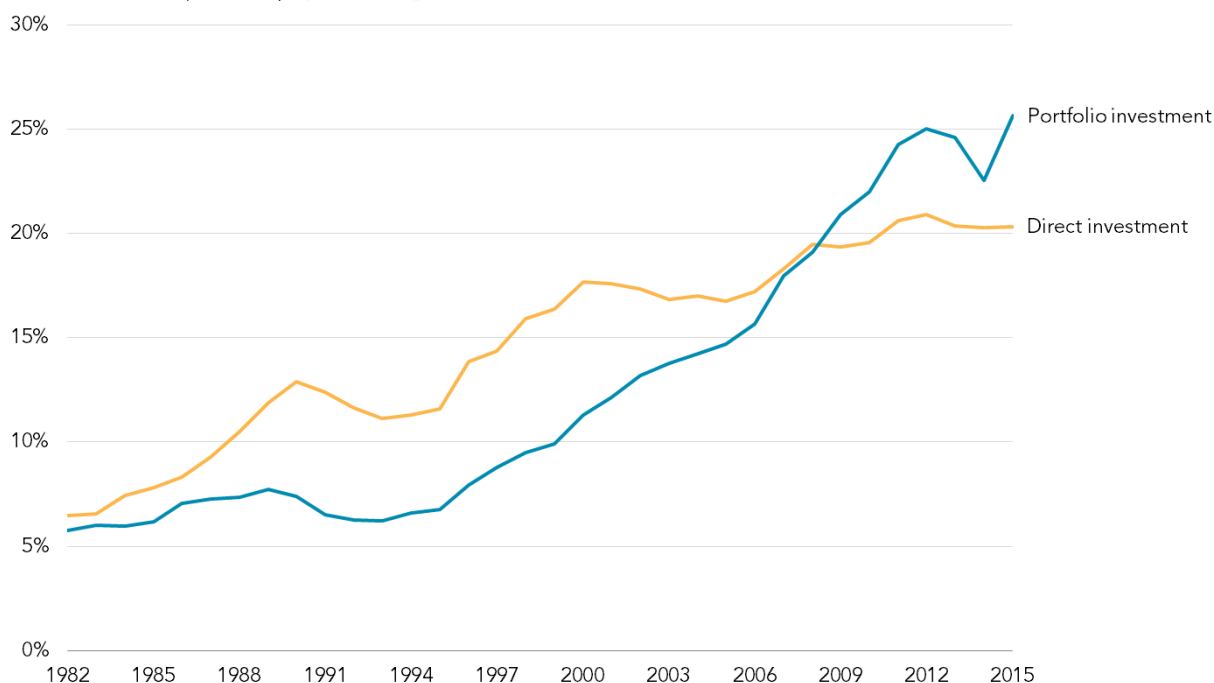
foreign direct investment, although direct investment is growing as fast as portfolio investment.<sup>4</sup>

**FIGURE 3**

### Foreigners' Holdings of U.S. Corporate Stock, 1965-2015

Direct and Portfolio Holdings, Market Value

*Percent of US Corporate Equity (excluding direct investment)*



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States."

We treat foreigners as nontaxable, as their income from stock generally is not subject to US tax—or subject to just a little tax. Their stock gains almost always are exempt from taxation. Their dividends are subject to a 30 percent US withholding tax for portfolio investments, which is typically reduced by treaty to 15 percent or, for direct investment, to 5 percent (or sometimes to zero).

## IMPLICATIONS FOR CORPORATE INTEGRATION

As I observed at the start, corporate earnings are ostensibly taxed twice, first to the corporation and second to the shareholders. Having two levels of tax distorts business decision-making in several important ways: whether to establish as a corporation, partnership, or other business form; whether to finance with debt or equity; and whether to retain or distribute earnings.

<sup>4</sup> Similarly, we and the Fed do not count US intercompany holdings.

Many reformers propose to end double-taxation by integrating corporate and shareholder taxes on corporate earnings. For example, the United States could tax corporate earnings 1) just to the corporation, 2) just to the shareholders, or 3) to both the corporation and the shareholders, but with a credit to the shareholders for taxes paid by the corporation.

In 2003, Treasury proposed the first option: to tax corporate earnings just to corporations by excluding dividends to shareholders from taxation at the individual level.<sup>5</sup> At that time, Congress chose instead to reduce the top tax rate on qualified dividends to the same rate permitted for long-term capital gains.<sup>6</sup> Both are now taxed at a maximum rate of 23.8 percent (rather than the 43.4 percent tax rate that applies to other forms of income).

Because of the trends in stock ownership, and the reduction in tax rates, corporate earnings now face a very low effective tax rate at the shareholder level. Three-fourths goes untaxed, by our estimate, and much of the rest faces low rates. Further, the tax on any gain can be deferred or eliminated if the stock is held until death or donated to charity. So, the United States effectively tries to collect the bulk of the tax on corporate earnings at the corporate level.

But many commentators have observed that taxing earnings only to corporations is problematic in today's environment, and I agree. Corporations are mobile—generally more so than individuals.<sup>7</sup> As a result, some US corporations have shifted their residence abroad to avoid US taxes (“inversions”). Others shift their income to lower-taxed jurisdictions through transfer pricing. The United States makes this possible by delaying the tax on these overseas earnings until they are repatriated (“deferral”). US multinationals now have stockpiled huge amounts of earnings overseas—\$2.4 trillion by some estimates.<sup>8</sup>

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<sup>5</sup> See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal*, JCS-7-03 (2003), at 18–33.

<sup>6</sup> *Jobs and Growth Tax Relief Reconciliation Act of 2003*, Pub. L. No. 108-27, 108th Cong., 1st Sess. (May 28, 2003).

<sup>7</sup> Avi-Yonah, Reuven, “And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century,” 67 *Tax. L. Rev.* 169 (2014).

<sup>8</sup> Citizens for Tax Justice, “Fortune 500 Companies Hold a Record \$2.4 Trillion Offshore,” March 4, 2016, [http://ctj.org/ctjreports/2016/03/fortune\\_500\\_companies\\_hold\\_a\\_record\\_24\\_trillion\\_offshore.php#.VzMBv4QrJD8](http://ctj.org/ctjreports/2016/03/fortune_500_companies_hold_a_record_24_trillion_offshore.php#.VzMBv4QrJD8). See also Richard Rubin, “US Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes,” *Bloomberg* March 4, 2015, <http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes>.

An alternative approach would tax corporate earnings only to shareholders, who cannot expatriate easily or shift their income to foreign affiliates.<sup>9</sup> The United States could move to such a system in a couple of different ways.

The United States could allow corporations to deduct dividends paid to shareholders. That would reduce the taxable income of corporations and increase that of shareholders. By our calculations, however, only about a quarter of dividends are paid to taxable accounts. So, the shift might generate relatively little revenue. To keep reform revenue neutral, Congress would need to substantially increase the tax rate on dividends and capital gains—perhaps both to individuals and tax-exempt accounts and institutions.<sup>10</sup>

Equivalently, the United States might tax corporate earnings at the entity level but allow the shareholders to claim a credit for the tax paid by the corporation (or, alternatively, permit a dividends paid deduction coupled with a withholding tax on dividends paid to shareholders).<sup>11</sup> Presumably, the credit or withholding tax would be nonrefundable to prevent a windfall for tax-exempt shareholders. But if these taxes were nonrefundable, tax-exempt shareholders, who represent the largest block of shareholders, might still pressure their corporations to shift income to lower-tax jurisdictions—or to move abroad.<sup>12</sup>

## **FINAL THOUGHTS FOR BUSINESS INCOME TAX REFORM: IS THE US CORPORATE INCOME TAX UNCOMPETITIVE?**

A key reason often given to pursue business tax reform is to lower US corporate tax rates in order to make US corporate taxes more competitive with the corporate taxes of other countries. Many commentators gauge US corporate tax competitiveness by comparing US corporate income taxes to foreign corporate income taxes (whether statutory, effective, or marginal).<sup>13</sup> But, as noted earlier, the effective tax rate on corporate earnings depends on both the corporate and shareholder income taxes. Today, in the United States,

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<sup>9</sup> Individuals face an exit tax on expatriating under Code sec. 877A, which Congress passed unanimously as part of the *Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act)*, Pub. L. No. 110-245, 110th Cong., 2nd Sess. (June 17, 2008).

<sup>10</sup> For example, Congress could treat part or all of the dividends and capital gains from stock of US corporations as unrelated business taxable income for tax-exempts.

<sup>11</sup> For a discussion, see Republican Staff of the Senate Finance Committee, “Comprehensive Tax Reform for 2015 and Beyond,” at 201-203, 113th Cong. S. Prt. No. 113-31 (Dec. 2014).

<sup>12</sup> Congress might also treat part or all of the dividends and capital gains from stock of foreign corporations as unrelated business taxable income to address this problem.

<sup>13</sup> See, for example, Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications* (Washington, DC: Congressional Research Service, 2014), comparing and describing corporate statutory, effective, and marginal tax rates, but not shareholder tax rates.

relatively few shareholders pay the second level of tax on corporate earnings. Those that do face a reduced rate on qualified dividends and long-term capital gains.

To fully compare the US tax burden on corporate earnings to foreign tax burdens, we should also compare the combined corporate and shareholder effective taxes. In some instances, this comparison may provide a better gauge of US tax competitiveness. For example, some countries may tax corporate earnings more fully at the shareholder level, and that could increase the cost of corporate capital in their countries (if their corporations depend substantially on local capital markets). More research is necessary to gauge the effective combined US and foreign tax burden on corporate earnings.

**TABLE 1**  
Comparing Effective Tax Rates Across Countries  
2015



	Corporate Income Tax Rate	Personal Dividend Income Tax Rate	Capital Gains Tax Rate	Effective Corporate and Shareholder Tax Rate	Integrated Tax System
Canada	26.3%	39.3%	22.6%	?	Full credit imputation
France	34.4%	44.0%	34.4%	?	Partial dividend exemption
Germany	30.2%	26.4%	25.0%	?	Classical
Italy	27.5%	26.0%	26.0%	?	Classical
Japan	32.1%	20.3%	20.3%	?	Modified classical system
United Kingdom	20.0%	30.6%	28.0%	?	Partial credit imputation
United States	39.0%	30.3%	28.7%	?	Modified classical system
G7 excluding US*	29.1%	29.1%	25.5%	?	

\* Weighted by 2015 GDP

**Sources:** OECD Tax Database, Tables II.1 and II.4; OECD Quarterly National Accounts: Historical GDP - expenditure approach; Tax Foundation, "Eliminating Double Taxation through Corporate Integration."

**Note:** Tax rates are combined national and subnational.





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