MITIGATING THE POTENTIAL INEQUITY OF REDUCING CORPORATE RATES

TPC Working Paper

July 29, 2009

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ABSTRACT

Since the statutory marginal U.S. income tax rate on corporate income is higher than the marginal rate imposed by all of our trading partners except Japan, there have been a number of proposals to reduce the U.S. marginal corporate rate. At the same time, it seems likely that the top individual rate will be increased. However, a differential between marginal corporate and individual rates could reduce the overall rate of tax on corporate distributions and enable higher-income taxpayers to shelter their income from services or investments. This paper suggests that we can mitigate these problems if the lower corporate rate is denied to income from services or passive investments and if there is always a second tax on distributed income. The latter requires reducing the step-up in basis at death and the deduction for charitable contributions by the amount of undistributed earnings to prevent taxpayers from permanently escaping tax on earnings retained in the corporation. Nonetheless lower corporate rates allow reinvested corporate profits to earn a permanent higher rate of return. Setting the combined individual and corporate rates on corporate distributions higher than the top individual rate offsets this advantage and also reduces the risk that corporations will be used to shelter income.

MITIGATING THE POTENTIAL INEQUITY OF REDUCING CORPORATE RATES

The statutory marginal U.S. income tax rate on corporate income is higher than the marginal rate imposed by all of our trading partners except Japan.[1] This higher rate of tax is said to hurt the ability of the United States to attract foreign investment. In response, there have been a number of proposals to reduce the U.S. marginal corporate rate.[2] At the same time, it seems likely that the top individual rate will be increased.

If the corporate rate is lower than the top individual rate, as was the case prior to 1986, corporations may again be used to shelter high-income individuals from high individual rates.[3] Currently, the top corporate rate of 35 percent is the same as the top individual rate, and there is an additional tax of 15 percent if corporate income is distributed to shareholders. This brings the combined burden on distributed corporate income up to 44.75 percent.[4] Therefore, the ability to shelter income in a corporation in order to reduce the overall tax burden is limited. Accordingly, it is ordinarily optimal for a closely held business to choose an entity that allows business income to be passed-through directly to the owners. In that case, there would be no corporate-level tax and the top marginal rate would be 35 percent,[5] the highest individual rate. However, if the corporate rate is reduced, closely held business might again choose to be subject to the corporate tax. In these circumstances, taxpayer efforts to minimize taxes, through choice of entity, the timing and manner of distributions, and the use of debt or equity, could reintroduce a number of complexities in the law that are largely avoided today as far as closely held business is concerned.[6]

This paper considers the implications of the potential disparity between individual and corporate rates on the equity and efficiency of the U.S. income tax and possible responses to mitigate this impact. A further reduction in the tax on capital income is troublesome. In my view, equity and efficiency suggest moving in the opposite direction, most importantly by eliminating the special treatment of capital gain. However, assuming progressivity can be maintained, modifying corporate and individual taxes so the burden on corporate income is consistent with the burden on other income can be justified.

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[1] As discussed below, in some circumstances, the effective rate of tax taking account of tax preferences would be the determining factor rather than the statutory rate. The degree of compliance could also be important. In addition, IRC §199 allows a deduction for qualified domestic production activities, which can be as high as 9 percent of taxable income. If that limit applies, the marginal rate on manufacturing activities in the U.S. could be said to be 31.85 percent or about 37 percent after taking account of state taxes, still somewhat higher than our trading partners.

[2] See, for example, H.R. 3970, 110th Cong. (2008). (Chairman Rangel introduced the bill, which would reduce the top corporate marginal rate to 30.5 percent.) Currently, no one has introduced such legislation this Congress. Additionally, while President Obama stated some support for the approach of closing loopholes and lowering the corporate rate, no specific policy proposal has come from the administration on this matter. See "Obama: Interested over Time in Lowering Corporate Tax Rate," Market News International, March 12, 2009.

[3] See Amy S. Elliot, "JCT's Kleinbard Warns of Growing Gap between Individual and Corporate Rates," *Tax Notes Today* 43-8 (2009).

[4] If the corporation earns $100 and the corporate rate is 35 percent, there would be $65 of after-tax income to distribute. At a 15 percent rate, the tax on the distribution is $9.75 or a total tax burden of $44.75 on $100 of income.

[5] Because of the 2.9 percent Medicare tax on self-employment income, the marginal individual rate could be higher if it is treated as self-employment income. As discussed below, the self-employment tax can be avoided in certain circumstances.

[6] The form of the distribution and the debt equity distinction remains important for publicly traded companies that cannot elect pass-through treatment.

To achieve this goal, we must impose an ultimate burden on distributed corporate income that is at least comparable to the rate of taxes on wages and interest. Therefore, to mitigate the reduced burden on corporate income, the tax rate on corporate distributions and capital gain must be increased above the current 15 percent rate to 20 percent or higher, for all taxpayers, not just the very rich as the president has proposed.[7] In addition, the opportunity to avoid tax on corporate distributions and transfers of stock must be eliminated by reducing the step up in basis at death and the charitable deduction by the amount of undistributed earnings. We should also limit potential abuse by denying the marginal rate reduction to income from personal services or passive sources.

Finally, the opportunity to use a corporation as a shelter could be reduced if the rate reduction were limited to publicly traded corporations. Although this course may be consistent with the rationale for removing tax impediments for investing in the United States, a corporate rate reduction limited to publicly traded companies seems politically unlikely. However, if the combined tax at the corporate level and on corporate distributions is sufficiently higher than the U.S. individual rate, closely held businesses might continue to prefer pass-through entities. This approach would therefore reduce the concern that corporations would be used as shelters. It would also mitigate the revenue loss and the potential windfall to existing shareholders. It is important, therefore, to consider whether the goal of corporate rate reduction is consistent with maintaining the current combined rate at 44.75 percent or increasing it. Significantly, even though the U.S. corporate rate is generally higher, the combined tax on distributions is not dramatically different than the tax imposed by some of our trading partners, which sometimes exceeds the top individual rate. If the combined rate stays constant, tax-exempt institutions may be the primary beneficiary of corporate rate reduction. This result suggests the possibility of imposing a tax on distributions to or sales by these entities.

Section I of this paper outlines the arguments for a reduction in the corporate rate. To highlight the potential advantages and risks of a reduction in marginal rates, section I compares corporate rate reduction with full integration of the corporate and individual taxes. Finally, it describes the permanent advantage of a corporate rate reduction, namely the ability to accumulate income at a faster rate within the corporation, which occurs even assuming the combined tax on distributed income is equivalent to the top individual rate.

Section II discusses choices as to the entity and income that would be entitled to the reduced rate. Section III discusses the possible treatment of corporate distributions and stock transfers.

Section IV summarizes the possibility of limiting the economic distortion and the tax advantage that potentially occurs when the corporate rate is lower than the individual rate. Section V concludes.

I. WHY LOWER THE CORPORATE RATE

Since mobile capital seeks the highest after-tax return, differences in tax rates affect the location of investment or the siting of income. The location of investment in machinery or real estate will be driven mainly by the effective rate after taking account of investment incentives. The

[7] United States Department of the Treasury, *General Explanations of the Administration's FY 2010 Revenue Proposals (Green Book)* 73-78 (2009), http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf.

statutory marginal rate may also affect reported income for any given location of tangible investment, if firms allocate more borrowing to high-tax countries (to increase the benefit of interest deductibility) or locate intangibles in low-tax countries (to reduce the tax burden on royalties). The latter requires that firms manipulate the transfer pricing on intercompany transactions to understate the value of intangibles transferred to low-tax countries, thereby shifting net income to them. In fact, manipulating transfer pricing on intercompany transactions to locate income in a low-tax country could be a general problem.

Therefore, since the U.S. statutory corporate tax is higher than the rates in most other countries, more income will be allocated to other countries.[8] If the effective tax rate is also higher, some potential investments in the United States will not be made even if the expected before-tax rate of return is higher than the alternatives.[9] Reducing the U.S. rate will mitigate this impact. Moreover, reducing corporate marginal rates can facilitate efforts to end deferral and tax U.S. corporations on worldwide income. This eliminates a distortion that inefficiently affects the location of investment and the repatriation of earnings. Although taxing the U.S. parent on worldwide income could decrease investment in U.S. resident corporations, some have suggested that if the U.S. reduced rates to keep the burden on foreign-source income constant, this is less likely to occur.[10] Similarly, a lower U.S. rate can also reduce the incentive for U.S. taxpayers to invest in low-tax foreign corporations.[11]

If corporate rates were reduced the United States could attract more investment even if the combined burden on distributed corporate income were equivalent to or even exceeded the top individual rate. The tax on dividends will not affect the shareholder's investment choice if the tax on distributions did not differ, as would be the case for U.S. persons.[12] In addition, because of tax treaties or tax credits, the statutory dividend tax may not affect foreign investors.[13] Further, since only the corporate tax affects reported corporate earnings and earnings per share, the shareholder's tax burden on distributions may not affect corporate decisionmaking, except to the extent it raises the cost of capital.

In fact, an examination of the schedule from the Organisation for Economic Co-operation and Development (OECD) of the tax burden on distributed corporate income indicates that in some countries (including the U.K. and France) the combined burden on such income is higher than the top personal rate.

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[8] See Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons* 8-10 (2005) http://www.cbo.gov/ftpdocs/69xx/doc6902/11-28-CorporateTax.pdf; Daniel J. Mitchell, "Corporate Taxes: America Is Falling Behind," *Cato Institute Tax and Budget Bulletin* (2007), http://www.cato.org/pubs/tbb/tbb_0707_48.pdf; Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices, and Implications* (edited by John W. Diamond and George R. Zodrow, 2008). For a skeptical view, see Jane G. Gravelle and Thomas L. Hungerford, *CRS Report for Congress: Corporate Tax Reform: Issues for Congress* (2008), 10-13, http://opencrs.com/document/RL34229/2008-07-24.

[9] See the authorities cited in note 8.

[10] Grubert and Altshuler, "Corporate Taxes," 5. A rate of 28 percent is suggested.

[11] Id., at 2, 6.

[12] See Gravelle and Hungerford, *CRS Report,* 37. Most dividends from foreign corporations are entitled to the special 15 percent rate. See, I.R.C. § 1(h)(11)(B)(i)(II), § 1(h)(11)(C).

[13] The statutory withholding tax on foreign investors is 30 percent and this remained unchanged in 2003 when the rate of tax on dividends was reduced to 15 percent. Tax treaties, which apply to a substantial majority of foreign investment, reduce the withholding rate, most commonly to 15 percent for portfolio investment and 5 percent for direct investment. I.R.C. § 1441 (a); 26 C.F.R. §1.1441-1; Internal Revenue Service, *Publication 901: U.S. Tax Treaties,* 35-36 (2009), http://www.irs.gov/pub/irs-pdf/p901.pdf.

TABLE 1

Combined Burden on Corporate Distributions Compared with the Tax Rate on Personal Income, 2007

Country	Corporate income	Net personal tax on distribution	Combined corporate income and distributions tax	Other personal income
Australia	30.0	23.6	46.50	46.5
Austria	25.0	25.0	43.75	50.0
Belgium	33.99	15.0	43.89	53.5
Canada	36.1	24.6	51.86	46.4
Czech Republic	24.0	15.0	35.40	32.0
Denmark	25.0	43.0	57.25	59.7
Finland	26.0	19.6	40.50	50.5
France	34.43	32.7	55.86	47.76
Germany	38.9	23.7	53.40	47.475
Greece	25.0	0.0	25.00	40.0
Hungary	20.0	35.0	48.00	36.0
Iceland	18.0	10.0	26.20	35.7
Ireland	12.5	41.0	48.38	41.0
Italy	33.0	18.0	45.03	44.9
Japan	39.54	10.0	45.59	50.0
Korea	27.5	29.3	48.72	38.5
Luxembourg	30.38	19.5	43.95	38.9
Mexico	28.0	0.0	28.00	28.0
Netherlands	25.5	22.0	41.89	52.0
New Zealand	33.0	8.9	38.98	39.0
Norway	28.0	28.0	48.16	40.0
Poland	19.0	19.0	34.39	40.0
Portugal	26.5	20.0	41.20	42.0
Slovak Republic	19.0	0.0	19.00	19.0
Spain	32.5	18.0	44.65	43.0
Sweden	28.0	30.0	49.60	56.5
Switzerland	21.3	40.4	53.08	42.06
Turkey	20.0	17.5	34.00	35.6
United Kingdom	30.0	25.0	47.50	40.0
United States	39.251	18.1	50.31	41.4
Federal only	35.0	15.0	44.75	35.0

Source: OECD tax database, http://www.oecd.org/ctp/taxdatabase, tables I.1, II.1, II.2.

Moreover, the OECD schedule indicates that the combined corporate and individual tax rate on dividends in the United States today is not dramatically different than the rate some of our trading partners impose. This suggests that a higher tax rate on distributions could accompany a reduction in the U.S. corporate rate, which could keep the combined rate about where it is today.[14] The increased tax on distributions could offset the advantage, described

[14] If the corporate rate were 30 percent and a 20 percent tax applied to the remaining 70 percent of corporate income, when it is distributed, the effective rate on distributions would be 14 percent for a combined burden of 44 percent. If the corporate rate were 25 percent and a 25 percent tax applied to the remaining 75 percent of corporate income, when it is distributed, the effective rate

below, of the enhanced build-up within the corporation made possible by the lower rate of tax on reinvested earnings.

A reduced corporate rate accompanied by an increased tax on distributions, which would maintain the combined rate above the current individual rate, could mitigate both the revenue loss and potential windfall to existing shareholders. For those who believe that the burden of the corporate income tax falls on capital, this would help maintain the current level of progressivity in the income tax, which is particularly important in light of growing income inequality. Even though new research suggests that labor may bear some of the burden of the corporate tax through reduced wage rates,[15] the political process is likely to view a reduction in corporate rates as a benefit to shareholders, which the increase in distribution taxes could offset. In addition, if the combined rate is higher than the rate applied to pass-through entities, particularly if the distribution tax could be made more certain, closely held businesses might have little incentive to avoid pass-through treatment, maintaining the status quo and avoiding many of the problems discussed below.

However, this approach is not universal. In some countries (for example, Italy),[16] the combined burden on distributed corporate income is roughly comparable to the top individual rates, while in others (including the Netherlands and Japan), the combined burden on such income is lower than the top personal rate.

A. Integration Compared

Integrating the corporate and individual taxes is a more direct way of equating the treatment of pass-through entities with taxation of corporate income.[17] As opposed to two levels of taxes, each lower than the top individual rate, integration taxes corporate earnings once, most commonly at the individual rate. Therefore, to compare the former, which I will refer to as a split-rate approach to taxing corporate earnings,[18] to integration, it is useful to posit a system that has a combined burden on distributions equivalent to the individual rate. If the top individual rate were roughly equivalent to 40 percent and the tax on distributions 20 percent, both rates as proposed by President Obama,[19] a 25 percent corporate rate would result in a combined rate on distributed income comparable to the top individual rate. Thus, if the corporation had $100 of

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on distributions would be 18.75 percent for a combined burden of 43.75 percent. These results can be compared with 44.75 percent today. As discussed in note 1, the section I99 deduction for qualified domestic production activities could be said to reduce the rate. However, for the purpose of simplicity, this paper will ignore the potential implications of section I99 which should be repealed if corporate rates are reduced.

[15] Some suggest that a corporate tax would reduce the flow of capital, so as to keep the after-tax rate of return constant. Since there would then be less capital per worker, wages would decline resulting in labor bearing the burden of the corporate tax through reduced wage rates. But see Gravelle and Hungerford, *CRS Report,* 17–26.

[16] In 2008, the German burden appears roughly comparable. The table shows 2007 rates since we do not yet have the personal rates for 2008. Between 2007 and 2008, the burden on distributions was reduced in Canada, Czech Republic, Germany, Iceland, Italy, Spain, Switzerland, and the United Kingdom. The burden was increased in the Netherlands but it is still less than the top personal rate.

[17] The most detailed proposals in the United States, a reporter's study by Alvin C. Warren, based on an American Law Institute project and a Treasury study (led by Michael Graetz) under the first President Bush, are set forth in *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998) (hereafter ALI).

[18] The term split-rate usually refers to a lower corporate rate on distributed earnings than the higher rate applied to undistributed earnings. This paper uses the term in a different way.

[19] See Greenbook surpa note 7 at 73 (proposing top rate of 39.6 percent), 77.

taxable income, it would retain $75 after tax. If the $75 were distributed immediately, at a 20 percent rate, the shareholder would pay tax of $15 and retain $60, as she would if the business entity were a pass-through and a 40 percent rate applied.[20]

Integration also attempts to match the treatment of pass-throughs. Under the most common form of integration, the corporate tax is effectively treated as a withholding tax that could offset the individual tax.[21] For example, if the corporate rate were 40 percent, a corporation that had taxable income of $100 would pay $40 in tax. If it distributed the after-tax income of $60, the dividend to the shareholder would be grossed-up or increased by the tax associated with the distribution. The dividend to the shareholder would be $100, and the shareholder would get a credit for the corporate tax ($40) that would fully offset the individual tax at a 40 percent rate. The shareholder retains the full $60 distribution as she would if the income were earned in a pass-through entity. If the shareholder's marginal rate were less than 40 percent, the shareholder could be entitled to a refund. The ALI study recommends this approach.[22]

A different but economically equivalent approach provides a corporate deduction for dividend distributions that would, in the above example, allow the corporation to distribute the entire taxable income of $100. A shareholder, whose marginal rate was 40 percent, would then pay a $40 tax on the dividend and retain $60. Since under these approaches, corporate income is eventually taxable only at the individual level, the distortions of the current system related to choice of entity or financing by debt or equity would be mitigated.[23]

A third approach retains the corporate tax but fully or partially exempts dividends from taxes. The United States does this currently by applying a 15 percent rate on dividends, which is equivalent to a partial exemption.[24] If the $60 dividend were fully exempt, the shareholder could again retain the full $60. But since the 40 percent corporate rate applies regardless of the shareholder's marginal rate, the potential distortion caused by the use of the corporate form remains, although at a much reduced level. The Treasury 1992 study recommended this dividend exemption approach, [25] but the individual rate schedule was flatter then than it is today.

Comparison with integration serves to highlight the issues raised by the split-rate approach, some of which, as noted below, are not immediately obvious. Integration directly deals with the inefficiencies in the present system relating to the choice of entity, the decision to use debt or equity financing, and the timing and form of distributions to shareholders. Nevertheless, while the business community would likely support corporate rate reduction, integration has

[20] More generally the distributin rate (d) should be set so that it equals (p-c)/(1-c) where p is the personal tax rate and c is the corporate tax rate. Business income earned in a pass-through would yield E(1-p) after taxes. Corporate earnings (E) distributed currently would yield E(1-c)(1-d). These two after-tax amounts would be identical when (1-d)=(1-p)/1-c) or, equivalently, when d=(p-c)/(1-c).

[21] ALI, 639–41.

[22] ALI, 607.

[23] See Tax Analysts supra note 17 at 641.

[24] See I.R.C. § 1(h)

[25] ALI, 81–84.

garnered little support. Putting aside the potential complexity in the design of an integration system, why should this be the case?[26]

The answer appears to be that integration will not likely result in a lower initial corporate-level income tax, which is said to be essential to encourage investment in the United States. The split-rate approach provides both a lower initial tax and an opportunity to reinvest earnings within a corporation to earn a permanent higher rate of return. The tax on distributions does not eliminate this benefit.

Moreover, the benefit from integration occurs by lowering the burden on distributions. Corporate managers have been unenthusiastic about integration, in part because they believe a lower tax burden on distributions might increase the pressure to distribute dividends. A lower corporate rate would not raise the same concerns.

A split-rate approach, however, unlike integration, does not eliminate the distortion of the current system. Therefore, it raises equity and efficiency issues that integration largely avoids. Most obviously, the tax on distribution might be delayed or totally avoided. Although, as discussed in section III, there are ways the distribution tax could be made a virtual certainty, this would not be easy to achieve.

Therefore, depending on the rate structure and the ability to avoid the tax on distributions, the split-rate approach could create a new preference for the corporate form and for equity over debt. Section IV summarizes these potential distortions and how they can be mitigated.

A split-rate approach, unlike integration, also does not directly raise either the matter of how to treat distributions to tax-exempt and nonresident shareholders or the treatment of distributions of tax-preferred income. Nevertheless, as discussed in section III, a comparison with integration demonstrates that these issues do arise under the split-rate approach.

Finally, some object to integration proposals on the grounds that reducing the tax burden on distributions would raise share prices, thus providing an undeserved windfall to shareholders. However, both a split-rate approach and the 2003 dividend tax rate reduction raise similar concerns.

In sum, a split-rate approach raises much the same issues as integration and involves much more difficulty in ensuring that the ultimate burden on shareholders is neither greater nor smaller than the burden of the individual tax. However, the initial and perhaps permanent tax reduction appeals to corporate managers. As discussed next, even if the distribution tax is unavoidable, the ability to earn a higher return on reinvested earnings would remain. On the other hand, the split-rate approach would over-tax low-bracket individuals compared with a shareholder credit.

B. Permanent Benefit of a Lower Corporate Rate

If the combined tax rate on corporate earnings and distributions is equivalent to the top individual rate and the rate on distributions does not change over time, deferring the distribution tax has no advantage. The advantage of the lower corporate rate is limited to the opportunity to

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[26] European countries abandoned integration in favor a split-rate system in part because they expected the ECJ to hold that failure to pass through the credit on dividends to nonresidents or to give a credit for foreign taxes to the same extent as domestic taxes violated the anti-discrimination rules. These issues do not arise under a split-rate system. Ben J.M. Terra and Peter J. Wattel, *European Tax Law,* 4th ed. (2005), 266–71.

achieve a higher rate of return on earnings from reinvested profits as long as these earnings remain in corporate solution. If earnings are retained in low-taxed foreign subsidiaries, the advantage is increased.

To illustrate,[27] suppose the corporate rate is 25 percent, distributions and gain on sales are subject to a 20 percent tax, and income from pass-through entities is subject to individual rates up to a maximum of 40 percent. If a corporation earned $100 and distributed the after-tax income of $75, shareholders would retain $60 after tax, identical to the amount retained if the 40 percent rate applied. Similarly, if the stock were sold before the income was distributed; the selling price should increase by $75, of which $60 would be retained after tax.

To understand the impact of a delay in distribution, first assume, counterfactually, that deferral of the distribution will not affect the after-tax rate of return on reinvested earnings. If this were true, deferral would not affect the result. Thus, suppose the corporation reinvested the $75 of after-tax earnings to earn 6 percent for two years. For simplicity, assume there were no additional corporate earnings during that period. At the end of two years, the corporation would accumulate $84.27. If it distributed this amount and a 20 percent tax applied, the shareholder would retain $67.42.

Similarly, if the unincorporated business invested $60 (the after-tax earnings from $100 at a 40 percent rate) to earn 6 percent after tax, the accumulation, at the end of two years, would be $67.42. Although the tax on distribution is deferred, since the base of the tax increased from $75 to $84.27 (the future value of $75), the burden of the tax is not reduced by deferral. The combined tax burden is 40 percent. If one assumes equal after-tax earnings, it is irrelevant whether a 40 percent tax is imposed initially as income is earned, at a split rate of 25 percent on corporate earnings and 20 percent on distributions, or totally deferred until distributed.

As noted, the distribution at the end of two years ($84.27) is the future value of the $75 of reinvested earnings. From this standpoint, since we know that if the $75 were distributed immediately, the result would be equivalent to a pass-through entity (that is, the $100 of earnings would be subject to $40 of tax), this must remain true despite the delay. Thus, the original return is fully taxed at the shareholder level. Conversely, if the $84.27 distribution is considered to be merely representative of the $75 of reinvested earnings, the return on such reinvested earnings is never taxed at the shareholder level. It is only taxed at the corporate rate.[28]

Therefore, if the earnings reinvested in the corporation were subject to a lower rate of tax, deferring the distribution would be an advantage. For example, if the pre-tax return were 10 percent, the after-tax return within the corporation would be 7.5 percent, not 6 percent. In that case, the accumulation, after two years, would be $86.68, so the shareholder would retain $69.34

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[27] For readers who prefer algebra to numerical examples, this equivalence can be illustrated as follows:

If corporate earnings (E) were currently distributed after payment of a corporate tax (at rate c), subject to a distribution tax (at rate d), the shareholder could invest the proceeds for y years to produce the following amount after paying annual taxes (at the personal rate p):

$$E(1-c)(1-d)[1+r(1-p)]^y$$

If on the other hand, corporate earnings were reinvested for y years before being distributed to shareholders, the net after-tax amount would be:

$$E(1-c)[1+r(1-c)]y\ (1-d)$$

The only difference between these amounts would be due to the difference between p and c.

[28] Daniel Halperin, "Rethinking the Advantage of Tax Deferral" (forthcoming *Tax Lawyer*).

after tax instead of $67.42, a difference of $1.92. The advantage is the ability to reinvest the $75 to earn 7.5 percent after tax in lieu of 6 percent. Thus, the difference in the return at 6 and 7.5 percent on $75 over two years is $2.41 ($86.68 is accumulated compared with $84.27), which reduced by the 20 percent tax on distributions, is $1.92.[29]

Table 2 illustrates the amount that could be retained after tax from a distribution from the corporation as a multiple of the after-tax accumulation in a pass-through entity for various rates of return and periods of accumulation, assuming a 25 percent corporate rate, a 20 percent tax on distributions, and an individual rate of 40 percent.

TABLE 2

Potential After-Tax Distribution from a C Corporation Compared to a Pass-Through Entity Given Pre-Tax Return and a Period of Accumulation at Assumed Tax Rates

	Pre-Tax Rate of Return			
	6	8	10	15
Years	percent	percent	percent	percent
0	100	100	100	100
1	101	101	101	102
2	102	102	103	104
3	103	103	104	106
4	104	105	106	109
5	104	106	107	111
6	105	107	109	113
7	106	108	110	115
8	107	110	112	118
9	108	111	113	120
10	109	112	115	123
15	114	119	123	136
20	119	126	132	150
25	124	133	142	167

Note: Assumes a 25 percent corporate tax rate, 20 percent rate on distributions, and 40 percent individual tax rate.

TABLE 3

Potential After-Tax Distribution from a C Corporation Compared to Pass-Through Entity Given Pre-Tax Return and a Period of Accumulation at Assumed Tax Rates

	Pre-Tax Rate of Return			
	6	8	10	15
Years	percent	percent	percent	percent
0	100	100	100	100
1	101	102	102	103
2	102	103	104	106
3	104	105	106	108
4	105	106	108	111
5	106	108	110	115
6	107	110	112	118
7	108	111	114	121
8	110	113	116	124
9	111	115	118	128
10	112	116	121	131
15	119	126	132	150
20	126	135	145	172
25	133	146	160	197

Note: Assumes a 20 percent corporate tax rate, 25 percent rate on distributions, and 40 percent individual tax rate.

Even if the combined rate remained 40 percent, the difference would be greater if the corporate rate were lower and the tax on distributions higher. Table 3, which posits a corporate rate of 20 percent and a 25 percent tax on distributions, reveals this result.

To illustrate how the advantage of the corporate rate could be mitigated if the combined burden is higher than the individual rate, table 4 posits a corporate rate of 25 percent combined with a 25 percent tax on distributions, while

[29] The result would not change if the corporate tax was 40 percent and distributions were tax free, as long as reinvested earnings earned 7.5 percent. Thus, $60 invested for two years at 7.5 percent produces $69.34 as opposed to $67.42, if the return were 6 percent, a difference of $1.92. If there were no corporate tax and $100 was invested, a 7.5 percent return would produce $115.56 after two years as compared to $112.36 if the return were 6 percent. The difference of $3.20 when reduced by the 40 percent tax, which would apply to distributions, is again $1.92.

retaining the 40 percent rate on individuals.

In sum, if distributions are taxed and the combined rate is equal to the individual rate, there is no advantage from the deferral of the tax on the initial corporate earnings. The advantage is the higher return on reinvested earnings. The initial return on the invested capital itself, as opposed to the return on the reinvestment of earnings, is fully taxed.

If rates change, either because Congress adjusts the rate structure (as it inevitably will) or because a given taxpayer's circumstances change, the ability of closely held companies to choose a low-rate year for corporate distributions can afford an advantage. However, this does not appear to be a serious problem. For the highest earners, the latter concern—changed circumstances—is relatively unimportant, because most taxpayers in this category will always be in the top bracket. Moreover, in the short term, statutory rates will more likely increase. Finally, given the realization rules, taxpayers already have widespread flexibility to time income.[30]

TABLE 4

Potential After-Tax Distribution from a C Corporation Compared to a Pass-Through Entity Given Pre-Tax Return and a Period of Accumulation at Assumed Tax Rates

	Pre-Tax Rate of Return			
Years	6 percent	8 percent	10 percent	15 percent
0	94	94	94	94
1	95	95	95	96
2	95	96	96	98
3	96	97	98	100
4	97	98	99	102
5	98	99	101	104
6	99	100	102	106
7	100	102	103	108
8	100	103	105	110
9	101	104	106	113
10	102	105	108	115
15	107	111	116	127
20	111	118	124	141
25	116	125	133	156

Note: Data assume a 25 percent corporate tax rate, 25 percent rate on distributions, and 40 percent individual tax rate.

II. APPLICABILITY OF A LOWER RATE OF TAX

This section first discusses the nature of the entity that would be entitled to the lower rate. It then considers possible limitations on eligible income.

A. Entity Eligible for Lower Rate

A business can be operated as a sole proprietorship, a partnership, a limited liability company, or a corporation. As suggested above, a non-publicly traded business has a choice of being subject to the corporate tax or electing to have income and losses reflected on the returns of the owners, generally referred to as pass-through treatment. Entities, which are subject to the corporate tax, are referred to as C corporations, after the subchapter of the Internal Revenue Code that governs their treatment.[31] Publicly traded companies are limited to Subchapter C unless income is passive.[32] Any business not publicly traded has the choice of operating as a pass-through entity.

[30] For a discussion of this issue in the context of deferred compensation, see Daniel Halperin and Ethan Yale, "Deferred Compensation Revisited" *Tax Notes* 939 (March 5, 2007): 941–42.

[31] Special-purpose entities, such as regulated investment companies and insurance companies, are not discussed in this paper.

[32] I.R.C. § 7704. There have been some efforts to inappropriately classify the income as passive in order to claim pass-through status. See Lee A. Sheppard, "Blackstone IPO in Jeopardy?" *Tax Notes Today* (2007) 116-2.

Subject to limits on the number and identity of shareholders and the complexity of the corporate structure, a business can incorporate and choose pass-through treatment by electing Subchapter S.[33] Moreover, the rise of limited liability companies (LLCs) in the 1990s allows firms to have the advantages of corporate liability shielding without forming a corporation.[34] Unincorporated entities—limited liability companies or partnerships—can elect to be taxed as either partnerships or corporations—so-called check the box.[35] Thus, there are few significant obstacles to pass-through treatment.[36]

If the top corporate and individual rates are the same, as they generally are today, pass-through treatment is generally preferable. This results in no tax at the entity level, as losses and income pass through to the owners, and no tax on distributions of previously taxed or exempt income. Since basis is increased by undistributed income, such income is not taxed again when stock is sold. In contrast, C corporations are subject to the corporate tax on entity-level income and distributions to owners are subject to a second tax at the individual level. Losses are limited to offsetting future or past corporate-level income through loss carrybacks or carryforwards. Not surprisingly, today the pass-through option is increasingly the norm. However, if individual rates go up and corporate rates come down, a preference for C corporation status may return.

There would appear to be three possible policy choices for access to the lower rate: First, limit corporate rate reduction to publicly traded corporations. Second, apply a maximum rate to all business income, including income of pass-through entities. And third, limit the lower rate to C corporations. For reasons noted below, the third choice seems most likely.

1. Limit Rate Reduction to Publicly Traded Corporations If we could limit the lower tax rate to publicly traded companies, then we could avoid the inequity from the potential ability of high-income individuals to shelter their investment and employment earnings in a low-taxed controlled corporation. Further, the issues discussed in section IV relating to choice of entity, the capital structure, and the timing and form of distributions from closely held corporations will not arise. In short, the introduction of a lower marginal rate on corporate income would lead to fewer problems.

If the primary concern is attracting international investment, arguably we need not worry about the tax rate on closely held companies. However, the trend to private equity has resulted in many large entities that are not publicly traded. Moreover, according to the OECD, small and medium-size enterprises (SMEs) "are significant contributors to the global economy accounting for approximately … 10 percent of FDI [foreign direct investment]" and "governments recognise that SMEs' contribution to economic growth and social cohesion could be enhanced by

[33] See I.R.C. § 1361

[34] The first LLC was created in Wyoming in 1977. However, it was not until 1988 that the IRS recognized that such entities could qualify as a partnership. Rev. Rul. 88-76 1988-2 Cum. Bull. 360.

[35] Prior to the issuance of new regulations, effective in 1997 (T.D. 86-97 Dec. 10, 1996), that made this elective, the status of an entity as a partnership or corporation depended on the presence of so-called corporate attributes, limited liability, free transferability of interests, centralized management, and unlimited life. This required careful structuring to achieve pass-through status and led to significant transaction costs, including extremely detailed legal opinions. With check the box, the prior law on the status of an entity as a partnership or corporation is now largely irrelevant.

[36] Subchapter S corporations continue to be formed perhaps because taxpayers and their advisors are unfamiliar with LLCs or partnerships and are wary of the complexities of partnership taxation. In addition, Subchapter S may offer greater opportunity to avoid self-employment tax.

increasing the level of SME participation to the international economy."[37] In the end, regardless of whether the economic argument for a lower rate extends to closely held business, it seems unlikely that denying the low-rate option to small business would be politically viable.

2. Apply Maximum Rate to Business Income of Pass-through Entities This approach has appeal if one is considering a lower rate on all income from capital. But if the goal is to subject corporate income to approximately the same burden as wages or interest, a second level tax on distributions that could make the overall rate of tax comparable or higher is essential. It seems unfair for income from a sole proprietorship or through a Subchapter S corporation or LLC to be *permanently* taxed at a lower rate than wages. If this is the result, it should be difficult or impossible to lower the corporate rate.

However, if a lower rate applied to income earned in a pass-through, the lower tax burden would be permanent, under current law, since distributions of previously taxed income from pass-through entities, unlike distributions from Subchapter C corporations, are not taxed. Further, a second level tax on distributions from pass-through entities, in the unlikely event it would prove acceptable, should probably be limited to distribution of income that took advantage of the maximum rate on business income. It is probably wise to avoid this complexity.

Moreover, use of losses to offset more highly taxed income at the individual level is troublesome, particularly if there is no net business income. For example, assume a business has a loss of $100 in year 1 and a profit of $100 in year 2. Under Subchapter C, since losses would offset future profits, there would be no income subject to the lower rate of tax. On the other hand, with a pass-through, in the absence of additional complex restrictions on the use of losses, the year 1 loss could offset more highly taxed income and the year 2 profit would be taxed at a low rate. For these reasons, this option does not seem viable.[38]

3. Limit the Lower Rate to Subchapter C Corporations While this approach potentially reintroduces all the planning opportunities and complexities of the pre-1986 regime, it seems the most viable. However, as discussed above, equity, as well as efficiency, requires that the ultimate tax burden on distributed income be at least roughly equivalent to the burden on wages and interest. Therefore, eliminating the opportunity, which now exists, to avoid a tax on distributed income is imperative. This is discussed in section III. Section IV recaps whether the pre-1986 distortions can be minimized. In any event, if a universal tax on distributions can be achieved and the combined rate is higher than the top individual rate, closely held businesses would be less likely to elect to be taxed under Subchapter C, avoiding any new complications.

B. Income Eligible for Lower Rate

If the principal purpose of the lower marginal rate for corporations is to eliminate the disincentive for mobile capital to invest in this country, the lower rate need not apply to businesses that must operate locally. This may, generally, be true of a personal service business. In any event, if the lower rate does not apply to wage income, it should not be available for any income from personal services. Further, since the lower rate would also not apply to interest and

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[37] OECD Centre for Entrepreneurship, "Governments Should Do More to Help SMEs Expand Abroad," http://www.oecd.org/document/14/0,3343,en_2649_34487_37667406_1_1_1_1,00.html. Exactly what is considered an SME or the relationship between SME status and public trading is not made clear.

[38] Attention may have to be paid to objections to higher individual rates on the grounds that it would apply to the reinvested profits of small business.

other passive income earned directly, sheltering such income within a lower taxed corporation should not be possible. Therefore, we need to be concerned that companies will attempt to maximize low-taxed corporate income by paying less than reasonable compensation, by accumulating investments inside the corporation, and by characterizing true debt as equity (or paying below-market interest) to minimize interest deductions. These issues are not new.

However, while inappropriately exaggerating corporate income to take advantage of a lower rate could have been a problem in the past, and even today, since there is a reduced rate on the first $75,000 of corporate income,[39] there has been little effort to prevent overstatement of C corporate income. Aside from provisions relating to the sheltering of investment income, the focus has been on preventing understatement by those seeking to avoid the corporate tax. Thus, there is much case law dealing with the distinction between debt and equity but all in the context of companies desiring to maximize interest. The case law on reasonable compensation from Subchapter C firms, unlike the situation under Subchapter S, similarly relates to denying deductions for unreasonable compensation.[40] However, as discussed next, there is precedent that can be drawn on in an effort to limit income eligible for lower rates.

1. Personal Service Income There is clear precedent for denying the lower corporate rate to income from personal services. Thus, currently the lower marginal rates on corporate income up to $75,000 do not apply to "qualified personal service corporations."[41] These are essentially employee-owned businesses performing services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. In fact, the special capital gains treatment for small business stock[42] excludes, in addition to the above, athletics, financial services, and any trade or business where the principal asset is the reputation or skill of one or more employees.[43] The exception for such income should continue and, ideally, the corporate rate on personal service corporations should increase if the individual rate increases.

However, a business not designated as a personal service corporation will have access to the lower rates, and it may gain an advantage by paying less than reasonable compensation to a shareholder-employee. Although there are no rules or proposals relating to Subchapter C companies in this situation,[44] the question of inadequate compensation has arisen in the context of partnerships and subchapter S corporations.

These entities are required by statute to recognize the reasonable value of personal services by family members.[45] The goal of these provisions is to prevent excessive shifting of income to children (or trusts) who own an interest in the partnership or corporation. This would occur if the value of the parents' services were understated. Today, shifting income to children or

[39] I.R.C. § 11(b).

[40] See James Parker and Claire Y. Nash, "Compensation Planning Concerns Differ for C and S Corporations," *Business Entities* (Sept./Oct. 2008), 34.

[41] I.R.C. §§ 448(d)(2), 11(b)(2).

[42] I.R.C. §1202.

[43] I.R.C. § 1202(e) (3) (A). Also excluded from section I202 are banking, insurance, farming, extraction industries, and hotels.

[44] I.R.C. § 269A gives the IRS the authority to allocate the income between a personal-service corporation and its employee owners if such allocation is necessary to prevent avoidance or evasion of federal income tax or to clearly reflect the income of the corporation or its owners. This affects corporations the principal activity of which is the performance of personal services by 10 percent owners if the principal purpose of the corporation is the evasion or avoidance of federal income tax by shifting income from the employee-owners to the corporation. There is very little case law under this provision.

[45] I.R.C. §§ 704(e)(2), 1366(e)

trusts has little in the way of income tax savings. Thus, trust income over $7,500 is taxed at the highest marginal rate and, subject to a *de minimus* exception, income of children under 18 is taxed at the parents' marginal rate.[46] Nevertheless, understating compensation may continue since it would increase the value of interests held by children while avoiding an estate or gift tax. However, there are only a handful of cases on this subject, nearly all very old.

Understating compensation to avoid the 2.9 percent Medicare portion of the tax on self-employment income, which applies to all earnings without limit (a problem even in the case of personal service corporations), is a more current concern. In a number of cases, where a shareholder of a Subchapter S corporation claimed not to have received any wage, the IRS has succeeded in recharacterizing distributions in the form of dividends or expense reimbursements as wages subject to employment tax.[47]

In the case of a partnership, the reasonable value of service is irrelevant in determining self-employment income.[48] All income of a general partner, except to the extent it is from specified passive sources such as interest or rents, is considered income from self-employment.[49] On the other hand, a limited partner has self-employment income only to the extent she receives a guaranteed payment for services.[50] This distinction assumed that a limited partner would lose her status, as such, if she performed substantial services. However, that assumption is no longer true.[51] Thus, partners have attempted to avoid self-employment tax by asserting status as a limited partner. Even though partners in limited liability companies may be indistinguishable from general partners, the treatment of these individuals as general or limited partners is apparently unclear.[52]

In 1997, to prevent avoidance of self-employment tax by claiming status as a limited partner, the Internal Revenue Service issued proposed regulations that would have denied limited partner status to anyone who performs 500 hours of service.[53] Congress placed a moratorium on enforcement of the regulation and no further action was taken.[54] In 2005, however, the staff of the Joint Committee on Taxation proposed a more comprehensive approach to the self-employment income of partners and shareholders of Subchapter S corporations.[55]

The staff of the Joint Committee proposed treating all partners and shareholders of Subchapter S corporations, except those that did not materially participate in the business, the way that a general partner is treated under current law.[56] If the partner did not materially

[46] The so-called kiddie tax. I.R.C. § 1(g).

[47] Treasury Inspector General for Tax Administration, "The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations," (2002) (Ref. No. 2002-30-125) http://www.ustreas.gov/tigta/2002reports/200230125fr.pdf.

[48] Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures" (2005) (JCS-02-05), 97, http://www.jct.gov/s-2-05.pdf (hereafter *JCT Report*).

[49] Id.

[50] Id.

[51] Id., 97–98.

[52] Id., 98–99.

[53] Reg 209824-96 62 F.R. 1702 (1-13-97, 97 TNT 14-11. See comments of New York State Bar Association at 97 TNT 59-24

[54] *JCT Report*, 98.

[55] See generally, id., 95–104.

[56] The Joint Committee referred to the passive loss rules, section IV69, for the meaning of material participation. Id., 102.

participate, the proposal would treat only the partner's "reasonable compensation" from the partnership as earnings from self-employment.[57] In the case of a service partnership,[58] it would eliminate the current law exception for passive income so the partner's entire net income would be treated as self-employment income.[59]

The JCT approach considers all income, except passive income in some circumstances, as income from self-employment, if the partner materially participates. Reasonable compensation for services would be relevant only if the partner did not materially participate. Obviously, the Joint Committee staff wanted to limit the situations where the reasonable value of services had to be determined, even if this meant assigning an excess value to personal services.

Although shareholder-employees in closely held C corporations could similarly try to avoid employment taxes by understating compensation, the Joint Committee proposal did not extend to C corporations. The problem may seem less significant because the code subjects this income to two levels of tax. Moreover, unlike partnership income, corporate income is not allocated. Thus, the amount attributable to the shareholder who is materially participating and therefore subject to self-employment tax is not obvious.

An alternative, which also does not require that reasonable compensation be directly valued, would determine the value of services by subtracting a reasonable rate of return on capital. For purposes of their dual income tax, the Nordic countries use this approach, applying a fixed statutory rate, to separate higher-taxed labor income from lower-taxed income from capital.[60] Under this approach the lower corporate rate would be limited to a specified return on capital.

The Joint Committee, however, rejected as administratively too difficult proposals that would have required the determination of a reasonable rate of return on capital. It noted that rates of return could vary significantly at different times or for different types of business.[61] The Joint Committee also thought a fixed rate under all circumstances to be too arbitrary.[62] Nevertheless, taxpayers have used this approach to justify high compensation. Thus, the 7th Circuit has recently held that if shareholders receive a far higher return on capital than reasonably expected, compensation is presumed to be reasonable.[63] For reasons noted below, I think this approach has promise.

As described above, if distributions are fully taxed, the advantage of the lower corporate rate is a higher return on reinvested earnings. Similarly, if there is a failure to pay reasonable compensation, then reinvestment of the amount that should have been paid out as compensation produces tax-preferred earnings. The advantage is as set forth in table 2. It is much greater if distributions are not taxed. In that case, the understated compensation would be taxed only at the

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[57] Id., 99–100.

[58] The definition was similar to the definition of a qualified personal services corporation under I.R.C. § 448(d)(2)

[59] *JCT Report,* 99.

[60] See, Peter Birch Sorensen, "The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada" *Canadian Tax Journal,* 55 (2007): 557; Vesa Kanniainen, Seppo Kari, and Jouko Yla—Liedenpohja, "Nordic Dual Income Taxation of Entrepreneurs," Int Tax Public Finance 14 (2007): 407.

[61] *JCT Report,* 101.

[62] Id., 101, N. 227.

[63] Menard Inc. v. Commissioners (7th Cir. 2009) *Tax Notes Today* (2009), 46-9, 560 F.3d 620. See G. Edgar Adkins, Jeffrey A. Martin, and Dustin Stamper, "Taxpayer Achieves Major Victory in Reasonable Compensation Case," *Tax Notes* March 24, 2009.

corporate rate. Therefore, exaggerating corporate earnings by minimizing compensation is a serious concern.

Further, if normal returns on capital are taxed at the low marginal rate and high tax rates are limited to abnormal returns, any disincentive for investment would be minimized. In this case, understating corporate income entitled to the lower corporate rate by overstating the amount of “compensation” would at least not affect total investment.

Moreover, as discussed above, the goal of the lower rate does not necessarily require extending it to closely held companies. Therefore, for companies in which employees (and their families) own more than a specified percentage of stock, it seems sensible to limit the amount of income entitled to the lower rate to no more than a return on capital equal to the rate of return on treasuries plus a specified percentage.[64] While the market value of corporate equity seems relevant for this purpose, avoiding the difficulty of valuation by using book value is appropriate. If market value exceeds book value, there is untaxed unrealized appreciation which can result in the equivalent of tax exempt earnings on the deferred amount. Limiting the lower corporate rate to a return on book value, merely serves to reduce the advantage of tax deferral. Similarly, overstating the return on capital when book value exceeds market value compensates for a failure to recognize the unrealized loss.

As in the case of personal service companies, income in excess of this amount should be taxed at the top individual rate. Since, the code taxes the after-tax income when distributed; the parties may well be better off paying additional compensation, which the Internal Revenue Service should allow as a deduction, and contributing the after-tax income as additional capital, which the company could eventually distribute tax-free. However, since compensation would bear an initial additional burden because of the 2.9 percent Medicare tax, avoiding additional compensation could remain preferable if distributions were delayed long enough.

2. Passive Income   It is abusive if high-income individuals can place their investments in a corporation to avoid individual-level tax on portfolio investments. The reduced rate also should not apply to investment earnings of an active business corporation, which retains profits beyond the needs of the business. While specific solutions to these potential abuses now exist, denying the lower rate to any investment income regardless of the circumstances may be appropriate.

The first of these problems has been met through the concept of a personal holding company.[65] Thus, for example, if an individual owns 100 percent of the stock of a corporation, whose assets consist solely of passive investments, the code defines this as a personal holding company. It imposes a penalty tax, historically equal to the highest individual rate, on “the undistributed personal holding company income” (roughly passive income).[66] The penalty rate was reduced to 15 percent in 2003,[67] which seems logical since one avoids the penalty tax by distributing income. Nevertheless, if a taxpayer can take advantage of a low corporate rate (as low as 15 percent today), an additional tax of 15 percent is not necessarily adequate to prevent abuse. The penalty could prevent abuse if the combined rate on corporate income, including the

[64] AFR (applicable federal rate) for varying maturities is published monthly by the IRS. 1274(d)(3).

[65] I.R.C. § 541

[66] I.R.C. § 545

[67] Under current law, the rate returns to the highest individual rate after 2010 when the lower rate on dividends is to expire. This is also the case under I.R.C. § 531 discussed in the next paragraph.

penalty rate, is equivalent to the top individual rate. However, it is probably simpler to tax personal holding companies, like personal service corporations, at the highest individual rate, as long as there is a low tax rate on dividends.

In any event, the definition of personal holding company income is complex.[68] Personal company holding company status can be avoided if stockholding is diversified enough so that five unrelated people do not own more than 50 percent of the shares or if assets are expanded into areas that the code does not recognize as passive investments, so that 40 percent of the ordinary income is not "personal holding company income."[69] Planning to take advantage of a lower corporate rate, while avoiding personal holding company status, was once quite common when individual rates were 70 percent or higher and the corporate rate considerably lower.

The second concern is dealt with by a 15 percent penalty tax on earnings accumulated in excess of reasonable business needs.[70] Since the penalty tax is equal to the burden on distributions, there would be no advantage to accumulating earnings. As noted, this should be sufficient to prevent abuse if the combined rate on corporate income is equivalent to the top individual rate. However, since reasonable business needs include reasonably anticipated future needs, the accumulated earnings tax is too easy to avoid, mostly penalizing those who did not sufficiently "plan."[71]

Since these two provisions are both complex and uncertain in application, this approach to deterring abuse should be avoided. A possibility is to tax all passive income within a corporation at the highest individual rate. One may consider this too harsh, if it is thought appropriate to allow the lower marginal rate on income earned by a normal level of working capital. Nevertheless, it seems best. Recall that if the return on reinvested earnings is taxed at the top individual rate, the result mirrors the treatment of pass-throughs assuming shareholders are taxed at this rate. Therefore, the corporation is not penalized when passive income is taxed at the higher rate; it just does not get an additional benefit as compared to a pass-through.

The Internal Revenue Code now distinguishes passive from active income in a number of circumstances. Taxpayers want to limit passive income to remain eligible under Subchapter S,[72] to avoid status as a personal holding company,[73] to be eligible for ordinary loss on disposition of small business stock,[74] and to avoid inclusion of undistributed income in a passive foreign investment company[75] or a controlled foreign corporation (under Subpart F).[76] On the other hand, in the case of a tax-exempt entity, passive income is preferable since it is exempt from the unrelated business income tax, while active income might be taxable.[77] All these provisions start from the basic rule that passive income includes dividends, interest, rents, royalties, and

[68] See I.R.C. § 543.

[69] I.R.C. §§ 541(a), 543.

[70] I.R.C. § 531

[71] See I.R.C. §§ 535(c), 537(a)(2)

[72] I.R.C. §1362(d)(3)(C)

[73] I.R.C. § 543(a)

[74] I.R.C. § 1244(c) (1) (C)

[75] I.R.C. § 1297(b). If such income is not reported currently, interest is charged on deferrals.

[76] I.R.C. § 954 (c)

[77] I.R.C. § 512(b)(1), (2), (3), (5).

annuities with varying exceptions to exclude income from active business activities. Reference could also be made to territorial systems, which exempt foreign-source active business income from tax in the residence country, but, generally, tax passive income.[78]

Taxing passive income at full rates also mitigates the tax advantage inherent in the deferral of executive compensation. Deferral causes the return on the investment to be taxed at the corporate rate instead of the individual rate.[79] This is a problem whenever the corporation has losses. However, the problem grows if there is a differential between the individual and corporate rate.

Corporate income would also be overstated if companies disguised debt as equity to avoid interest deductions, which would reduce corporate income. There is probably no way to apply a bright line test here. It may be noted, however, that taxpayers have been very successful in disguising equity as debt, in order to reduce corporate income. Reliance on this precedent could, at least, help the IRS keep understatement of interest somewhat in check. In addition, because it may increase risk, independent parties may be more wary of the adjustments required to disguise debt as equity. Thus, to achieve the advantage, annual distributions must be forgone to accumulate income that would be taxed at the low corporate rate.

III. DISTRIBUTIONS

This paper has argued that equity requires that the combined tax on distributed income should at least equal the single rate of tax on pass-through entities. Of course, the assumption of equivalence does not hold if distributions or sales are not taxed.

Distributions will not be taxed if the shareholder is tax-exempt or, in some cases, the beneficiary of a treaty as a nonresident. Heirs of individuals who hold onto stock until death can avoid tax on accumulated income by selling stock that will now have a basis equal to fair market value at the date of death. Tax on built-in gain is also avoided when stock is donated to charity. This section considers whether a second tax can be imposed in these circumstances.

A. Inherited Property

Property transferred by bequest generally takes a basis equal to the value at the date of death, a so-called step-up in basis.[80] Although equity demands that either the unrealized appreciation should be taxed at death or the heirs should take a carryover basis, the step-up seems likely to continue. If so, an heir will be able to sell stock tax-free and wipe out any tax on undistributed earnings. However, step up in basis does not apply to what the Internal Revenue Code refers to as income in respect of a decedent, generally income to which a decedent was entitled prior to death but which was not includible in computing his taxable income.[81] Examples include salary, distributions from an IRA, income from a Series E United States savings bond, and gain on stock

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[78] See Joint Committee on Taxation, "Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment" (June 25, 2008), JCX 55-08, 38.

[79] Halperin and Yale, "Deferred Compensation," 943. See Daniel I. Halperin, "Interest in Disguise: Taxing the 'Time Value of Money'" *Yale Law Journal* 95 (1986): 506.

[80] I.R.C. § 1014.

[81] See I.R.C. §§ 691, 1014(c); see also 26 C.F.R. 1.691(a)-1(b).

sold during lifetime but for which payment had not been received before death. Since basis is reduced from fair market value by the amount of income in respect of a decedent, this income is subject to tax in the hands of the heir.

The decedent earned her share of the corporation's undistributed income prior to death, and thus, the code should treat it as income to her. If she operated the business as a pass-through entity, the income is taxed when she earned it regardless of whether it was distributed. In fact, payments to a retiring or deceased partner, other than in liquidation of the partner's interest in property, are considered income in respect of a descendent.[82] Thus, when heirs of a deceased partner retain a continuing interest in the income of the partnership, including payment for goodwill and receivables, such amounts are taxable even though the amounts received do not exceed the date-of-death value.

The ALI integration study proposed to tax distributions at the shareholder's rate even if received after death.[83] Thus, the proposal would have reduced the basis step up by undistributed earnings in order to preclude the refund of the previously paid corporate tax. As the reporter's study put it:

> The increase in basis at death is intended to remove from the tax base, unrealized gains not previously realized gains.... Accordingly some limitation is necessary to prevent integration from extending the exemption of section I014 to pre-death corporate income.[84]

Since one should consider the split-rate system an alternative way of taxing income to the beneficial owner, treatment of accrued income under a split-rate system should follow the partnership and integration result. The treatment of stock in a DISC is directly analogous. The basis of the heir is reduced from fair market value by the DISC income attributable to the disposed stock, which accumulated in the taxable years that the deceased held the stock.[85]

Note that the basis of an annuity contract would not change at death. Therefore, the code treats postdeath distributions from the annuity contract as taxable to the same extent as if they were received by the descendent prior to death.[86] This treatment reflects the idea that even though the insurer has not distributed the income prior to death, it accrues to the descendant as it is earned by the insurer and the annuity increases in value. Similarly, the decedent has earned her share of the corporation's undistributed income prior to death. Such income is not identical to unrealized appreciation and a step-up in basis is inappropriate.

One should reduce fair market value basis by the descendant's pro rata share of earnings increased by the corporate taxes paid on such earnings, less any amount distributed to the shareholder that was not applied against the shareholder's basis. As discussed in the ALI study,

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[82] I.R.C. §§ 753, 736(a).

[83] ALI, 705–6.

[84] Id., 705.

[85] I.R.C. §§ 1014(d), 995(c). Under I.R.C. § 1014(b)(5) in the case of death between 8-26-37 and 1-1-05, the basis of stock of a foreign personal holding company is the lesser of fair market value and decedent's basis.

[86] William Augustine Conway, "Tax-Deferred Annuity Rescue: The Good, the Bad, and the Taxes" (2006), http://www.conway-law.com/cep/retire/Annuities.doc; David Port, "Annuity Taxation Primer: The Good, the Bad, and the Obvious" (2008), http://www.seniormarketadvisor.com/r/smaMag/d/contentFocus/?adcID=9c2874b999c12a9286579927b26b172b.

allocation of earnings may face administrative problems, particularly when the company is not closely held.[87]

B. Charitable Gifts

The code usually measures charitable contributions of property by fair market value, which means that any built-in gains would escape tax. If this rule applied to contributions of corporate stock, there would be no individual level tax on undistributed corporate earnings at the time of the gift. However, there is precedent for taxing the built-in gain on transfers to charity. This is accomplished indirectly by reducing the amount of the charitable deduction by the amount to be effectively "included" in income.[88] The same considerations that would lead one to deny a full step-up in basis at death suggest reducing the deduction for a charitable gift by a like amount.[89]

C. Tax-Exempt Shareholders

It is not clear that a corporate rate reduction should result in a reduction of the tax burden on tax-exempt investors. Tax-exempt institutions that own corporate stock are effectively subject to the corporate tax. If they directly engage in business, they may be subject to the tax on unrelated business income (UBIT), which is generally at the corporate rate.[90] Without further action, reducing the corporate rate would reduce these taxes.

Shareholder credit systems of integration must explicitly decide whether the credit will be refundable to tax-exempt investors, such as pension plans and universities. If the credit were refundable, these tax-exempt investors would not pay tax on distributed corporate income.[91] For this reason, some would suggest denying tax-exempt investors the credit, effectively imposing the corporate level tax.[92]

Although a split-rate system does not directly face this issue, the same question is involved when the corporate rate is reduced, namely whether the effective tax burden on tax-exempt investors should be reduced. Such a reduction is particularly problematic if the tax rate on dividends is increased so that the overall burden on distributed corporate income is unchanged for taxable shareholders. In these circumstances, tax-exempts would have a much greater benefit from the rate cut.

However, to prevent the tax reduction, one must tax distributions to tax-exempt institutions and sales of corporate stock by these entities. Although such taxation seems a decidedly more controversial step than denying the credit, the ALI study suggests taxing corporate distributions of interest and dividends to tax-exempts at an unspecified rate and refunding any excess credit.[93] The ALI study would also tax sales of corporate instruments.[94]

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[87] ALI, 705-06. The DISC provision assumes this issue can be handled. See 26 C.F.R. §1.995-4(e).

[88] I.R.C. § 170(e).

[89] Since the gain on DISC stock would be converted to ordinary income to the extent of undistributed earnings, the charitable deduction on the transfer of such stock would be reduced by that amount. I.R.C. § 170(e)1(A), 995(c).

[90] I.R.C. §§ 511(a), 512.

[91] ALI, 728.

[92] Id., 732, n. 142.

[93] Id., 730–31.

[94] This approach eliminates the preference for investment in debt by tax-exempts. Further, by making the credit refundable, the ALI avoids the need to develop a mechanism to prevent tax-exempts from shifting the tax credit to investors who can make use of it. Id., 731.

D. Foreign Investors

The possibility of avoiding the tax on distributions could also arise in the case of nonresident investors. Nonresidents are subject to withholding on dividends not effectively connected to a U.S. business at 30 percent.[95] However, tax treaties lower the rate, most often to 15 percent for portfolio investors and 5 percent for direct investment (10 percent ownership).

To retain the corporate level tax, the ALI study suggests that foreign investors be subject to tax on dividends at the highest individual rate, which would be offset by the available credit.[96] To achieve a similar result under a split-rate system, one must tax distributions to foreign investors. As of now, however, the statutory withholding rate is higher than the rate applicable to U.S. persons, and the treaty rate for portfolio investment is generally equivalent to the current 15 percent statutory rate. The tax on direct investment may be lower, but modifying this rate by treaties—to the extent a higher rate would be inconsistent with the goal of the lower corporate rate—is appropriate.

E. Lower Combined Tax on Preference Income

Another issue more hidden with a split-rate system is the treatment of corporate tax preferences. Under current law, sole proprietors and partners can enjoy the benefits of untaxed income, which results from tax preferences, even if used for personal enjoyment.[97] On the other hand, corporate distributions out of untaxed income are subject to tax, currently at a 15 percent rate.

European integration systems generally continued this disparity between corporations and pass-throughs.[98] Thus, if distributions came from untaxed income, corporations may have had to specifically withhold an additional tax. [99] Therefore, if the corporation planned to distribute $100 of untaxed income, the government would withhold $40 and the shareholder would receive $60. Again, if the individual's marginal rate were 40 percent, the amount withheld would just offset the individual's tax liability on the deemed distribution of $100. Thus, distributed preference income was fully taxed at the individual rate.

The ALI study did not directly resolve this issue. It rejected the pass-through of timing preferences as too administratively difficult to achieve. The ALI did develop an optional mechanism for pass-through of exempt income and tax credits. If one did not choose this alternative, however, a distribution of funds, which did not bear corporate tax, would be fully taxed to the shareholder.

In contrast to the latter, the split-rate approach would reduce the burden on tax-preferred income since only the reduced individual rate would apply. To prevent this from occurring, the original Bush administration proposal in 2003, to eliminate the tax on dividends, would not have

[95] A 25 percent rate on the corporation and a 30 percent withholding rate is a combined rate of 47.5 percent. Effectively connected income is taxed to the same extent as the income of residents.

[96] ALI, 752-53.

[97] The basis of an interest in a partnership or subchapter S corporation increases by the amount of exempt income earned by the company. IRC Sections 705(a)(1)(B), 1367(a)(1).

[98] ALI, 653.

[99] An ordering rule generally allowed taxed earnings to be distributed first. The U.K. calls the withheld amounts advanced corporate tax (ACT). More information on these rules appears in the ALI study. Id., 653.

applied unless corporate tax had been paid.[100] Business did not support this proposal, perhaps, because it provided no benefit to companies that made extensive use of tax preferences, thereby reducing the value of such preferences, including the numerous tax credits.[101] Thus, as enacted, a reduced 15 percent rate applies to all dividends.[102] Therefore, Congress, in effect, made the decision to reduce the burden on preference income, and we need not necessarily revisit it in connection with a corporate rate cut, which has no direct impact on that issue.

If one reopened the matter, to fully tax income, which is untaxed at the corporate level, distributions of tax-preferred income would have to bear an additional tax equivalent to the corporate tax. Although, as noted above, this effectively occurs under integration systems, which require withholding additional tax when a corporation distributes untaxed income, such additional tax looks more radical in the absence of a shareholder credit.

A tax on distributions of tax preferred income also adds significant complexity, because otherwise, as discussed below, it would not appear necessary for a corporation to track the source of distributions. On the assumption that dividend distributions arise first out of taxed income, comparing the amount of taxable income (since the enactment of the reduced rate) to distributions would not appear difficult. However, non-pro-rata redemption of shares raises the question as to how much of the distribution one should consider previously taxed income as opposed to a return of capital. Moreover, to the extent distributions are greater than income, one must create rules to determine if the source was untaxed preference income, which would be taxed, or taxable earnings accumulated before enactment or capital contributions, which would not be.

IV. COMPLEXITY AND DISTORTION FROM RATE DISPARITY

This section summarizes the potential economic distortion and tax advantage that occurs when the corporate rate differs from the individual rate. For most of our history, individual rates were higher than corporate rates, considerably higher until 1980.[103] This was true prior to the Tax Reform Act of 1986 and to a small extent between 1993 and 2000. Thus, prior to 1986, it often made sense for a closely held business to operate as a C corporation.

Even today, one may prefer Subchapter C to pass-through treatment in certain circumstances. Although the top federal corporate rate and the highest individual rate are now the same at 35 percent, there are instances in which the marginal rate of tax on corporations is less than the marginal tax rate on individuals.[104] Most importantly, the corporate rate on the first

[100] Department of Treasury, “General Explanation of Administration’s Fiscal Year 2004 Revenue Proposals” (February 2003). This was largely based on the 1992 study, see note 18.

[101] See Michael Doran, Managers, Shareholders and the Corporate Double Tax, 95 Virginia L. Rev. 517, 574-76, 586 (2009) (noting that the providers of tax preferences were important opponents).

[102] Since this was combined with a reduction in the capital gain rate from 20 to 15 percent, it benefitted taxpayers in addition to those receiving dividends.

[103] The corporate rate was 52 percent when the top individual rate was 91 percent prior to 1964 and 48 percent when the individual rate was reduced to 70 percent at that point. Internal Revenue Service, *Corporate Income Tax Brackets and Rates, 1909–2002* (2003), http://www.irs.gov/pub/irs-soi/02corate.pdf. The rates prior to 1986 were 15, 18, 30, and 40 percent, each on $25000 of income, and 46 percent in excess of $100,000. The top individual rate was 70 percent to 1980 and 50 percent thereafter.

[104] For example, the various phase-outs in the individual tax could raise the marginal rate for some taxpayers over 35 percent. Because of the 2.9 percent Medicare tax on self-employment income, the corporate rate would be lower than the marginal rate on

$75,000 of income is 25 percent or less for some corporations.[105] Thus, if one could limit income to $75,000, one could prefer Subchapter C status. The postdeath redemption of shares, which could be tax-free, heightens this preference.

Of course, even when initial rates are lower, use of Subchapter C is not necessarily a permanent advantage. There is a potential second tax on distributions that could raise the overall level of tax above what it would have been on a pass-through entity. Corporations therefore may avoid distributions if possible. As discussed above, deferral of the distribution alone does not reduce the tax burden if the rate of tax is constant. Since this is probably not well understood, some deferral of dividend distributions probably occurred based on the mistaken belief that it would reduce the burden. Still, it is clearly better to forgo dividends and try to convert distributions into capital gain by sale or redemption of shares. The 2003 dividend rate change reduces but does not eliminate this benefit.

Thus, planning for distributions to minimize the tax burden was extremely important (often the linchpin of law school courses on corporate tax) and the rules are extraordinarily complex. Prior to 2003, the code taxed dividends at ordinary rates without regard to basis of shares. However, it considered redemptions as sales subject to tax at capital gain rates to the extent the proceeds exceeded the applicable basis. Redemption of stock following death was ideal since there was no second level tax, as the heirs or estate had a basis equal to the date-of-death value.[106] There is an extraordinary set of rules designed to prevent the disguising of dividends as redemptions.[107] Since 2003, the code taxes corporate dividends at the capital gain rate so it is often unimportant to determine the character of the transaction.[108] Redemptions, however, may attract basis, which can be particularly important following death, and gains, unlike dividends, can be offset by capital losses.

Conversely, some firms, which chose Subchapter C, sought to minimize income subject to the corporate tax. Although it would seem simpler to choose a pass-through entity in the first place, there may have been both tax and nontax reasons to prefer Subchapter C. Thus, before limited liability companies became widely available, Subchapter C may have offered the only route to protection against liability, particularly since Subchapter S was far more restricted than it is today. Many existing C corporations maintained their status even when LLCs became widely available, since liquidating C corporations would have a tax cost. Moreover, some entities, such as banks, may not be able to make use of LLCs[109] or Subchapter S.[110] Further, some have suggested that the corporate form facilitates employment arrangements and avoids the uncertainties associated with the relatively new limited liability company.[111]

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wages. Moreover, state income taxes may apply a lower top marginal rate to corporations than to individuals, so the overall corporate rate might be lower than the overall individual rate.

[105] Corporate income up to $10 million is taxed at 34 percent. I.R.C. § 11(b)(1)

[106] I.R.C. § 1014

[107] See generally James J. Eustice, “Federal Income Taxation of Corporations and Shareholders, Part 9” (2009).

[108] See I.R.C. § 1(h)(3)(B).

[109] Robert Wood, *Limited Liability Companies Formation, Operation, and Conversion* 2nd ed. 2000, 8.

[110] I.R.C. § 1361(b)(2)(A)

[111] Victor Fleischer, “The Rational Exuberance of Structuring Venture Capital Start-ups,” *Tax Law Review* 57 (2004): 151–53. Fleischer also referred to the possibility of a slightly lower capital gain rate on sale of corporate stock. I.R.C. § 1202, and the possibility of deferring tax on sale by rolling proceeds into a new venture, I.R.C. § 1045. For an earlier examination of the

On the tax side, use of a corporate entity makes it easier to merge the business into a public company tax-free.[112] Finally, one may want to limit corporate income to the amount taxed below the normal rate, up to $75,000 currently, and distribute earnings above that amount as compensation or interest, subject only to a single individual level tax. Under this plan, one can significantly reduce the combined tax, particularly if distributions of earnings taxed to the corporation were taxed at capital gains or became exempt following death. If this is the goal, it is now more important to limit corporate income, as the benefit of the lower rate begins to phase-out as income exceeds $100,000.[113]

In all the circumstances discussed in the two previous paragraphs, the effort to limit corporate income might dictate the payment of excessive compensation or, put another way, disguising dividends as deductible compensation. There are many cases regarding these matters. Alternatively, corporations could issue purported debt that promised deductible interest. Another large number of cases involved the debt equity distinction. These issues, which remain today, would be mitigated if the combined burden on corporate distributions approximated the top individual rate.

On the other hand, others may seek to take advantage of low corporate rates by maximizing corporate income. As noted above, firms following this route could pay less than reasonable compensation and minimize interest deductions by characterizing debt as equity or paying below market interest on debt. The following discusses how the proposal so far described could serve to mitigate these distortions.

A. Choice of Entity

If the lower rate applies to business income of all entities including Subchapter S and Partnerships, one would, as under current law, have little reason to choose Subchapter C. Avoiding Subchapter C would provide a loss pass-through and also allow income to be taxed at less than the corporate rate.

However, if the lower rate applied only to income taxed at the corporate level, small business might have an incentive to elect Subchapter C, as under pre-1986 law. This preference would be magnified if one could avoid the tax on distributions. If the combined corporate tax burden could not exceed the top individual rate, the only downside would be a potentially higher tax burden on tax-preferred income and the lack of pass-through for losses. One could retain the loss pass-through opportunity by using a pass-through entity as a start up as and converting to Subchapter C when income becomes positive.

On the other hand, if the combined burden on distributed income is higher than the top individual rate, there may not be a significant incentive to choose Subchapter C even if only Subchapter C corporations enjoyed the lower rate. This could mean little would change as to entity choice.

practice in Silicon valley to invariably use C corporations, see Joseph Bankman, "The Structure of Silicon Valley Start-ups," *U.C.L.A. L. Rev.* 41 (1994): 1737.

[112] For a partnership to merge into a corporation without tax generally requires first incorporation and then waiting for some period of time. This is not always easy to achieve. See Fleischer "The Rational Exuberance," 175–84 (regarding venture capital exit strategies).

[113] I.R.C. § 11(b).

Assuming C corporation status becomes a more widespread choice, the key question is whether it is possible to prevent inappropriate use of the lower corporate rate. Thus, as discussed, the reduced rate should not apply to personal service income or passive income, and it should not be possible to avoid the second level tax on distributions. Further, the opportunity to overstate corporate income by paying inadequate compensation should be limited, as described above. This would narrow the difference between entity forms. None of this, however, prevents a permanent lower tax on the return from reinvested earnings.

B. Debt versus Equity

Under current law, if a closely held business chooses the pass-through form, the debt equity distinction is largely irrelevant. However, one can usually redeem debt at no cost because basis would equal the amount distributed. It may be harder to use basis against equity distributions.

Publicly traded firms that cannot avoid Subchapter C and those closely held companies choosing C corporations continually try to avoid corporate tax by disguising as debt for tax purposes instruments treated as equity for regulatory and accounting purposes. This may be particularly advantageous when the shareholder rate is lower, as in the case of tax-exempts. Since interest is deductible even if not paid, debt enables one to retain funds while reducing corporate taxes. Integration could eliminate the disparity between debt and equity. A reduction in the corporate rate would reduce the payoff for this manipulation and may, in fact, create a preference for equity.

Thus, if the corporate rate is lower than the individual rate, taxpayers may prefer equity since this will allow greater accumulation of income to be taxed at the corporate rate. If taxpayers can avoid or reduce the tax burden on distributions, equity may provide a greater advantage. On the other hand, if the combined rate on dividends is equivalent to the individual rate on interest, at least if distributions will inevitably be taxed, it would reduce the debt-equity distortion compared with current law.

In sum, if the rate cut induces closely held companies to select Subchapter C, the pressure on the debt-equity distinction could increase, particularly if one can avoid the burden of the distribution tax. On the other hand, companies are less likely to make this choice if the combined rate remains higher, at least if they cannot avoid the distribution tax.

C. Timing of Distribution of Profits

If distributions are always taxed at the same rate, timing does not affect the tax burden, although it could cause concern if rates change over time. However, if taxpayers can avoid the distribution tax by death or charitable gifts, deferring distributions can be an advantage.

Delay in distribution also maximizes access to the lower marginal rate on corporate income. Therefore, it is important that the lower rate not apply to passive income and that limits be placed on inadequate compensation.

D. Nature of Distributions

If corporate equity faces a higher tax burden than debt, as under current law, taxpayers will turn to unreasonably high compensation and the disguising of equity as debt in order to inappropriately reduce corporate income. In contrast, if the combined corporate rate is not higher than the individual rate, taxpayers have little incentive to disguise distributions as interest or compensation. Instead, as noted above, understatement of interest or compensation to increase corporate income inappropriately may be more of a problem.

As to distribution with respect to equity, if the code entitles dividends to capital gain rates, the tax treatment of the distribution differs only with respect to basis recovery. Timing of basis recovery does matter, however. At a 20 percent rate, the amount of the tax savings from treating a distribution as recovery of basis is equal to 20 percent of the capital contribution. The amount does not grow over time. Therefore, it is obviously better to get the tax savings as soon as possible.

Today, whether basis recovery occurs depends on a complex set of rules. Some rules are applied at the corporate level, to determine if the distribution is out of earnings, taxable or untaxed, or amounts to a return of the capital contributions to the corporation. There are also rules at the shareholder level, to determine whether there has been a dividend or redemption, which depends upon whether there has been a reduction of the shareholder's interest in the corporation.[114] Given the diminished importance of the determination, at least if one could reduce the basis of stock after death as discussed above, basis recovery could depend solely on the shareholder's situation and, perhaps, more arbitrary rules could be devised to eliminate much of the complexity. One possibility is to compare the amount of the distribution to the total value of the shareholder's holdings.

Since capital losses cannot offset dividend income, the nature of the distribution can matter apart from the question of basis recovery. The code restricts capital losses to preclude cherry picking, where the taxpayer recognizes losses and defers gains. We could alleviate much of the problem if we allow capital losses in excess of unrealized gains without restriction. Resolving this issue is well beyond the scope of this paper.

V. CONCLUSION

We should not make a decision to reduce the marginal corporate rate without considering the impact on the ability of higher-income taxpayers to shelter their income from services or investments or to reduce the overall rate of tax on corporate distributions. This paper suggests that we can mitigate these problems if the lower corporate rate is denied to income from services or passive investments and if there is always a second tax on distributed income. The latter requires reducing the step-up in basis at death and the deduction for charitable contributions by the amount of undistributed earnings to prevent taxpayers from permanently escaping tax on earnings retained in the corporation. Setting the combined individual and corporate rates on corporate distributions higher than the top individual rate also reduces the risk that corporations will be used to shelter income. Further, tax exempts should probably pay tax on distributions and on undistributed earnings at the time of sale.

[114] See James Eustice, "Federal Income Taxation of Corporation and Shareholders" ¶¶ 9:03-9:05 (2009).