



# TaxNewsFlash

## United States

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### **Legislative update: Senator Hatch's statement on tax reform, corporate integration**

In a speech on the Senate floor shortly before the Senate adjourned, Senator Orrin Hatch (R-UT), the Chairman of the Senate Finance Committee, discussed tax reform and his efforts to develop a proposal to better integrate the corporate and individual tax systems.

Chairman Hatch indicated that his idea is to allow corporations to deduct, from taxable earnings, dividends they distribute to shareholders, resulting in only one level of tax on those earnings (at the shareholder level)—similar to the way debt is treated.

Chairman Hatch also stated that he had received “very positive” feedback from the Joint Committee on Taxation on his proposal, including that his proposal would increase capital investment and reduce effective tax rates for U.S. businesses; would alleviate some of the “pressures that drive corporate inversions and help prevent erosion of the U.S. tax base overall;” and could do so without adding to the deficit or shifting the tax burden from higher-income to middle- and lower-income taxpayers.

Chairman Hatch also noted that he and his staff are prepared to address concerns about the potential impact of the proposal on tax-exempts, charitable organizations, and retirement security stakeholders when the proposal takes legislative form. [As described in the “background” section below, these concerns have arisen due to the possible imposition of withholding on both interest and dividends under a dividends paid deduction regime.]

With regard to when he might try to move his proposal forward, Chairman Hatch indicated that he was “excited to see how the debate over comprehensive tax reform plays out in the near future and where [the integration] concept might fit in that broader discussion.” He further cautioned that it is important to “take the time to reflect of the results and acknowledge the realities on the ground. “ Specifically, he stated:

*I remain very interested in the concept of corporate integration and continue to believe that it would have a positive impact on our tax system and our economy overall. But, let's be honest . . . after this election, the ground has shifted, and, while we don't know how everything will play out in the coming months, it's safe to assume that the tax reform discussion is shifting as well. I remain very interested in the assumptions and parameters that have, for some time now, governed the tax reform debate will have to be modified, if not thrown out entirely.*

*Right now, we are seeing more momentum for COMPREHENSIVE tax reform – that is reform that deals with both the individual and business tax systems – than we've seen in a generation or more. And, if we're going to do right by our economy and the American people, we need to think in those comprehensive terms. . .*

*I believe that corporate integration can and should be part of the comprehensive tax reform discussion that appears to be on the horizon. But, given the current reality, any substantive tax reform proposal will need to be considered and evaluated in the context of what has quickly become a much broader discussion.*

*Let me be clear: I am not walking away from the idea of corporate integration.*

*On the contrary, I am excited to see how the debate over comprehensive tax reform plays out in the near future and where this concept might fit in that broader discussion. . . .*

*This discussion about comprehensive tax reform promises to be one of the big-ticket items in the coming Congress, and I am excited to be a part of it.*

Read Chairman Hatch's [statement](#).

## **Background**

“Corporate integration” generally refers to integrating the individual and corporate tax rules so that corporate income is subject to only one level of tax. Under current law, entities that are treated as partnerships or S corporations for federal income tax purposes are already subject to an integrated tax system because they generally are subject to tax on business income at only one level—the owner level. Other specialized entities (such as real estate investment trusts and regulated investment companies) also are subject to integrated tax regimes. However, “C corporation” income generally is subject to tax at two levels: (1) at the corporate level when income is earned; and (2) at the shareholder level when income is distributed.

There are several different ways integration could be achieved. For example, (1) the corporate tax could be eliminated and earnings could be taxed at the shareholder level; (2) corporations could be allowed a deduction for dividends paid; (3) dividends could be exempt from tax at the shareholder level; or (4) shareholders could be given an income tax credit to reflect corporate-level tax paid with respect to dividends. There also are methods to achieve partial—rather than full, integration—such as

providing reduced corporate rates on distributed earnings relative to retained earnings, reducing the rates at which shareholders pay tax on dividends, and providing a partial deduction for dividends paid.

For many years, various players in the tax community have explored proposals to modify the rules applicable to C corporations to better achieve integration. For example, in 2003, President George W. Bush proposed excluding dividends paid by a corporation from a shareholder's gross income—this would have resulted in only one level of tax being imposed on the corporation's income (at the corporate level). As the measure moved through the legislative process, however, the proposal was modified to instead provide for taxing "qualified" dividend income at a preferential rate relative to ordinary income. Thus, complete integration was not achieved.

A [report on comprehensive tax reform](#) [PDF 15 MB] prepared by the Republican staff of the Senate Finance Committee in December 2014 (the "Republican Staff Report") provides a lengthy description of the history of integration proposals since the beginning of the income tax system, why corporate integration is desirable, integration regimes currently contained in the Code, integration systems in use by other countries, and the methods by which integration can be achieved (including through a dividends paid deduction). For example, the report explains the need for integration as follows:

*Eliminating the two-tier system would reduce or eliminate at least four distortions to economic and financial choices: (1) the incentive to invest in non-corporate businesses rather than corporate businesses, (2) the incentive to finance corporations with debt rather than equity, (3) the incentive to either retain or distribute earnings depending on the relationship among the corporation, the shareholder and the capital gains tax rate, and (4) the incentive to distribute earnings in a manner to avoid or significantly reduce a second level of tax, such as payments giving rise to deductions or stock repurchases that give rise to basis recovery and capital gains.*

The Republican Staff Report also discusses the difficulties associated with integrating the individual and corporate tax systems, given the large amount of corporate debt and equity held by tax-exempt entities. The report explains that, under current law, a single level of tax is imposed (at the corporate level) on earnings distributed to a tax-exempt owner to the extent the shareholder can exclude the dividend from income for purposes of the unrelated business income tax (UBIT); however, if the corporation instead distributes its earnings in the form of interest to the tax-exempt entity, those earnings may be subject to no tax at any level if the corporation deducts the interest while the tax-exempt entity excludes it from UBIT. The report explains that "...the difficulty in adopting integration with respect to tax-exempt investors is that achieving the policy goals of taxing business income once and equalizing the treatment of debt and equity will necessarily affect the tax position of tax-exempt investors relative to current law because current law is so far out of alignment with the two policy goals." With respect to a dividends paid deduction in particular, the report proceeds to explain:

*If the dividends paid deduction is adopted to achieve integration, then parity is achieved between debt and equity because the corporation will deduct both interest and dividend payments but the goal of a single tax on business income is not satisfied. The tax-exempt investors will, under current law, exclude the interest and dividends from gross income for purposes of UBIT. As a result, under the dividends paid deduction, tax-exempt investors would have to be taxed on both interest and dividends. This could be accomplished through a new compensatory withholding tax or requiring the tax-exempt investors to include interest and dividends in gross income for purposes of UBIT.*

The Senate Finance Committee held two hearings earlier this year on corporate integration. The Finance Committee explored the potential advantages of corporate integration as well as the difficult issues associated with it (including those associated with the treatment of tax-exempt entities) during these hearings.

### **KPMG observation**

Chairman Hatch and his staff have dedicated a lot of time to exploring corporate integration. Chairman Hatch's statement does not indicate whether or when he might release a detailed proposal for a dividends paid deduction. Instead, it provides flexibility for Chairman Hatch to determine, as the tax reform process evolves, how and whether corporate integration might fit into the debate over tax reform.

The tax reform process itself can be expected to be very dynamic. At this point, tax reform appears to be a priority for congressional Republicans and the Trump Administration. However, putting together tax reform legislation can be difficult, and it is not certain whether tax reform would be enacted in the next couple of years and, if so, what its details would be.

For more information on the tax reform process, read a KPMG report, [Understanding the Tax Reform Process: FAQ](#) [PDF 1.4 MB]

### **Prior reports about corporate integration from KPMG**

- [Legislative update: CRS report on corporate tax integration](#)
- [Finance Committee hearing on debt vs. equity, corporate integration](#)
- [Legislative update: Senate Finance hearing on corporate integration](#)
- [Legislative update: JCT report on corporate integration, for Finance hearing](#)

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