Eliminate the Double Taxation of Corporate Earnings

Current Law

Income earned by a corporation is taxed at the corporate level, generally at the rate of 35 percent. If the corporation distributes earnings to shareholders in the form of dividends, the income generally is taxed a second time at the shareholder level (at rates as high as 38.6 percent). If a corporation instead retains its earnings, the value of corporate stock will reflect the retained earnings. When shareholders sell their stock, that additional value will be taxed as capital gains (generally at a maximum rate of 20 percent for long-term capital gains). The combined rate of tax on corporate income can be as high as 60 percent, far in excess of rates of tax imposed on other types of income.

Reasons for Change

The double taxation of corporate profits creates significant economic distortions.

- First, double taxation creates a bias in favor of debt as compared to equity, because payments of interest by the corporation are deductible while returns on equity in the form of dividends and retained earnings are not. Excessive debt increases the risks of bankruptcy during economic downturns.

- Second, double taxation of corporate profits creates a bias in favor of unincorporated entities (such as partnerships and limited liability companies), which are not subject to the double tax.

- Third, because dividends are taxed at a higher rate than are capital gains, double taxation of corporate profits encourages a corporation to retain its earnings rather than distribute them in the form of dividends. This lessens the pressure on corporate managers to undertake only the most productive investments because corporate investments funded by retained earnings may receive less scrutiny than investments funded by outside equity or debt financing.

- Fourth, double taxation encourages corporations to engage in transactions such as share repurchases rather than to pay dividends because share repurchases permit the corporation to distribute earnings at reduced capital gains tax rates.

- Fifth, double taxation increases incentives for corporations to engage in transactions for the sole purpose of minimizing their tax liability.

By eliminating double taxation, the proposal will reduce tax-induced distortions that, in the current tax system, encourage firms to use debt rather than equity finance and to adopt noncorporate rather than corporate structures. Because shareholders will be exempt from tax only on distributions of previously taxed corporate income, the proposal will reduce incentives for certain types of corporate tax planning. In addition, the proposal will enhance corporate governance by eliminating the current bias against the payment of dividends. Dividends can provide evidence of a corporation's underlying financial health and enable investors to evaluate more readily a corporation's financial condition. This, in turn, increases the accountability of corporate management to its investors.

Proposal

Overview

The proposal would integrate the corporate and individual income taxes so that corporate earnings generally will be taxed once and only once. Under the proposal, public and private corporations would be permitted to distribute nontaxable dividends to their shareholders to the extent that those dividends are paid out of income previously taxed at the corporate level. The proposal generally would be effective for distributions made on or after January 1, 2003, with respect to corporate earnings after 2000.

To calculate the amount that can be distributed to its shareholders without further tax, a corporation will compute an excludable dividend amount (EDA) for each year. The EDA reflects income of the corporation that has been fully taxed. Thus, for example, a corporation with $100 of income that pays $35 of U.S. income taxes will have an EDA of $65 that can be distributed as excludable dividends.

If an amount would be a dividend under current law, it will be treated as an excludable dividend to the extent of EDA. Excludable dividends will not be taxed to shareholders. If a corporation's distributions during a calendar year exceed its EDA, only a proportionate amount of each distribution will be treated as an excludable dividend. Ordering rules are provided below for distributions that exceed EDA.

The capital gains tax on the sale of stock will be retained. Without further change, this would create an incentive for corporations to distribute previously taxed income as excludable dividends rather than retaining earnings for future investment. This is because excludable dividends would not be taxed to the shareholders but capital gains that represent retained earnings would be taxed to the shareholders when they sell their shares.

To ensure that distributions and retentions of previously taxed earnings are treated similarly, shareholders will be permitted to increase their basis in their shares to reflect that the retained earnings have already been taxed at the corporate level. As an alternative to distributing excludable dividends, corporations generally may allocate throughout the year all or a portion of the EDA to provide these basis increases. The basis increases will not be taxable. The effect of the basis increases will be to reduce the capital gains realized when shareholders sell their stock to the extent that the sales price reflects the corporation's retained, previously taxed earnings.

Technical Explanation

Corporate Level

A. In General

Corporations will continue to calculate their income under current law rules and will pay tax according to the existing graduated rate schedule. The corporate alternative minimum tax (AMT) will continue to apply.

The rules for computing earnings and profits will be retained. The rules for treating corporate level transactions, such as acquisitive and divisive reorganizations, liquidations, and taxable acquisitions will generally be the same as under current law. Corporations may continue to file consolidated returns as under current law. The consolidated return regulations will be amended to reflect the dividend exclusion.

B. The Excludable Dividend Amount

Corporations will be able to determine with certainty on January 1 the amount of their EDA for the year.

To compute EDA, the corporation will first convert U.S. income taxes shown on its U.S. income tax return filed during the prior year into an equivalent amount of income taxed at a 35 percent rate. The formula divides U.S. income taxes shown on the return by the maximum statutory corporate tax rate (currently 35 percent) and then subtracts the U.S. income taxes shown on the return. For purposes of the computation, U.S. income taxes includes U.S. income taxes on foreign source income that have been offset by foreign tax credits. It also includes AMT.

Although the graduated rates of tax on corporate income set forth in section 11(b) will still apply, taxes will be grossed-up for purposes of calculating the EDA as if all income were subject to U.S. tax at a 35 percent rate. Similarly, taxes paid at the AMT rate will be grossed-up at a 35 percent rate. Because the proposal treats AMT as U.S. income taxes, it will not treat as U.S. income taxes the portion of regular taxes that are offset by the AMT credit allowed under section 53.

These steps in calculating EDA are illustrated as follows:

$$\frac{\text{U.S. income taxes}}{.35} - \text{U.S. income taxes}$$

The calculation of EDA then adds excludable dividends received in the prior year by the corporation as a shareholder and retained earnings basis adjustments (as described below) for the prior year made with respect to stock owned by the corporation. For example, an excludable dividend received by a corporation on March 31, 2004, will be included in its EDA for 2005. These additions to EDA will ensure that multiple levels of corporate ownership do not result in more than one level of tax on income that has been previously taxed at the corporate level.

For purposes of computing a corporation's EDA for a particular calendar year, U.S. income taxes means U.S. income taxes (other than estimated taxes) shown on returns filed by the corporation in the previous calendar year. Thus, for example, U.S. income taxes shown on a return filed on September 15, 2005, will be used to compute EDA for 2006. In addition, U.S. income taxes include U.S. income taxes paid pursuant to an assessment of deficiency in that year and will be reduced, but not below zero, by refunds of income taxes paid during that year. Refunds of income taxes and payments of additional income taxes that are attributable to a taxable year ending prior to January 1, 2001, will not be included in the computation of the EDA.

To the extent the EDA for a particular calendar year exceeds the current and accumulated earnings and profits, the excess will be added to the EDA for the following calendar year. Otherwise, any remaining EDA not distributed or added to shareholder basis will expire.

C. Retained Earnings Basis Adjustments

As an alternative to distributing excludable dividends, corporations will be permitted to allocate throughout the year all or a portion of their EDA to increase their shareholders' basis in their stock.

The sum of excludable dividends and basis increases cannot exceed the lesser of EDA or current and accumulated earnings and profits. As described below, all dividend distributions during the year will be treated as excludable dividends to the extent of EDA. Consequently, basis increases will be permitted only to the extent that the total dividend distributions during the year do not exceed EDA. If the corporation's earnings and profits is less than EDA, then basis increases are limited to the excess of earnings and profits over excludable dividends.

The basis increases will not be taxable. Basis increases will reduce the EDA and earnings and profits.

Basis increases must be allocated in the same manner as a distribution would be allocated. Basis increases may not be allocated, however, to stock that is preferred and limited as to dividends. Regulations may address other situations where a corporation has multiple classes of stock.

Allocated basis increases reflecting retained earnings are referred to as REBAs. A corporation will maintain records of the total REBAs made with respect to its stock in prior years. The cumulative amount of REBAs for all years is referred to as the CREBA.

From time to time, a corporation's EDA for a calendar year may be less than the distributions it intends to make. Instead of treating distributions in excess of EDA as taxable dividends, as described below, the proposal treats those distributions as effectively reversing basis adjustments that were allocated in prior years. These distributions reduce CREBA. This flexibility reflects the fact that, even though a corporation's taxable income may fluctuate, it may maintain a stable dividend payout.

D. Distributions

For a distribution to be an excludable dividend, it must be a dividend under current law, i.e., out of earnings and profits.

If a distribution is a dividend under current law, it will be treated as an excludable dividend to the extent of EDA. Distributions that are excludable dividends reduce EDA and earnings and profits.

If dividend distributions are less than EDA, a corporation may permit its shareholders to increase their basis in their stock as discussed above.

If a corporation's distributions during a calendar year exceed its EDA, only a proportionate amount will be treated as an excludable dividend.

Distributions that are not excludable dividends generally will be treated as:

- first a return of basis and then capital gain to the extent of the CREBA,
- then a taxable dividend to the extent of the corporation's earnings and profits,
- then a return of capital to the extent of the shareholder's remaining basis, and
- then capital gain.

The distinction between a redemption distribution that is treated as a dividend and a redemption that is treated as a sale or exchange of stock will remain as under current law. The proposal, however, may modify the attribution rules (particularly as they relate to options) for purposes of determining whether a redemption distribution is treated as a dividend.

A redemption that is treated as a sale or exchange of stock will reduce pro rata the redeeming corporation's current year EDA and CREBA. For example, if a corporation redeems two percent of its stock, the corporation will reduce its current year EDA and CREBA by two percent.

The rules under sections 304, 305, and 306 will be retained. To the extent that those rules characterize transactions as distributions to which sections 301 and 316 apply, EDA will be reduced accordingly.

E. Refunds of Taxes

The rules governing refunds of taxes will be revised to ensure that EDA for a year in which shareholders have already derived a benefit is not affected. In general, if a refund is due in a particular calendar year, the refund will be paid to the extent the corporation has paid U.S. income taxes shown on a final return previously filed in that calendar year. If any refund remains unpaid, the corporation may recompute its EDA for the current year as if the refund reduced the U.S. incomes taxes previously used to compute the current year's EDA. This permits an additional refund to be paid currently. The recomputed EDA will be used to determine the character of distributions made, and the amount of basis adjustments permitted to be allocated, during the entire year. Any refund that is not paid currently will be credited against future tax liability.

Refunds attributable to taxable years ending prior to January 1, 2001, will be paid as under current law.

F. Carryback of Net Operating Losses

The rules governing the carryback of net operating losses will be revised to ensure that EDA for a year in which shareholders have already derived a benefit is not affected. Accordingly, under the proposal, net operating losses of corporations may be carried back one year. For example, a net operating loss attributable to a taxable year ending during 2003 may be carried back one year to the taxable year ending in 2002. If a net operating loss is carried back, however, the EDA for the current year must be recomputed. That recomputed EDA will be used to determine the character of distributions made, and the amount of basis adjustments allocated, during the entire year.

The proposal will not affect the carryback period for net operating losses arising in taxable years ending prior to January 1, 2003.

G. Reorganizations and Liquidations

The proposal retains current law rules that treat a qualifying corporate reorganization and certain corporate liquidations as tax-free at the shareholder level and at the corporate level. Under current law, the acquired corporation's tax attributes, including its asset basis, carry over to the acquiror. These rules will be amended to provide for the carryover of the acquired corporation's EDA and CREBA.

The proposal retains current law rules governing tax-free spin-offs. Under the proposal, rules will be provided to divide the CREBA, if any, of the distributing and controlled corporations between the distributing and controlled corporations based on the relative fair market values of their assets and to ensure that duplicate CREBA is eliminated.

H. Consolidated Returns

The Secretary of the Treasury will amend the consolidated return regulations to effect the provisions of the proposal. For example, regulations might provide that, in a consolidated group, EDA will be calculated on a consolidated group basis based on U.S. income taxes of the group, and then apportioned among the entities that were members of the group during the taxable year based on each member's separate taxable income. No EDA will be allocated to members that generated a loss during the taxable year. The stock basis adjustment rules of the current consolidated return regulations, rather than the rules described above, will control for members of a consolidated group.

I. Limits on Tax Motivated Acquisitions

Section 269 will apply, as under current law, to discourage tax motivated acquisitions, including acquisitions undertaken for the purpose of obtaining an EDA or a CREBA. Because EDA generally expires at the end of each year, the proposal does not include section 382-type rules.

J. Accumulated Earnings Tax and Personal Holding Company Tax

The accumulated earnings tax and personal holding company tax will be repealed because they are of diminished importance in a system that does not impose a shareholder level of tax on dividends. Their repeal will simplify compliance with the tax laws.

K. Foreign Corporations

U.S. income taxes on income of a foreign corporation that is effectively connected with a U.S. trade or business will be treated as U.S. income taxes for purposes of the EDA computation. Branch profits taxes will not be treated as U.S. income taxes for purposes of computing EDA, and any branch profits taxes paid will reduce a foreign corporation's EDA. A foreign corporation's EDA will be increased by any excludable dividends received by it as a shareholder as well as distributions from CREBA of the distributing corporation, reduced by any applicable U.S. withholding taxes. U.S. withholding taxes imposed on a foreign corporation will not be treated as U.S. income taxes for purposes of the EDA computation.

Consistent with the general rule, distributions from a foreign corporation first will be attributable to EDA and then CREBA. Shareholders receiving distributions of those amounts will not be entitled to receive foreign tax credits for foreign taxes paid or accrued with respect to those amounts.

L. S Corporations

The S corporation rules will be retained under the proposal with certain modifications. Under current law, the income of S corporations is subject to an entity level tax only in limited circumstances. To the extent an S corporation pays income tax at the corporate level, the S corporation will compute EDA based on that tax and the income subject to that tax will not be taxed again at the shareholder level.

In addition, under the proposal, distributions first will be treated as excludable dividends to the extent that the corporation's EDA does not exceed its earnings and profits and then will be from CREBA. After these distributions, the remainder will be characterized as under current law.

M. Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

Under the proposal, a RIC or a REIT that has excludable dividend income will generally pass through this income as excludable to its shareholders. In addition, RICs and REITS will be able to pass through REBAs as basis adjustments.

Under current law, RICs and REITs are entitled to a deduction for the dividends they distribute to their shareholders. Under the proposal, RICs and REITs will not be allowed a deduction for distributions that are designated as excludable or from CREBA. For purposes of the distribution requirements of RICs and REITs, excludable dividends will be treated in the same manner as tax-exempt interest.

N. Insurance Companies

Insurance companies are allowed to deduct benefits paid on insurance contracts (death benefits, annuity payments, payments for property and casualty losses) plus an estimate of benefits to be paid in the future (i.e., amounts added annually to reserves held by the company to fund future benefit payments). Under current law, to prevent a double benefit with respect to exempt income, insurance companies are required to allocate exempt earnings on a pro rata basis between the insurance company's general earnings and those amounts set aside to pay benefits. Any earnings otherwise exempt that are allocated to pay benefits are treated as not exempt from tax. These allocations are made by means of certain proration rules. These rules set forth computations that produce the percentage of exempt income to be allocated to the company and the percentage to be treated as held to pay policy benefits.

Under the proposal, all excludable dividends will be subject to proration. The basis increase attributable to REBAs will be adjusted to take into account these proration rules. In addition, all excludable dividends and REBAs attributable to assets held in a separate account funding variable life insurance and annuity contracts will be allocated to the separate account.

O. Cooperatives

Cooperatives will compute EDA in the same manner as a C corporation and will be permitted to distribute excludable dividends or to allocate REBAs to the extent of EDA.

Shareholder Level

A. Distributions

1. In General

Under the proposal, shareholders generally will exclude from gross income dividends that are characterized as excludable dividends. Each year, shareholders will receive a Form 1099 from the corporation setting forth which portions of their distributions are excludable dividends, taxable dividends, or returns of capital. In addition, the statement will show the amount by which shareholders are entitled to increase their basis in their stock as a result of REBAs.

2. Special Rules for Dividend Exclusion and REBAs

Under current section 246(c), corporate shareholders must hold their stock for more than 45 days (and for more than 90 days in the case of preferred stock) during the 90-day period (and the 180-day period in the case of preferred stock) beginning 45 days (and 90 days in the case of preferred stock) before the ex-dividend date to be eligible to claim a dividends received deduction. A rule similar to section 246(c), with the same holding period requirements, will apply to excludable dividends received and REBAs allocated to both corporate and noncorporate shareholders.

Under current law, section 1059 requires stock basis reductions for certain dividends received by corporate shareholders. Under the proposal, section 1059 will be extended to apply to excludable dividends received and REBAs allocated to both corporate and noncorporate shareholders. For purposes of the section 246(c) and 1059 rules, a shareholder who acquires stock from a decedent will treat its holding period with respect to that stock as beginning on the date used for purposes of determining the fair market value of the stock for estate tax purposes.

Under current section 852(b)(4), if a shareholder of a RIC receives an exempt-interest dividend in respect of a share held by the shareholder for 6 months or less, any loss on the sale of the share is disallowed to the extent of the exempt-interest dividend. Similar rules will be provided if a shareholder of a RIC receives a distribution that is designated as an excludable dividend or is entitled to make a REBA.

B. Capital Gains

Shareholders will be taxed on sales of their stock, as under current law. REBAs should largely prevent shareholders from being taxed on the portion of appreciation in the value of their shares that is attributable to previously taxed income that the corporation has chosen to retain rather than pay out as dividends. The capital loss limitation will remain as under current law.

C. Redemptions

In general, a redemption of stock is characterized as either a distribution under section 301 or a sale or exchange of stock as under current law.

D. Corporate Shareholders

Under the proposal, an excludable dividend received by a U.S. corporation will not be taxable. Excludable dividends received by a corporation will increase the recipient corporation's EDA and will, therefore, remain excludable when distributed by the recipient corporation.

Under current law, a corporation that receives a dividend from another corporation is entitled to a dividends received deduction. Under the proposal, the 100 percent deduction for dividends received from a corporation 80 percent or more of which is owned by another corporation will be retained. The 70 and 80 percent deductions for dividends received, however, will only be available for distributions of pre-2001 earnings and profits that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003.

E. Shareholder Level Debt

Section 246A, which prohibits the dividends received deduction for debt-financed portfolio stock, will be modified to apply to both corporate and noncorporate shareholders and to require that otherwise excludable dividends be included in income if attributable to debt-financed stock. Additionally, because under section 163(d) excludable dividends will not be treated as investment income, excludable dividends will not increase the amount deductible as investment interest.

F. Shareholder AMT

The proposal does not affect the alternative minimum tax. Excludable dividends will not be an AMT adjustment or preference. In addition, excludable dividends will not be a preference for adjusted current earnings for corporate AMT.

G. Foreign Shareholders

In the case of foreign shareholders, the withholding tax on dividends will be retained for distributions out of earnings and profits, whether or not excludable, and will apply to distributions from CREBA. U.S. withholding tax will not apply to REBAs.

REBAs allocable to stock held by a foreign shareholder will not increase the basis of the foreign shareholder's stock. Any distributions to a foreign shareholder from CREBA will not decrease the foreign shareholder's stock basis.

If the foreign shareholder is a corporation, distributions of excludable dividends, reduced by any applicable U.S. withholding taxes, will increase the EDA of the foreign shareholder. REBAs will not increase the EDA of a foreign corporate shareholder. Distributions from the distributing corporation's CREBA to foreign corporate shareholders will be treated in the same manner as an excludable dividend received.

H. Pension Plans, 401(k) Plans, and Individual Retirement Accounts (Retirement Plans)

In a Retirement Plan, all investment income, including all dividend income, is effectively free from tax. The proposal's treatment of Retirement Plans will not change current law.

Generally, under current law, amounts contributed to a Retirement Plan are not subject to tax when contributed. Income of the Retirement Plan is not subject to tax when earned. Instead, contributions and earnings are subject to tax when distributed. In contrast, contributions to a Roth-IRA are made with after-tax dollars. However, both the after-tax contributions and income earned on those contributions are free from tax when distributed.

All investment income, including dividend income, earned by a Roth-IRA is free from tax. The tax treatment of other retirement plans is economically equivalent to Roth-IRA treatment. A plan with tax-free contributions and no tax until withdrawal produces the same after-tax benefit for an individual as a plan with after-tax contributions and tax-free investment returns.

Because all investment income is effectively free from tax in Retirement Plans, investments in these plans will remain tax advantaged relative to investments outside of these plans.

I. Employee Stock Ownership Plans (ESOPs)

Under current law, a corporation is entitled to a deduction for certain dividends paid with respect to shares held by an ESOP sponsored by the corporation or another corporation in the same controlled group. Under the proposal, an otherwise excludable dividend will be taxable if a deduction is allowed in respect of such dividend. The amount of the dividend, however, will not reduce a distributing corporation's EDA. If both a deduction and an exclusion for a dividend were permitted, then the amounts paid would not be taxed at either the corporate or the shareholder level.

In addition, REBAs will not be permitted to be made to the basis of shares held by an ESOP. The corporation will be permitted a deduction for distributions from CREBA in respect of shares held by an ESOP. Correspondingly, such distributions will not decrease the basis of such shares and, instead, will be taxable if paid in cash. Finally, such amounts will not reduce a distributing corporation's CREBA.

J. Private Foundations

Under current law, private foundations are subject to tax on net investment income. Under the proposal, excludable dividends and distributions from CREBA will not be included in the calculation of net investment income for this purpose.

K. Treatment of Owner of Rights to Acquire Stock

Under the proposal, the Secretary may promulgate regulations treating the holder of a right to acquire stock as a shareholder as necessary to prevent the creation of stock losses or reduction of stock gains.

Reporting and Recordkeeping

Forms 1099 will be revised to provide information to shareholders to indicate the amounts of excludable dividends, taxable dividends, and returns of capital. The revised form will also indicate the amounts of REBAs so that shareholders can adjust their basis.

A corporation will calculate the EDA and the CREBA and will report those amounts to the IRS annually on its income tax return.