

MANAGERS, SHAREHOLDERS, AND THE CORPORATE DOUBLE TAX

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INTRODUCTION

Ecclesiastes rightly declares that there is nothing new under the sun.¹ The biblical author of course did not have contemporary United States tax policy in mind, but no matter: the observation fits just the same. Ideas about tax policy and tax reform cycle every few years through a narrow range of proposals that lead policy-makers and interest groups over familiar terrain. The details may change modestly from one round to the next, but the outcomes are more or less invariant. After a few turns of the cycle, one may be sorely tempted to agree that the whole point of the exercise is, in fact, just to maintain the constant motion of the process. Policy-makers who propose tax reforms that interest groups oppose can extract rents from those groups in a cynical bargain either to retreat from the reforms or, in the event the reforms become law, to undo them through future legislation.² Old policy proposals serve this end just as well as new ones; indeed, old proposals may be preferable if they allow policymakers and interest groups to anticipate the endgame with greater confidence.

Whatever the motivations that drive the cyclical nature of tax policy, a recent turn of the wheel has again put forth one of the more intriguing reform proposals: relief from the double taxation of corporate income. The corporate income tax is now 100 years

¹ Ecclesiastes 1:9.

² See, e.g., Richard L. Doernberg & Fred S. McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 Minn. L. Rev. 913 (1987); J. Mark Ramseyer & Minoru Nakazato, Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow, 75 Va. L. Rev. 1155 (1989).

old,³ and there have been two levels of tax on corporate profits for most of that period.⁴ The first tax applies at the corporate level when profits are earned, and the second tax applies at the shareholder level when profits are distributed as dividends.⁵ By contrast, profits earned by non-corporate businesses incur only a single level of tax.⁶ This double tax on corporate income is widely regarded as “unusual, unfair, and inefficient,”⁷ and numerous government and academic proposals would repeal it. These proposals typically provide for “integration” of the tax on corporate income and the tax on individual income such that corporate profits would be taxed exactly once.⁸ President Bush made the most serious joust at the corporate double tax in recent years when he proposed in 2003 that shareholders be permitted to exclude dividends from income.⁹ Had Congress enacted this dividend-exclusion proposal, it would have eliminated the second level of the double tax.¹⁰ Congress instead decided to scale back the double tax by lowering the tax rate that shareholders pay on dividends.¹¹ This relief expires in

³ Howard E. Abrams & Richard L. Doernberg, *Federal Corporate Taxation* 1 (6th ed. 2008) (“We have had a corporate income tax continuously since 1909.”).

⁴ Congress enacted the double taxation of corporate income in 1936. Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 *Wm. & Mary L. Rev.* 167, 170–71, 228 (2002) [hereinafter Bank, *Corporate Managers*]; Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 *N.C. L. Rev.* 613, 619–20 (1990).

⁵ Abrams & Doernberg, *supra* note 3, at 1.

⁶ See *id.* at 11.

⁷ Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 *Yale L.J.* 325, 326 (1995) (footnotes omitted); see also Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 *Harv. L. Rev.* 717, 738 (1981).

⁸ Abrams & Doernberg, *supra* note 3, at 7–16; Joseph A. Pechman, *Federal Tax Policy* 179–88 (5th ed. 1987). A classic discussion of corporate double taxation and integration is Charles E. McLure, Jr., *Must Corporate Income Be Taxed Twice?* (1979).

⁹ Press Release, The White House, *President Discusses Taking Action to Strengthen America’s Economy* (Jan. 7, 2003), <http://www.whitehouse.gov/news/releases/2003/01/20030107-5.html>. For extended discussion of the dividend-exclusion proposal, see *infra* Part II.

¹⁰ U.S. Dep’t of the Treasury, *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals* 12 (2003), available at <http://www.ustreas.gov/offices/tax-policy/library/bluebk03.pdf> [hereinafter *Treasury 2003 Bluebook*].

¹¹ *Jobs and Growth Tax Relief Reconciliation Act of 2003*, Pub. L. 108-27, § 302, 117 Stat. 752, 758 (codified as amended in 26 U.S.C. 1) [hereinafter *Jobs and Growth Act*].

2010;¹² without additional legislation, the full effect of the corporate double tax will return in 2011.

Proposals for further relief from the corporate double tax are back near the top of the tax agenda for both political parties as well as for both the legislative and the executive branches. Two key players in the formation of tax policy, the House Committee on Ways and Means and the Treasury Department, have given serious thought to lowering the tax rate on corporate income in order to reduce the burden imposed by the first level of the double tax. The Chairman of the Ways and Means Committee has introduced legislation that would lower the corporate tax rate from 35 percent to 30.5 percent; this would be paid for in part through the repeal of designated corporate tax preferences.¹³ The Treasury Department estimates that, by broadening the corporate tax base, the tax rate on corporations could be lowered to 28 percent without any loss of federal revenues.¹⁴ President Obama has suggested that proposals to eliminate corporate tax preferences and reduce the corporate tax rate may be “very appealing.”¹⁵

One might reasonably think that integration or other double-tax relief should be an easy sell in the legislature. If the status quo burdens corporate profits with two levels of tax, removing or reducing either the tax on corporations or the tax on shareholders ought to be attractive both to corporations and to shareholders. At a minimum, removing or reducing the double tax should increase after-

¹² The lower tax rates were to expire at the end of 2008, Jobs and Growth Act § 303, but they were extended by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. 109-222, § 102, 120 Stat. 345, 346 (codified as amended in 26 U.S.C. 1).

¹³ Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3001 (1st. Sess. 2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3970ih.txt.pdf; see also Comm. on Ways & Means, Legislation Summary, H.R. 3970: Tax Reduction and Reform Act of 2007 (Oct. 29, 2007), available at <http://waysandmeans.house.gov/media/pdf/110/Summary%20for%20Distribution.pdf>. News reports indicate that the Chairman is contemplating an even steeper reduction in the corporate tax rate. See, e.g., Ryan J. Donmoyer & Peter Cook, Rangel Plans Push to Cut Top Corporate Tax Rate to 28 Percent, Bloomberg.com, Nov. 15, 2008, http://www.bloomberg.com/apps/news?pid=email_en&refer=&sid=ag7lSuB.yyII.

¹⁴ Office of Tax Policy, U.S. Dep't of the Treasury, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century 44 (2007), available at http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf.

¹⁵ Michael Joe, Obama Says Corporate Rate Reduction in Exchange for Closing Loopholes is a Possibility, Tax Notes Today, Mar. 13, 2009, LEXIS, 2009 TNT 47-1.

tax returns on corporate investments, even if rent-seeking managers siphon off some of the higher returns through their compensation. And, if the economists at the Treasury Department are correct, double-tax relief should increase overall economic growth, potentially making everyone better off.¹⁶ Large federal budget deficits should pose no obstacle: many proposals would pay for double-tax relief by eliminating corporate tax preferences (pejoratively known as “loopholes” and “tax breaks”). Why, then, does Congress not enact integration or other double-tax relief by acclamation?

There being nothing new under the sun, the legislature has considered and rejected many integration proposals over the years.¹⁷ There are occasional changes at the margins, with the current (but temporary) reduced tax rates on dividends possibly setting the high-water mark for double-tax relief. But, as this Article will argue, the “unusual, unfair, and inefficient” double taxation of corporate profits generally has survived recent political challenge because many managers, shareholders, and third parties rationally prefer having the double tax to not having it. More precisely, the substantial heterogeneity of interests among managers, shareholders, and collateral interests affected by the double tax ensures that there are winners as well as losers under the status quo. Many corporations have low effective tax rates that translate into low costs of equity capital; many shareholders are entirely or partly exempt from tax, and several industries depend on the existence of the double tax so that they can sell investments sheltered from it. These and other managers, shareholders, and collateral interests benefit from the status quo. Yet, other managers, shareholders, and collateral interests—including corporations with high effective tax rates and fully taxable shareholders—do not. Double-tax winners have no rational basis to support integration proposals that would equalize the after-tax outcomes for themselves and the dou-

¹⁶ U.S. Dep’t of the Treasury, Treasury Conference on Business Taxation and Global Competitiveness Background Paper 1–2, 710 (2007), available at <http://www.treasury.gov/press/releases/reports/07230%20r.pdf> [hereinafter Treasury Background Paper].

¹⁷ See Arlen & Weiss, *supra* note 7, at 330 (citing unsuccessful bills).

ble-tax losers with whom they compete in the capital and business markets.

The literature on the corporate double tax has missed this critical point. The most prominent political explanation for the persistence of the double tax is the agency-cost explanation set forth by Jennifer Arlen and Deborah Weiss.¹⁸ They argue that shareholders, who face collective-action and other obstacles to lobbying, generally favor repeal of the double tax but that managers, who control the lobbying resources of their corporations, generally assign low priority to integration and in some cases oppose it outright.¹⁹ Thus, they conclude that “the resilience of the corporate [double] tax is a manifestation of the most enduring source of problems in corporate law, the separation between ownership and control of large corporations.”²⁰ This agency-cost explanation, however, does not adequately account for important points, including the substantial

¹⁸ Arlen & Weiss, *supra* note 7. Their analysis remains widely cited and generally accepted. See, e.g., Daniel N. Shaviro, *Decoding the U.S. Corporate Tax* 20 (2009); Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 *Geo. L.J.* 889, 894 (2006) [hereinafter Bank, *Capital Lock-In Theory*]; Bank, *Corporate Managers*, *supra* note 4, at 260–61; Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 *Wm. & Mary L. Rev.* 447, 534–37 (2001) [hereinafter Bank, *Entity Theory*]; Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 *Mich. St. L. Rev.* 591, 593 n.7; Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 *Wake Forest L. Rev.* 239, 259 (2003); Joshua Mishkin, *The State of Integration in a Partial Integration State*, 59 *Tax Law.* 1047, 1057–58 (2006); Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 *S.C. L. Rev.* 1, 34–36 (2003); Katherine Pratt, *Deficits and the Dividend Tax Cut: Tax Policy as the Handmaiden of Budget Policy*, 41 *Ga. L. Rev.* 503, 517 (2007); Razeen Sappideen, *Imputation of the Corporate and Personal Income Tax: Is It Chasing One’s Tail?*, 15 *Am. J. Tax Pol’y* 167, 184–85, 202–03 (1998); Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 *Tax L. Rev.* 329, 337 n.11 (2003); David A. Skeel, Jr., *Public Choice and the Future of Public-Choice-Influenced Legal Scholarship*, 50 *Vand. L. Rev.* 647, 667–68 (1997) (book review). For similar agency-cost accounts, see James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 *Cardozo L. Rev.* 697, 716 (1997); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 *Mich. L. Rev.* 410, 411 n.8 (2000).

¹⁹ Arlen & Weiss, *supra* note 7, at 327.

²⁰ *Id.* Without specifically endorsing the analysis of Arlen & Weiss, Alvin Warren has argued that, “with rare exceptions, corporate management remarkably has been uninterested in proposals that would eliminate the double taxation of corporate income distributed to shareholders as dividends” and that, “[g]iven the choice, corporate management seems to prefer corporate tax reductions through reduced rates or accelerated capital cost deductions” Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 *Wm. & Mary L. Rev.* 157, 173 (1997).

heterogeneity of interests that managers, shareholders, and other parties have with respect to the double tax or the differential effects that various integration models would have on managers, shareholders, and other parties. Once the double-tax winners and losers are identified and the differential effects on those winners and losers are sorted out, it becomes clear that the persistence of the corporate double tax cannot be explained simply as a failure of managers to act in the interests of shareholders. Instead, the underlying political problem is more nuanced, more complex, and more intractable.

This Article will make three distinct contributions to the existing literature. First, it will examine the heterogeneity of interests among managers, shareholders, and other parties regarding the double tax and the differential effects of various integration proposals on those heterogeneous interests. This examination will suggest that the persistence of the corporate double tax can be attributed not to the divergence of interests between managers (understood as a single group) and shareholders (understood as a single group) but to the divergence of interests *among* managers, the divergence of interests *among* shareholders, and the divergence of interests *among* other parties affected by the double tax. The examination will also establish why certain managers, shareholders, and third parties rationally support certain approaches to eliminating the corporate double tax while other managers, shareholders, and third parties rationally oppose those approaches but support different approaches. Second, this Article will provide a detailed account of the actual lobbying positions taken by managers, shareholders, and collateral interests during the pendency of the Bush administration's dividend-exclusion proposal. That account will provide clear and substantial support for the argument that the story of the corporate double tax must include substantial heterogeneity of interests within the key interest groups. The Bush administration's proposal failed because managers, shareholders, and collateral interests lined up on both sides of it and fought to a near standstill; the lowering of dividend tax rates that Congress ultimately enacted was simply a compromise that found the broadest support within and among these groups. Third, this Article will draw out general conclusions and tentative predictions implied by

this political account of the corporate double tax. Specifically, the analysis will demonstrate that *any* integration proposal will elicit both support and opposition from among managers, shareholders, and other parties. This inevitability of political winners and losers implies both that the corporate double tax is well entrenched and that policymakers interested in repealing the double tax should pursue integration methods that provide the greatest flexibility for adjustment and accommodation during the legislative process. Ultimately, however, politically viable integration may prove no more attractive than the status quo.

I. HETEROGENEITY AND THE CORPORATE DOUBLE TAX

This Part argues that the heterogeneity of interests among managers, shareholders, and third parties grounds the persistence of the corporate double tax. Section A sets out the mechanics of the double tax, including the temporary relief enacted by Congress in 2003. Section B explains why the persistence of the double tax presents a puzzle to legal scholars and discusses the agency-cost explanation of that puzzle. Section C examines the pervasive heterogeneity of interests among managers, shareholders, and third parties, and it argues that any approach to eliminating or mitigating the corporate double tax will provoke both support and opposition from within each of those groups.

A. The Mechanics of the Double Tax

The mechanics of the corporate double tax are reasonably straightforward.²¹ The Internal Revenue Code imposes a tax on the “taxable income” of every corporation.²² A corporation’s “taxable income” includes its income less certain deductions,²³ such as the ordinary and necessary expenses of conducting its business.²⁴ The corporation may be entitled to certain tax preferences (special tax breaks subsidizing particular investments made by the corpora-

²¹ For a thoughtful discussion of the principles underlying the corporate double tax, see generally Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 *Yale L. J.* 90 (1977).

²² I.R.C. § 11(a) (West 2008).

²³ I.R.C. §§ 61(a), 63(a) (West 2008).

²⁴ I.R.C. § 162(a) (West 2008).

tion), but the basic scheme taxes the corporation's net business profits at a flat rate of 35 percent.²⁵ The corporation's business profits are taxed a second time when distributed to the corporation's shareholders as a dividend.²⁶ Assuming the dividend were taxable as ordinary income, the tax rate paid by shareholders would range from 10 percent (for lower-income shareholders) to 35 percent (for higher-income shareholders).²⁷ To illustrate: if a corporation with one shareholder earns net business profits of \$100 and pays a corporate-level tax of \$35, it will have \$65 available for distribution as a dividend. If the shareholder is subject to the 35-percent tax rate, she will pay \$22.75 of tax on the \$65 dividend, and she will net \$42.25 in after-tax profits.²⁸ The \$100 of distributed business profits is taxed twice: once to the corporation and again to the shareholder.²⁹

The outcome would be different if the \$100 were earned by a non-corporate business. If the shareholder earned the \$100 through a sole proprietorship, she would pay a single level of tax at her 35-percent rate, and she would net \$65 in after-tax profits. Similarly, if she earned the \$100 through a partnership, she would pay a single level of tax at her 35-percent rate and would net \$65 in after-tax profits. In either case, she would improve her after-tax return by \$22.75. The difference, of course, is simply the imposition of a single tax rather than a double tax. The non-corporate business profits bear one level of tax at a 35-percent rate; the corporate business profits bear two levels of tax at a combined 57.75-percent rate.

Congress enacted partial and temporary relief from the corporate double tax in the Jobs and Growth Tax Relief Reconciliation

²⁵ I.R.C. § 11(b) (West 2008). Although there is progressivity built into the rate schedule, any corporation with at least moderate income (by corporate standards) is taxed at a flat rate of 35 percent. Abrams & Doernberg, *supra* note 3, at 55.

²⁶ I.R.C. §§ 61(a)(7), 301(c)(1) (West 2008).

²⁷ I.R.C. § 1(a)-(d) (West 2008).

²⁸ As discussed below, the shareholder generally would pay tax on the dividend at a 15-percent tax rate under temporary legislation enacted in 2003; the 35-percent rate is used here for illustrative purposes.

²⁹ If the corporation had not distributed its \$65 after-tax profits to the shareholder as a dividend, the value of the corporation's shares would have increased by \$65; the shareholder would pay a shareholder-level tax on the \$65 upon selling her shares.

Act of 2003 (the “Jobs and Growth Act”).³⁰ The Jobs and Growth Act provided that most dividends would be taxed at capital gains rates ranging from 0 percent (for lower-income shareholders) to 15 percent (for higher-income shareholders).³¹ The effect should be readily apparent. If the corporation from the example above earns \$100 of net business profits, pays \$35 of corporate income tax, and distributes the remaining \$65 as a dividend, the shareholder will pay \$9.75 of tax on the dividend (assuming the 15-percent tax rate). This will leave her with \$55.25 of after-tax profits—less than the \$65 available through a non-corporate investment but more than the \$42.25 available through the corporate investment when the dividend is taxed as ordinary income. And, in fact, this result was intended to stake out a middle position. The Jobs and Growth Act was a compromise among President Bush, who wanted a complete exclusion of dividends,³² the Senate, which would only pass a scaled-back version of the dividend exclusion,³³ and the House, which would not agree to eliminate the shareholder-level tax.³⁴

Apart from the relief under the Jobs and Growth Act, the tax code provides other approaches for corporations and shareholders to sidestep the double tax. The tax code includes numerous corporate tax preferences that shelter corporate income. Additionally, a corporation can substitute debt financing for equity financing and claim deductions that effectively remove the corporate-level tax on business profits paid out as interest.³⁵ Other mechanisms reduce or eliminate the double tax at the shareholder level. A corporation may redeem stock held by shareholders as a way of distributing profits without paying dividends. The redemption, if treated as a sale,³⁶ allows shareholders to recover their basis in the redeemed stock before including any portion of the proceeds in income.

³⁰ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, § 302, 117 Stat. 752, 758 (codified as amended in 26 U.S.C. 1).

³¹ *Id.* The lower rates apply to “qualified dividend income”—generally defined as dividends received from domestic corporations and specific types of foreign corporations. I.R.C. § 1(h)(11)(B) (West 2008).

³² Treasury 2003 Bluebook, *supra* note 10, at 12; Press Release, The White House, *supra* note 9; see also *infra* Part II.

³³ S. 1054, 108th Cong. §201 (as passed by Senate, May 15, 2003).

³⁴ H.R. 2, 108th Cong. §302 (as passed by House, May 9, 2003).

³⁵ I.R.C. § 163(a) (West 2008).

³⁶ The tax code treats certain redemptions (particularly those that are proportional among shareholders) as dividends rather than as sales. I.R.C. § 302 (West 2008).

Dividends received by shareholders that are exempt from tax, such as charitable organizations and tax-qualified retirement plans, bear no shareholder-level tax. Dividends received by shareholders that are themselves corporations are covered by a dividends-received deduction of up to 100 percent.³⁷

Still, there are limits to how many tax preferences a corporation can claim, how much debt it can issue, how many of its own shares it can redeem, and how many of its shareholders are exempt from tax or are also corporations. There are limits, in other words, to how much the corporation and its shareholders can avoid double taxation of the corporation's distributed profits. The tax law must therefore distinguish between those businesses treated as corporations and those treated otherwise. As a general proposition, any business with interests that are publicly traded is classified as a corporation and is subject to the corporate double tax; any other business is classified as a non-corporate business and is not subject to the double tax unless the owner or owners of the business elect to treat the business as a corporation.³⁸

³⁷ I.R.C. § 243 (West 2008).

³⁸ The path to this outcome is somewhat tortuous, but the result is clear. The tax code defines a "corporation" to include an association, joint-stock company, and insurance company, and it defines a "partnership" to include a syndicate, group, pool, joint venture, "or other unincorporated organization" that is not a trust, estate, or corporation for tax purposes. I.R.C. § 7701(a)(2), (3) (West 2008). The so-called "check-the-box" regulations expressly provide that unincorporated businesses generally will be treated as partnerships (if there are two or more owners) or as disregarded entities (if there is only a single owner). Treas. Reg. § 301.7701-2(c)(1), (2) (2008). But see Treas. Reg. § 301.7701-2(b)(2)-(8) (2008) (providing corporate status for certain businesses even if not incorporated). The check-the-box regulations also provide, however, that the owners of any partnership or disregarded entity can elect to treat the business as a corporation for tax purposes. Treas. Reg. § 301.7701-3(a) (2008). Although no election out of corporate status can be made by the owners of an incorporated business, see Treas. Reg. § 301.7701-2(b)(1) (2008), there is no tax rule that requires the owners to incorporate the business in the first place. Hence, the rule is genuinely elective through two distinct steps: first, by the decision whether to incorporate the business (if the business is incorporated, the double tax applies); and second, by a check-the-box election made for any unincorporated business (if an election is made for an unincorporated business, the double tax applies). But cutting across the check-the-box regulations is a statutory rule providing (with narrow exceptions) that any publicly traded partnership will be treated as a corporation for tax purposes. I.R.C. § 7704(a) (West 2008). Thus (ignoring the narrow exceptions), it is not possible for a publicly traded business to avoid the double tax: it will either be a publicly traded incorporated business, in which case the check-the-box regulations will pull it

Thus, the corporate double tax is a mandatory outcome for all publicly traded businesses—but only for publicly traded businesses. If one assumes that investors prefer to avoid the double taxation of business profits, one would expect that owners of privately held businesses generally will structure those businesses to avoid being treated as corporations for tax purposes.³⁹ Whether it makes policy sense or not, the corporate double tax serves as a toll charge imposed by the government on accessing capital through the securities markets. Equity investments made in businesses that are traded on the New York Stock Exchange, NASDAQ, and similar exchanges and markets bear heavier taxation than equity investments made in other businesses. Thus, all else equal, the cost of capital to privately held businesses should be lower than that of publicly held businesses, with the difference attributable to the corporate double tax. The playing field is not level as to public and private businesses but (at least at first glance) is level as to public businesses. To the extent that public businesses compete with private businesses for equity capital, the double tax puts the public businesses at a disadvantage; to the extent that public businesses compete with each other for equity capital, the double tax (again, at first glance) applies to all alike.

B. The Paradox of the Double Tax

The continuing existence of the corporate double tax is paradoxical. Both policymakers and academics generally agree that the double tax results in significant distortions of economic and business decisions and argue for its repeal.⁴⁰ The double tax plainly

into corporate status and the double tax; or it will be a publicly traded unincorporated business, in which case the statute will pull it into corporate status and the double tax. (Note that this discussion ignores any potential for status as an S corporation, which effectively is not available for publicly traded businesses.)

³⁹The owner or owners of a privately held business might determine that there are good tax reasons for electing into the corporate double tax. For example, the owner or owners may be able to manage the taxable income of their business by paying more or less of its profits out as deductible compensation, and they may be able to take advantage of the graduated rate structure applicable to corporations with comparatively smaller taxable incomes. There also may be non-tax considerations that lead investors to incorporate a privately held business.

⁴⁰On the government side, see The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 60, 124–25, 162 (2005) [hereinafter *Advisory Panel Report*]; Treasury 2003 Bluebook, *supra*

provides incentives for new investment through unincorporated businesses, which distorts the allocation of capital across the corporate and non-corporate sectors.⁴¹ It encourages corporate financing

note 10, at 12; U.S. Dep't. of the Treasury, *A Recommendation for Integration of the Individual and Corporate Tax Systems 2* (1992); U.S. Dep't. of the Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992) [hereinafter *Treasury Integration Report*]; The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 117, 120–29* (1985) [hereinafter, *Treasury II*]; U.S. Dep't of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, Volume 2: General Explanation of the Treasury Department Proposals 134–44* (1984) [hereinafter *Treasury I*]; U.S. Dep't of the Treasury, *Tax Reform Option Papers Prepared by Treasury Department on September 2, 1977 for the White House, 196 Daily Tax Rep. 49–53 (Supp. 1977)* [hereinafter *Treasury Option Papers*]; U.S. Dep't of the Treasury, *Blueprints for Basic Tax Reform 4–5, 68–75* (1977) [hereinafter *Treasury Blueprints*]. On the academic side, see, for example, Am. Law Inst., *Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes: Reporter's Study of Corporate Tax Integration* (Alvin C. Warren, Jr., Reporter) (1993) [hereinafter *Warren ALI Integration Study*]; Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 *Tax L. Rev.* 265 (1995); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 *Harv. L. Rev.* 532 (1975); John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 *Tax Notes* 1445 (1990); Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 *Tax Law.* 1 (1985); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future*, 10 *Va. Tax Rev.* 237 (1990); Anthony P. Polito, Note, *A Proposal for an Integrated Income Tax*, 12 *Harv. J. L. & Pub. Pol'y* 1009 (1989). For criticisms of both the *Treasury Integration Report* and the *Warren ALI Integration Study*, see Michael L. Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 *Tax L. Rev.* 509 (1992). There have also been proposals to address the distortions of the corporate double tax short of integration. See, e.g., Am. Law Inst., *Subchapter C (Supplemental Study)* (William D. Andrews, Reporter) (1989) [hereinafter *Andrews ALI Supplemental Study*]; Am. Law Inst., *Subchapter C: Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions* (William D. Andrews, Reporter) (1982) [hereinafter *Andrews ALI Study*]; George K. Yin, *A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax*, 78 *Geo. L.J.* 1837 (1990); Ethan Yale, *A Better Way to Tax Corporate Distributions: Allow Basis Recovery on Ordinary Dividends* (Sept. 12, 2008) (unpublished manuscript, on file with the Virginia Law Review Association).

⁴¹ Advisory Panel Report, *supra* note 40, at 99; *Treasury Integration Report*, *supra* note 40, at 3. One would expect that, in equilibrium, the pre-tax rate of return available through unincorporated businesses should fall and the pre-tax rate of return through incorporated businesses should rise such that, all else equal, the after-tax rates of return should be equivalent. Warren, *supra* note 7, at 725. Even then, how-

through debt rather than equity, which increases the risk of corporate insolvency.⁴² The double tax also encourages the retention of earnings in the corporation.⁴³ Although this may facilitate long-term corporate investments,⁴⁴ it may also decrease shareholder monitoring of managerial investment decisions.⁴⁵ Those distortions probably reduce economic growth, making everyone worse off.⁴⁶ Most (although not all⁴⁷) academic commentators therefore have agreed with the Treasury Department that Congress should integrate the corporate and individual income taxes.

At first, integration would appear generally to advance the interests both of corporations and shareholders. On the one hand, repeal of the double tax should lower the cost of equity capital for

ever, one would expect that “the total amount of capital investment, as well as the relative size of the corporate and non-corporate sectors, might not be optimal.” *Id.* at 737.

⁴² Office of Tax Policy, *supra* note 14, at 81; Advisory Panel Report, *supra* note 40, at 99–100.

⁴³ Advisory Panel Report, *supra* note 40, at 100; Treasury Integration Report, *supra* note 40, at 13, 116–18.

⁴⁴ Bank, Capital Lock-In Theory, *supra* note 18, at 901.

⁴⁵ See Arlen & Weiss, *supra* note 7, at 348.

⁴⁶ See Treasury Integration Report, *supra* note 40, at 111–12 (calculating the economic losses of the corporate double tax from \$2.5 to \$25 billion per year).

⁴⁷ For arguments in favor of retaining the corporate double tax, see generally, Chorvat, *supra* note 18; Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World?, 39 *Case W. Res. L. Rev.* 965, 1081–99 (1989); Stanley S. Surrey, Reflections on “Integration” of Corporation and Individual Income Taxes, 28 *Nat’l Tax J.* 335 (1975). Of course, not every defense of the corporate income tax is also a defense of the corporate double tax as it currently exists in the United States. See, e.g., Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 *Va. L. Rev.* 211 (1991); Schlunk, *supra* note 18. Reuven Avi-Yonah argues that the corporate income tax can be “justified as a means to control the excessive accumulation of power in the hands of corporate management.” Reuven S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 *Va. L. Rev.* 1193, 1244 (2004). He argues that such control cannot “be effectively achieved in a capitalist economy by means other than a corporate tax imposed at a significant rate.” *Id.* at 1249. There are two problems with this argument, however. First, although Avi-Yonah asserts that this justification lines up “more or less precisely [with] the current scope of the tax we have today,” *id.* at 1245, it actually would justify a tax on any large concentration of wealth—not just concentrations that issue shares on public exchanges and markets. Second, as the conditional tax-exempt status of tax-qualified retirement plans and charitable organizations demonstrates, it is possible to exert substantial public control over private concentrations of wealth even with a zero-percent tax rate. For an historical argument linking the corporate income tax to corporate regulation, see generally Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 *Ind. L.J.* 53 (1990).

corporations, allowing managers to finance a broader range of investment opportunities through new equity.⁴⁸ Additionally, less reliance on debt financing should decrease the risk of corporate insolvency, which should also decrease the riskiness of manager investments in their firm-specific human capital. On the other hand, managers may prefer to finance corporate investments with retained earnings rather than new equity investments, and the double tax may facilitate that strategy through a lower tax burden on undistributed corporate profits.⁴⁹ Shareholders may also benefit from integration if repeal of the double tax increases share values.⁵⁰ Although no one knows the exact economic incidence of the corporate-level tax,⁵¹ integration may relieve shareholders of whatever corporate-level taxes they actually bear.

If the double tax binds only businesses that are large enough and sophisticated enough to issue publicly traded securities, why are those businesses and their owners not powerful enough to force its repeal? And why is the general consensus among policymakers and academics favoring integration not adequate, with or without the self-interested lobbying of corporations and shareholders? Explanations assuming that legislators wrongly conceive of the double tax only as a burden on profit-mongering corporations and shareholders have little plausibility.⁵² Explanations that rely on the ob-

⁴⁸ To the extent that integration were to cause investments to shift from non-corporate to corporate equity and thereby increase the cost of capital for non-corporate businesses, managers of non-corporate businesses might become more constrained in their own business investments.

⁴⁹ See Bank, *Capital Lock-In Theory*, supra note 18, at 939–42; Arlen & Weiss, supra note 7, at 356–59.

⁵⁰ The effect of integration on share values is not clear. See infra note 57.

⁵¹ See Pechman, supra note 8, at 141–46; Arnold C. Harberger, *The Incidence of the Corporation Income Tax Revisited*, 61 *Nat'l Tax J.* 303 (2008); Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Research, Working Paper No. 11686, 2005).

⁵² See, e.g., Arlen & Weiss, supra note 7, at 331–33. For arguments against other explanations of the corporate tax, see Avi-Yonah, supra note 47, at 1197–212. Bank offers a different explanation for the corporate income tax. His account centers on capital lock-in, the legal power of corporate boards to refuse to release capital from the corporation. Bank, *Capital Lock-In Theory*, supra note 18, at 892–93. He argues that the corporate income tax is a “pro-business compromise between the retained earnings penalty that could result from partnership or accrual-style taxation and the indefinite deferral that would result from having only a distributions tax.” *Id.* at 894.

scure incidence of the corporate income tax similarly do not account for the failure of integration.⁵³ It is more plausible that some-one legislators care about—that is, some powerful or influential interest group—is either not pushing hard enough for integration or, more likely, is pushing hard against it. The most prominent political explanation for the persistence of the corporate double tax is the agency-cost explanation.⁵⁴ That explanation attributes the “resilience” of the corporate double tax to “the separation between ownership and control of large corporations.”⁵⁵ Shareholders of public companies “invariably” support tax changes that increase the value of existing capital.⁵⁶ Assuming that share values prior to elimination of the double tax reflect the anticipated burden of the double tax,⁵⁷ integration would “confer windfalls on existing shareholders.”⁵⁸ Integration would decrease the anticipated tax burden on corporate profits, and that, all else equal, would cause share values to rise.⁵⁹ Shareholders, the explanation argues, therefore

Whether Bank is correct or not is beside the point for present purposes. Even if his account is right, it only explains the existence of a corporate-level tax; it does not explain the corporate double tax. Any concerns about a “retained earnings penalty” and “indefinite deferral” could be addressed with a corporate-level tax alone.

⁵³ The intuition here is captured by the familiar aphorism of Senator Russell Long (“Don’t tax you; don’t tax me; tax that man behind the tree.”). One might think that, because the incidence of the corporate income tax is not entirely understood, neither managers nor shareholders have clear incentives to lobby for its repeal. That explanation, however, falls short for two reasons. First, at best it explains only the persistence of the corporate income tax; it does not account for the persistence of the corporate double tax. Second, it does not account for the substantial resources that managers commit to seeking corporate tax preferences that mitigate the effect of the corporate-level tax.

⁵⁴ See generally Arlen & Weiss, *supra* note 7.

⁵⁵ *Id.* at 327.

⁵⁶ *Id.* at 336.

⁵⁷ That assumption—based on the “new view” that dividend taxes are capitalized into share values—is controversial. See generally Alan J. Auerbach & Kevin A. Hassett, *On the Marginal Source of Investment Funds*, 87 *J. Pub. Econ.* 205 (2003); George R. Zodrow, *On the “Traditional” and “New” Views of Dividend Taxation*, 44 *Nat’l Tax J.* 497 (1991); see also Treasury Integration Report, *supra* note 40, at 116–18; Warren ALI Integration Study, *supra* note 40, at 33–39; Warren, *supra* note 7, at 753–54, 757.

⁵⁸ Arlen & Weiss, *supra* note 7, at 338.

⁵⁹ *Id.* Of course, integration would also lower the tax burden on new equity, but that lower burden would be capitalized into the value of the new equity at the time the investment is made. *Id.*

support integration.⁶⁰ Managers of public corporations, by contrast, “are primarily concerned with stimulating new investment.”⁶¹ Tax preferences such as accelerated depreciation for new machinery enable managers “to expand their firms by increasing the after-tax profitability of new investments.”⁶² That, in turn, raises manager returns on the human-capital investments they make in their companies.⁶³ Corporate “[m]anagers therefore attach a low priority to integration, which provides a large windfall to existing capital, and only a small stimulus to new investment.”⁶⁴

The agency-cost explanation thus characterizes the conflict as the result of managers and shareholders assigning different priorities to tax subsidies for existing investments and tax subsidies for new investments.⁶⁵ Shareholders, the explanation maintains, are not hostile to subsidies for new investments;⁶⁶ they simply prefer windfalls for their existing shares. Similarly, managers “prefer to lobby for [corporate tax preferences] that may be less advantageous to shareholders but are more cost-effective in stimulating investment.”⁶⁷ Managers “do not actively oppose” integration,⁶⁸ but they

⁶⁰ Id. at 341.

⁶¹ Id. at 336.

⁶² Id. at 341. That assertion of the agency-cost explanation, although broadly accurate, overlooks the possibility that such tax preferences may benefit old capital as well as new capital. Congress can extend new tax preferences to pre-enactment investments, thereby conferring windfall gains on corporations that have made past investments in whatever activities are covered by the new preferences. Additionally, even tax preferences that are prospective only may subsidize past investments. For example, the enactment of favorable cost-recovery rules for new industrial factories and equipment will increase the value of past decisions made by corporate managers to begin or continue manufacturing operations. Thus, if Congress were to allow expensing of all machinery placed into service during the first two years after enactment, there would be a large windfall to Boeing, Ford, and similar corporations.

⁶³ Id. at 336, 341.

⁶⁴ Id. at 336; see also id. at 342 (“Managers have testified in favor of integration, but they have generally reserved their active lobbying efforts for tax preferences for new investments . . .”); id. at 344 (“Although managers have supported integration, they have consistently preferred other measures that would reduce corporate sector taxes.”).

⁶⁵ Id. at 338.

⁶⁶ Id. at 336 (“Shareholders . . . sometimes, but not always, support policies that stimulate investment.”).

⁶⁷ Id.

⁶⁸ Id.

“have chosen not to lobby vigorously for [it].”⁶⁹ However, shareholders face collective-action problems and other obstacles to lobbying,⁷⁰ and that leaves managers as “the only vocal public participants” in debates over integration proposals.⁷¹ Thus, “managerial diffidence” is “the key to explaining the failure of integration efforts.”⁷²

The agency-cost explanation recognizes that some managers may take stronger positions supporting or opposing integration, but it considers those managers to be outliers. Thus, “[a] few managers” of corporations that cannot take advantage of existing tax preferences may support integration, but even these managers would prefer the enactment of new preferences.⁷³ Other managers may actively oppose integration because the double tax facilitates trapping earnings inside the corporation:⁷⁴ the fact that the double tax burdens distributed corporate earnings more than retained earnings reduces shareholder demand for dividends and encourages managers to use retained earnings as a source for financing corporate investments.⁷⁵ Even so, the agency-cost explanation argues that only “[a] small group” of corporate managers actively resists integration by reason of this retained-earnings trap.⁷⁶ The basic story remains one of manager diffidence to integration.

There are, however, good reasons to doubt the agency-cost explanation. The explanation argues that the double tax creates a wedge between the interests of shareholders, who generally prefer integration to targeted tax preferences, and the interests of manag-

⁶⁹ Id. at 327.

⁷⁰ Id. at 363.

⁷¹ Id. at 328.

⁷² Id. at 327. Others had reached a similar conclusion before Arlen and Weiss published their analysis. See Robert J. Leonard, *A Pragmatic View of Corporate Integration*, 35 *Tax Notes* 889, 894–95 (1987); Lee A. Sheppard, *Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax*, 27 *Tax Notes* 637, 647 n.15 (1985).

⁷³ Arlen & Weiss, *supra* note 7, at 342.

⁷⁴ Id. at 348. Alternatively, some managers may oppose integration if they believe that the revenue cost of eliminating the double tax will be offset by the elimination of corporate tax preferences. Id. at 341, 347.

⁷⁵ Id. at 348–61. Bank, however, argues that “[t]he notion that retained earnings became trapped in the corporation because of double taxation is a myth.” Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 *Tax L. Rev.* 463, 466 (2003).

⁷⁶ Arlen & Weiss, *supra* note 7, at 348.

ers, who generally prefer targeted tax preferences to integration. But that argument minimizes important differences among shareholders, among managers, and among the terms of different integration models. It also ignores entirely the interests of third parties affected by integration. Although the agency-cost explanation acknowledges some heterogeneity among managers and among shareholders, it does not consider heterogeneity to be the driving force in the political economy of the double tax. Rather, the agency-cost explanation centers on the divergence between the interests of managers as a group and the interests of shareholders as a group. In other words, to the extent that the agency-cost explanation sees heterogeneity among the relevant interests, the explanation nonetheless fails to draw the right conclusions from it. At best, the agency-cost explanation accounts for only one aspect of a considerably more complex and nuanced story about the political economy of the corporate double tax.

C. Heterogeneity of Interests and Effects

The tax positions and interests of managers are heterogeneous; so too are the tax positions and interests of shareholders. The double tax does not have uniform effects on corporations as a group or on shareholders as a group, and the unevenness of the corporate-level and shareholder-level taxes leaves certain managers and shareholders better off under the status quo than other managers and shareholders. Additionally, there are collateral interests on both the manager side and the shareholder side that have economic stakes in the double tax.⁷⁷ In many cases, those stakes consist of selling investments that reduce or eliminate either the corporate-level or shareholder-level tax. This heterogeneity of interests among managers, among shareholders, and among third parties

⁷⁷ As used here, the term “collateral interest” generally refers to a party with an interest in the corporate double tax other than as a manager or shareholder. A party will be referred to as a collateral interest on the manager side if the party’s interest in the double tax relates primarily to the corporate-level tax, and a party will be referred to as a collateral interest on the shareholder side if its interest in the double tax relates primarily to the shareholder-level tax. For example, a trade association representing alternative energy is a collateral interest on the manager side because corporate investments in alternative energy generally qualify for corporate tax preferences.

makes it treacherous to generalize about policy preferences on eliminating or mitigating the double tax. Additionally, integration itself is not a monolith. Policymakers and academics have proposed numerous integration models, and these models would have varying effects on different corporations, shareholders, and collateral interests. Even if one reasonably assumes that all affected parties would respond to integration legislation with rational self-interest, mapping out their positions *ex ante* is not straightforward. The potential effects on manager, shareholder, and third-party interests are sufficiently disparate to ensure that *any* proposal for integration will draw both political support and political opposition from within each group.⁷⁸

1. Managers and Collateral Interests

The corporate double tax creates several potential fault lines among managers.⁷⁹ First, many managers occupy a dual position: they are both managers and shareholders. Managers often own substantial equity stakes in their companies; in certain cases, directors set a minimum number of shares that managers must own. Although managers may buy shares on the open market, most of their shares are provided as compensation. These include shares granted outright, shares acquired through the exercise of stock options, and restricted shares in which the managers vest over time by continuing in their positions. The equity interest of managers is larger still once other stock-based compensation—such as “phantom” shares and unexercised stock options—are taken into account. Thus, if integration does create a windfall for existing stock investments, managers with substantial shareholdings may be eager to eliminate the double tax. Managers do not face the same collective-action problems that generally prevent other individual share-

⁷⁸ For an early analysis of the interest-group effects of integration, including discussion about the heterogeneity of interests among managers and among shareholders, see Charles E. McLure, Jr. & Stanley S. Surrey, *Integration of Income Taxes: Issues for Debate*, 55 *Harv. Bus. Rev.* 169, 174–81 (1977).

⁷⁹ See Cathie J. Martin, *Shifting the Burden: The Struggle over Growth and Corporate Taxation* 35 (1991) (“The most notable characteristic of the business community in the United States is its high degree of fragmentation. . . . Fragmentation in the business community means that no unambiguous class mandate for corporate taxation is expressed.”).

holders from lobbying; in fact, managers are uniquely positioned to determine the lobbying positions of their corporations and to deploy substantial corporate resources in support of those positions. But other managers—perhaps those with smaller shareholdings—may not consider the prospect of a personal windfall as a reason for positioning their companies in favor of integration; these managers might decide their corporations' lobbying positions based on their self-interest as managers rather than their self-interest as shareholders.⁸⁰

Even if managers ignore their own interests as shareholders, they may adopt different stances on integration because their companies may have different tax burdens. The corporate-level tax sets a deceptively simple baseline: corporate profits are taxed at a flat 35% rate. But this baseline exists only as an abstraction; the tax code contains numerous corporate tax preferences of varying scope and applicability that make the corporate-level tax *as applied* very uneven. These preferences provide “a special exclusion, exemption, or deduction[,] a special [tax] credit, a preferential rate of tax, or a deferral of tax liability”⁸¹ intended by Congress to encourage certain types of corporate investments. Because they are limited to particular industries, or even to particular corporations, they distribute unequal tax subsidies and create uneven tax burdens.

For example, current law provides a tax credit for engaging in research and development activities⁸² and allows for the expensing of certain research and experiment costs.⁸³ These preferences are worth over \$9 billion each year to corporations that engage in such

⁸⁰ In general, manager compensation has become more heavily concentrated in the equity of their own companies since the middle of the 1990s. The effect of this development on the political economy of the double tax could not have been incorporated, then, into the agency-cost explanation. To the extent, however, that managers held significant shareholdings (whether or not of their own companies) prior to the middle of the 1990s, managers occupied a dual position that could have been incorporated into the agency-cost explanation.

⁸¹ Congressional Budget and Impoundment Control Act of 1974 § 3(3), 2 U.S.C. § 622 (2000). For the sake of simplicity, the discussion in this Subsection (I.C.1), concerning corporate tax preferences, ignores the effects of the corporate alternative minimum tax.

⁸² I.R.C. § 41 (West 2008).

⁸³ *Id.* § 174 (West 2008).

activities (such as defense contractors),⁸⁴ but they are useless to corporations that do not (such as interstate bus companies). Corporations engaged in foreign activities benefit from a deferral of active income from their controlled foreign corporations and other preferences related to foreign activities. These preferences are worth almost \$20 billion to corporations having international business transactions, but nothing to corporations with purely domestic activities.⁸⁵ Numerous preferences for energy-related industries provide corporate tax benefits worth about \$6.5 billion;⁸⁶ accelerated depreciation for machinery and business property confers preferences of almost \$20 billion;⁸⁷ a special deduction for domestic manufacturing and production is worth \$7.4 billion;⁸⁸ and an exclusion for federal subsidies paid to employers that provide a prescription-drug plan for Medicare-eligible employees is worth \$1.1 billion.⁸⁹ Insurance companies are entitled to various preferences that sum to over \$7 billion,⁹⁰ and the construction industry enjoys, among other preferences, a tax credit for developing low-income housing worth \$5.5 billion.⁹¹ The list, of course, goes on, providing something like an honor roll for corporate lobbyists. The total value of the various tax preferences for corporations engaged in different industries and businesses in 2009 exceeds \$118 billion⁹²—about 33% of the projected corporate income tax receipts for the government's current fiscal year.⁹³ But, importantly, not all corpo-

⁸⁴ Staff of Joint Comm. on Taxation, 110th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012*, at 60 (Comm. Print 2008) [hereinafter *Joint Committee Tax Expenditures Estimates*].

⁸⁵ *Id.* at 60, 69. The Staff of the Joint Committee on Taxation no longer classifies deferral for active income of controlled foreign corporations or deferral for active financing income as a tax expenditure. *Id.* at 69.

⁸⁶ *Id.* at 60–63.

⁸⁷ *Id.* at 69. Again, the Staff of the Joint Committee on Taxation no longer classifies this item as a tax expenditure. *Id.*

⁸⁸ *Id.* at 66. See also Treasury Background Paper, *supra* note 16, at 5.

⁸⁹ *Joint Committee Tax Expenditures Estimates*, *supra* note 84, at 57.

⁹⁰ *Id.* at 64–65.

⁹¹ *Id.* at 65.

⁹² *Id.* at 50–69.

⁹³ Cong. Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, at 83 (2008) (projecting corporate income tax revenues of \$356 billion for fiscal year 2009).

rations benefit equally. Each preference is limited by its terms to corporations engaged in a particular industry or activity.⁹⁴

Similarly, debt financing and tax shelters also create unevenness in the corporate-level tax. Interest payments can be deducted for corporate tax purposes, but different corporations rely differently on debt financing,⁹⁵ reflecting variance in creditworthiness and tolerance for insolvency risk. Those managers who are able and willing to borrow more heavily can effect greater reductions in their corporate-level tax burden. Different managers also have different propensities to enter into structured tax-avoidance transactions—tax shelters—as a means for reducing the corporate-level tax burden.⁹⁶

The unevenness resulting from the different use of corporate tax preferences, interest deductions, and tax shelters shows up in effective tax rates and marginal effective tax rates. A study covering large corporations in the years 2004 through 2006 found that effective tax rates, averaged over that three-year period, ranged from a low of 10.2% to a high of 43.6%, with a median of 30%.⁹⁷ Of the eighty corporations included in the study, five had effective tax rates under 20%, thirty-six had effective tax rates of at least 20% but under 30%, thirty-six had effective tax rates of at least 30% but under 40%, and three had effective tax rates of at least 40%.⁹⁸ A separate study covering the years 1995 to 2000 (which used a different methodology) found less extensive but still significant divergence among effective corporate tax rates.⁹⁹

⁹⁴ Treasury Background Paper, *supra* note 16, at 2.

⁹⁵ See, e.g., Pechman, *supra* note 8, at 184.

⁹⁶ See generally U.S. Dep't of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (1999).

⁹⁷ See Martin A. Sullivan, Reported Corporate Effective Tax Rates Down Since Late 1990s, 118 *Tax Notes* 882, 885–86 (2008). An effective corporate tax rate is the corporate tax expense divided by corporate pre-tax income. See George K. Yin, How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500, 89 *Va. L. Rev.* 1793, 1795 (2003).

⁹⁸ Sullivan, *supra* note 97, at 885–86.

⁹⁹ Yin, *supra* note 97, at 1830–50 (finding that effective corporate tax rates ranged from 25 to 30 percent). The variance in corporate effective tax rates has been the case for some time. See Martin, *supra* note 79, at 1213 (reporting divergent effective corporate tax rates among different industries in 1980 and 1981). Arlen and Weiss also note that “the incidence of preferences varies widely between corporations” and that “[t]he uneven distribution of preferences means that different sectors face different

Similarly, there is a broad range of marginal effective tax rates in the corporate sector.¹⁰⁰ As calculated by the Treasury Department in 2007, the overall marginal effective tax rate for equity-financed investments was 39.7%; the overall marginal effective tax rate for debt-financed investments was negative 2.2%.¹⁰¹ As calculated by the Congressional Budget Office in 2003, the marginal effective corporate tax rate for equity-financed investment in industrial structures was 41.0%, but the rate for equity-financed investment in machinery was only 23.6%.¹⁰² By comparison, the marginal effective corporate tax rate for debt-financed investments in machinery was *negative* 45.9%.¹⁰³ And, as calculated by the Congressional Budget Office in 2002, the marginal effective corporate tax rates on other investments ranged from a low of 9.2% for “petroleum and natural-gas structures” to a high of 36.9% for “computers and peripheral equipment”;¹⁰⁴ the rate was 30.4% for commercial buildings, 22.7% for farm tractors, 20.1% for railroads, 17.8% for communications equipment, 16.7% for construction machinery, and 14.5% for aircraft.¹⁰⁵

These differences in effective tax rates and marginal effective tax rates are significant for managers’ decisions about whether and how to lobby on integration. Because of differences in effective rates, certain corporations “are granted full or partial relief from

effective tax rates.” Arlen & Weiss, *supra* note 7, at 357. However, they regard the variance in corporate tax rates as bearing primarily on the retained-earnings trap. *Id.* at 357–59. In other words, they apparently do not consider the variance in corporate effective tax rates as having significance in determining manager lobbying positions on integration apart from the limited point that “a few” managers “oppose integration because of the retained earnings trap.” *Id.* at 358.

¹⁰⁰ A marginal effective tax rate is “a hypothetical tax rate that, if applied to properly measured income, would have the same incentive effect as [that] implied by the various . . . features of the actual tax code.” Treasury Background Paper, *supra* note 16, at 23.

¹⁰¹ Office of Tax Policy, *supra* note 14, at 82.

¹⁰² Cong. Budget Office, *Corporate Income Tax Rates: International Comparisons* 35, 41 (2005); see also Martin, *supra* note 79, at 29 (“The corporate tax system skewed investment from structures to equipment: income generated by structures is taxed at roughly 30 percent; that of equipment, at approximately 20 percent.”).

¹⁰³ Cong. Budget Office, *supra* note 102, at 44.

¹⁰⁴ Cong. Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform 10–11* (2005) (providing 2002 data).

¹⁰⁵ *Id.*

corporate level tax”;¹⁰⁶ others are not. All else equal, managers of corporations with low tax burdens should not consider integration to be as attractive as their counterparts at corporations with high tax burdens. Indeed, managers at low-tax corporations may want to resist integration if they anticipate that eliminating the double tax would level the playing field in effective tax rates among corporations.¹⁰⁷ The intuition here is straightforward. Because the double tax generally applies to all corporations that issue equity in the public securities markets, the managers of the corporations subject to the double tax are competing with each other for investment capital. This competition cuts across industries: a company in one sector must compete for investment capital with a company in a different sector, even though those two companies do not compete with each other in the sale of their products and services.

In seeking investment capital, relative effective tax rates matter a great deal because the relative effective tax rates affect the after-tax rates of return offered to investors. Managers of companies with low effective tax rates enjoy lower costs of equity capital and, as a result, greater opportunities for corporate expansion. Thus, it is entirely rational for managers of low-tax corporations to prefer the status quo—that is, to prefer the double taxation of corporate profits—over any change to the double tax that would have the effect of leveling corporate effective tax rates. These managers rationally should prefer a system of double taxation that imposes high relative tax rates on other corporations to a system of integration, even if the integrated system would reduce all corporate effective tax rates in absolute terms.¹⁰⁸ Managers at high-tax corpora-

¹⁰⁶ Treasury Background Paper, *supra* note 16, at 4.

¹⁰⁷ Arlen & Weiss, *supra* note 7, at 341 (“Corporate managers prefer to lobby on behalf of provisions that help only their firms or industries.”); see also Martin, *supra* note 79, at 114–16 (providing examples of corporations lobbying for provisions that benefit their firms or industries). Arlen and Weiss maintain that tax preferences such as accelerated depreciation “can be targeted to specific industries” but that “[i]ntegration affects all firms.” Arlen & Weiss, *supra* note 7, at 341. The first point is certainly valid: corporate tax preferences do affect different firms differently. But the implication of the second point is the question at issue: indeed, it is in part because of the uneven effects of corporate tax preferences that integration also affects firms differently.

¹⁰⁸ See Doernberg & McChesney, *supra* note 2, at 927 (“A tax can be beneficial to some private producers if it strikes their competitors even harder.”).

tions, of course, should have precisely the opposite disposition: they should prefer a leveling of effective tax rates through integration to the continuation of uneven effective tax rates under the status quo.¹⁰⁹

The unevenness of the corporate-level tax affects collateral interests as well. A tax preference intended to induce a corporation to make a particular type of investment often benefits the industry in which the investment is made. The low-income housing tax credit, for example, increases the aggregate amount invested in affordable housing and, by extension, benefits both the non-corporate construction firms that build the housing and the lower-income families who live in it. Those collateral interests have a stake in the corporate double tax even though they are neither managers nor shareholders. Any repeal or reduction in the value of a corporate tax preference—for example, through elimination of the corporate-level tax—could significantly affect those collateral interests. In certain cases, their stake in the continuation of corporate tax preferences may even be greater than that of managers: if the incidence of corporate tax preferences shifts to third parties, those third parties would bear the burden of losing those preferences. There is every reason to suppose that these collateral interests would participate actively in any integration proposal that might strengthen or weaken corporate tax preferences.

2. Shareholders and Collateral Interests

The second level of the double tax also applies unevenly. Again, the baseline is relatively straightforward. Any corporate profits distributed to shareholders as dividends are taxed to the shareholders. Historically, ordinary-income rates applied; currently, capital-gains rates apply. Any retained corporate profits remain untaxed until shareholders sell their stock; at that point, capital-gains rates apply. The tax law, however, creates substantial departures from this baseline, including the complete elimination of the shareholder-level tax for a large number of shareholders.

At least twenty-five percent of corporate equity is held by shareholders that are exempt from federal income tax. As of the

¹⁰⁹ See Arlen & Weiss, *supra* note 7, at 342 (noting that managers of corporations with low use of corporate tax preferences may “actively support integration”).

third quarter of 2008, the total value of outstanding corporate equity is \$19.6 trillion.¹¹⁰ Of this, \$3.8 trillion (19% of the total)¹¹¹ is held directly by private and government retirement plans; these plans are completely exempt from tax.¹¹² Mutual funds hold \$4.1 trillion of corporate equity (21% of the total),¹¹³ and 25% of mutual fund shares in turn are owned by private and government retirement plans.¹¹⁴ Another \$97.4 billion of corporate equity (about 0.5% of the total),¹¹⁵ is held by state and local governments; these also are exempt from tax. Thus, even without counting the corporate shares held by tax-exempt foundations, charities, universities, and similar organizations, 25 out of every 100 dollars of corporate equity is owned by shareholders who pay no income tax on dividends or on gains from the sale of their stock.¹¹⁶

A large amount of corporate equity is held by other corporations. Financial services companies (exclusive of mutual funds) hold \$1.45 trillion in corporate stock (about 7% of the total).¹¹⁷ Outside the financial services industry, many public companies own stock in other companies, whether those other companies are themselves publicly traded or are part of a controlled group of parent and subsidiaries. Dividends received by a corporation are subject to a 70% dividend-received deduction that effectively reduces the tax rate on such dividends to 10.5%.¹¹⁸ The amount of the de-

¹¹⁰ Bd. of Governors of the Fed. Reserve Sys., Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 2008, at 90 tbl.L.213 (2008) [hereinafter Board of Governors]. This figure includes the value of stock in U.S. companies held by foreign persons and the value of stock in foreign companies held by U.S. persons; it excludes inter-corporate holdings by companies outside the financial sector. Id.

¹¹¹ Id.

¹¹² I.R.C. § 501(a), (c) (West 2008).

¹¹³ Board of Governors, supra note 110, at 90 tbl.L.213.

¹¹⁴ Id. at 90 tbl.L.214.

¹¹⁵ Id. at 90 tbl.L.213.

¹¹⁶ The 25% number is potentially several percentage points too low. See, e.g., Treasury Integration Report, supra note 40, at 67 (indicating that tax-exempt shareholders own approximately 37% of directly held corporate equity). One analysis concluded that in 2000 only 46% of corporate dividends were taxable at the shareholder level. William G. Gale, About Half of Dividend Payments Do Not Face Double Taxation, 97 Tax Notes 839 (2002).

¹¹⁷ Board of Governors, supra note 110, at 90 tbl.L.213.

¹¹⁸ I.R.C. § 243 (West 2008).

duction increases for higher shareholdings: once the shareholding corporation owns at least 80% of another corporation, the dividends-received deduction generally increases to 100%, eliminating any shareholder-level tax on dividends.¹¹⁹ Finally, approximately 11% of the value of corporate equity is held by foreign investors.¹²⁰ As a default rule, dividends received by foreign shareholders are taxed at a flat withholding rate of 30%.¹²¹ However, this rate generally is lowered under bilateral tax treaties. For example, under the treaty between the United States and the United Kingdom, dividends paid by U.S. companies to U.K. taxpayers generally are taxable by the U.S. at a rate of 15%.¹²²

Ignoring foreign shareholders, the shareholder-level taxes on corporate profits are as shown in Table 1. The first and second rows in Table 1 cover corporate profits attributable to equity; the third row, included for comparison, covers corporate profits attributable to debt. As Table 1 demonstrates, the second level of the double tax on profits distributed as dividends actually applies only in the case of a taxable non-corporate shareholder; for a tax-exempt shareholder or a corporate shareholder, the second level of the double tax on such profits is either eliminated or reduced.

¹¹⁹ Id. §§ 243, 1504(a) (West 2008). For 2004, only \$51 billion of the \$274 billion in dividends received by corporate shareholders was subject to the double tax; the remaining \$223 billion in dividends was covered by dividends-received deductions and foreign tax credits. Office of Tax Policy, *supra* note 14, at 78.

¹²⁰ Board of Governors, *supra* note 110, at 90 tbl.L.213.

¹²¹ I.R.C. § 871(a) (West 2008).

¹²² See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 10, § 2, July 24, 2001, S. Treaty Doc. No. 107-19 (2002).

Table 1
Investor-Level Taxes on Corporate Profits

| | Taxable Non-Corporate Investor | Taxable Corporate Investor | Tax-Exempt Investor |
|--|---|----------------------------------|------------------------|
| Corporate Profit Distributed as Dividend | Taxable (at Capital-Gains Rate) | Deductible (70% to 100%) | Not Taxable |
| Corporate Profit Realized on Stock Sale | Taxable (at Capital-Gains Rate) | Taxable | Not Taxable |
| Corporate Profit Distributed as Interest | Taxable (at Ordinary-Income Rate) | Taxable | Not Taxable |

The elimination and reduction of shareholder-level tax for tax-exempt and corporate shareholders do not require that the distributing corporation have paid any corporate-level tax on the amounts distributed. Thus, if a corporation earns income that is covered by a corporate tax preference, such as a special exclusion or deduction, and distributes that income as a dividend to a tax-exempt or corporate shareholder, there may be no tax imposed at either level. This is shown in Table 2, which sets out the combined corporate-level and shareholder-level taxes on \$100 of corporate business profits. The first two rows show the results for profits distributed as dividends (the last two rows, which show the results for profits distributed as interest, are included for comparison). If the double tax were fully imposed on the \$100, the corporate-level tax would be \$35, and the shareholder-level tax would be \$9.75 (\$22.75 in the case of a corporate shareholder) for a total tax of \$44.75 (\$57.75 in the case of a corporate shareholder). Because of the combination of corporate-level preferences and shareholder-level exemptions and deductions, however, full double taxation actually occurs *only* in the case of dividends paid out of non-preference income to taxable non-corporate shareholders. All other dividends are taxed only once or not at all.

Table 2
 Combined Corporate-Level and Investor-Level Taxes on \$100 of
 Corporate Income

| | Taxable Non-Corporate Investor | Taxable Corporate Investor | Tax-Exempt Investor |
|--|--------------------------------------|----------------------------------|------------------------|
| Non-Preference Income Distributed as Dividend | \$44.75 | \$35 | \$35 |
| Preference Income Distributed as Dividend | \$15 | \$0 | \$0 |
| Non-Preference Income Distributed as Interest | \$35 | \$35 | \$0 |
| Preference Income Distributed as Interest | \$35 | \$35 | \$0 |

Assumptions: Corporate tax rate is 35%; individual tax rate for ordinary income is 35%; individual tax rate for capital gains is 15%; corporate tax preference provides for full exclusion or deduction; corporate shareholder entitled to 100% dividends-received deduction.

It would be a mistake, then, to conclude that double taxation represents the norm in the taxation of corporate profits. Just as the corporate-level tax is made uneven by corporate tax preferences, interest deductions, and tax shelters, the shareholder-level tax is made uneven by exemptions and dividends-received deductions. This creates different, and potentially inconsistent, interests among shareholders. There is little reason to suppose that all shareholders would want the same outcome if integration legislation were in play.

Additionally, there are important collateral interests on the shareholder side that could be affected by the reduction or elimination of the double tax. For example, tax-qualified retirement plans are themselves investment vehicles for employees. The tax-exempt status of these plans allows employees to shelter income, including corporate dividends, from the income tax: all else equal, an employee generally will have a higher post-tax return by holding dividend-paying corporate stock in a tax-qualified retirement plan

rather than by holding it directly. But the advantage is relative; if there were no shareholder-level tax on dividends paid by stock held outside a plan, there would be no tax justification for holding the stock inside the plan.¹²³ The employee, moreover, is not the only one who benefits from the arrangement: investment managers, trustees, actuaries, accountants, record-keepers, and other consultants receive fees from tax-qualified retirement plans and the employers that sponsor the plans. In some cases—for example, a pension plan actuary or record-keeper—the consultant’s entire business consists of providing services to tax-qualified retirement plans. Because the plan itself is effectively a tax shelter from the individual income tax, including the shareholder-level tax on dividends, these consultants may have a strong interest in the continuation of the double tax. Similar considerations arise for third parties such as life insurance companies, bond dealers, and realtors because of the relative tax advantages for investments in annuity contracts, tax-exempt bonds, and real estate.

By contrast, there are other collateral interests that may benefit from eliminating the double tax. Certain brokerage firms, mutual funds, and other investment firms, for example, would potentially increase their business if individuals and other taxable investors shift their portfolios toward corporate stock. These and other collateral interests on the shareholder side reasonably may see themselves as having stakes in integration that are important enough to justify joining the lobbying fray.

3. Integration Models

Policymakers and academics have developed a remarkable variety of integration models.¹²⁴ Under simplifying assumptions (includ-

¹²³ See, e.g., Daniel Halperin, Commentary, Will Integration Increase Efficiency?—The Old and New View of Dividend Policy, 47 *Tax L. Rev.* 645, 646 (1992) (“[I]ntegration might have a significant impact on tax-exempt organizations . . . particularly for the establishment of pension plans.”).

¹²⁴ A note on terminology: the term “integration” (or “full integration”) is often used to refer precisely to pass-through taxation of business income earned by corporations. See, e.g., Emil M. Sunley, Corporate Integration: An Economic Perspective, 47 *Tax L. Rev.* 621, 624 (1992). The term is also used, however, to refer more broadly to the elimination of the taxation of corporate profits distributed as dividends (“partial integration”). *Id.* To confuse matters a bit further, George Yin has suggested a

ing equivalent corporate and shareholder tax rates), the models produce equivalent outcomes,¹²⁵ but they have widely differential effects once relevant tax differences are taken into account. An overview of several integration models grounds the basic equivalence:

A *shareholder-allocation* model attributes corporate income directly to shareholders. It preserves the corporate tax but gives shareholders a credit for that tax.¹²⁶ Shareholders increase basis in their shares for the corporate income allocated to them, and they treat corporate distributions first as a return of basis and then as capital gains.

Example: Assume that the corporate and shareholder tax rates are 35% and that Corporation X, which is owned entirely by Shareholder Y, earns \$100 of taxable income.¹²⁷ Under the shareholder-allocation model, Corporation X pays \$35 tax on the \$100 income, and Shareholder Y is treated as having \$100 of income. Shareholder Y owes \$35 of tax and claims a \$35 credit for the tax paid by Corporation X. If Corporation X later distributes \$65 to Shareholder Y, Shareholder Y excludes that \$65 from income and nets \$65.

A *mark-to-market* model taxes shareholders on the sum of the annual increase in the value of their shares and any dividends dis-

method for *achieving* integration through double taxation. George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, 480–501 (1992). In this Article, the term “integration” is used in the broad sense to refer to the elimination of the corporate double tax. Cf. Warren, *supra* note 7, at 739 (using the term “integration” to refer “to the elimination of corporate taxes on distributed corporate earnings”).

¹²⁵ Treasury Integration Report, *supra* note 40, at 61; cf. Warren, *supra* note 7, at 775–77 (demonstrating that the shareholder credit and dividend deduction integration methods have equivalent effects).

¹²⁶ See Treasury Integration Report, *supra* note 40, at 27–29; Treasury Blueprints, *supra* note 40, at 69; George F. Break & Joseph A. Pechman, Federal Tax Reform: The Impossible Dream? 101–03 (1975); Pechman, *supra* note 8, at 185–86 (describing it as full integration or the “partnership method”); Dodge, *supra* note 40, at 279–81 (describing it as full integration or the “pass-through” model); Polito, *supra* note 40, at 1030. It would also be possible to structure shareholder-allocation integration such that no tax was collected at the corporate level. See, e.g., McLure, *supra* note 40, at 549–50; Yin, *supra* note 124, at 433–36. Prominent versions of the shareholder-allocation model, however, would retain the corporate tax for purposes of collecting the shareholder-level tax. See, e.g., Treasury Integration Report, *supra* note 40, at 27.

¹²⁷ Except where otherwise stated, these assumptions apply throughout the examples discussed in the remainder of this overview.

tributed to them.¹²⁸ The model generally does not require a determination of corporate-level income, and it permits elimination of the corporate-level tax.

Example: Corporation X earns \$100 and distributes nothing to Shareholder Y. At the end of the year, the market value of the Corporation X stock has increased by \$100, and Shareholder Y includes that \$100 in income. Shareholder Y pays \$35 tax and adjusts basis upward by \$100. If Corporation X later distributes \$100 to Shareholder Y, Shareholder Y excludes the \$100 from income and (taking into account the \$35 tax already paid by Shareholder Y) nets \$65.¹²⁹

A *dividend-deduction* model leaves both the corporate-level and shareholder-level taxes in place but gives the corporation a deduction for dividends paid to shareholders.¹³⁰

Example: Corporation X earns \$100 and distributes the entire amount as a dividend to Shareholder Y. Corporation X pays tax of \$0 (\$100 income minus \$100 deduction); Shareholder Y pays \$35 of tax and nets \$65.

A *split-rate* model taxes distributed corporate income at a rate lower than the rate for retained corporate income.¹³¹ If the rate for distributed income is zero, the split-rate model is the same as the dividend-deduction model.

Example: Corporation X earns \$100 and distributes the entire amount as a dividend to Shareholder Y. Corporation X pays tax of \$0 (\$100 of distributed income, taxable at a rate of 0%); Shareholder Y pays \$35 of tax and nets \$65.

A *dividend-exclusion* model preserves the corporate-level tax but eliminates the shareholder-level tax for dividends.¹³²

¹²⁸ See Warren ALI Integration Study, *supra* note 40, at 47; Abrams & Doernberg, *supra* note 3, at 11; Dodge, *supra* note 40, at 309–11; Taylor, *supra* note 40, at 298–310.

¹²⁹ This ignores the time value of money.

¹³⁰ See Warren, *supra* note 7, at 745–46, 774; see also Treasury II, *supra* note 40, at 122 (proposing partial dividend deduction); Treasury I, *supra* note 40, at 136 (same); Andrews ALI Supplemental Study, *supra* note 40, at 3, 88–89 (proposing deduction for certain dividends on new equity); Andrews ALI Study, *supra* note 40, at 328, 366–70 (same).

¹³¹ See Pechman, *supra* note 8, at 184; Warren, *supra* note 7, at 775.

¹³² See Advisory Panel Report, *supra* note 40, at 124–25; Treasury Integration Report, *supra* note 40, at 17–18; Warren ALI Integration Study, *supra* note 40, at 47;

Example: Corporation X earns \$100 and distributes its after-tax profits to Shareholder Y. Corporation X pays \$35 in tax and distributes \$65 to Shareholder Y. Shareholder Y excludes the \$65 from gross income and nets \$65.

An *imputation-credit* model preserves the corporate-level tax but converts it to a withholding mechanism for the shareholder-level tax.¹³³ The includable amount of any dividend is increased (“grossed up”) by the corporate-level tax attributable to the amount distributed; the shareholders claim a credit for the corporate-level tax.

Example: Corporation X earns \$100 and distributes its after-tax profits to Shareholder Y. Corporation X pays tax of \$35 and distributes \$65. Shareholder Y includes \$100 in gross income (the \$65 actually distributed and a \$35 gross up), owes \$35 tax on the distribution, and claims a \$35 credit. Shareholder Y nets \$65.

A *comprehensive business income tax* model eliminates the tax distinction between corporate and non-corporate businesses.¹³⁴ Every business pays an entity-level tax on its taxable income, which generally is calculated in the same manner as corporate taxable income but without any deduction for interest payments. Shareholders and creditors exclude all distributions, whether characterized as dividends or interest.¹³⁵

Example: Corporation X earns \$100 and distributes its after-tax profits to Shareholder Y. Corporation X pays tax of \$35 and distributes \$65. Shareholder Y excludes the \$65 distribution from income and nets \$65.

Table 3 summarizes the equivalent effects of these integration models under simplified assumptions. As the table indicates, each model yields combined corporate-level and shareholder-level taxes

Break & Pechman, *supra* note 126, at 97–98; Pechman, *supra* note 8, at 184–85; Peel, *supra* note 40, at 13–14.

¹³³ See Treasury Integration Report, *supra* note 40, at 95; Treasury Option Papers, *supra* note 40, at 49–50; Break & Pechman, *supra* note 126, at 99–100; Pechman, *supra* note 8, at 184; Warren, *supra* note 7, at 744–45, 773–74.

¹³⁴ See Treasury Integration Report, *supra* note 40, at 39–40; cf. Advisory Panel Report, *supra* note 40, at 162 (proposing a “flat 30 percent tax on all businesses other than sole proprietorships, regardless of their legal structure”).

¹³⁵ In this way, the comprehensive business income tax would not simply integrate the corporate-level and shareholder-level taxes, it also would fundamentally alter the tax treatment of non-corporate businesses.

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of \$35 on business income of \$100, netting \$65 for the shareholder. This compares to combined taxes of \$57.75 and a net of \$42.25 under the corporate double tax for non-corporate shareholders receiving a dividend from \$100 of corporate earnings not subject to any tax preferences. Although important as a baseline, this equivalence among the integration models is misleading, and it breaks down once the analysis accounts for relevant tax differences among corporations and among shareholders.

Table 3
General Equivalence of Integration Models

| | Double Tax (current law) | Shareholder Allocation | Mark to Market | Dividend Deduction | Split Rate | Dividend Exclusion | Imputation Credit | Comprehensive Business Income Tax |
|---------------------------------|--------------------------------|---------------------------|----------------------|-----------------------|---------------|-----------------------|----------------------|---|
| Corporate Income | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Corporate Tax | 35 | 35 | 0 | 0 | 0 | 35 | 35 | 35 |
| Dividend Distribution | 65 | 0 | 0 | 100 | 100 | 65 | 65 | 65 |
| Shareholder Income | 65 | 100 | 100 | 100 | 100 | 0 | 100 | 0 |
| Shareholder Tax | 22.75 | 35 | 35 | 35 | 35 | 0 | 35 | 0 |
| Shareholder Credit | 0 | 35 | 0 | 0 | 0 | 0 | 35 | 0 |
| Total Taxes (both levels) | 57.75 | 35 | 35 | 35 | 35 | 35 | 35 | 35 |
| Net to Shareholder | 42.25 | 65 | 65 | 65 | 65 | 65 | 65 | 65 |

Assumptions: Corporate tax rate is 35% (but 0% under shareholder-allocation and mark-to-market methods and for income distributed as dividends under split-rate method); individual tax rate is 35%; no portion of the \$100 constitutes preference income. Additionally, both the time value of money and any benefits of deferring dividends are ignored.

a. Differential Effects at the Corporate Level

Integration models have differing effects on high-tax and low-tax corporations. As explained above, variance in corporate effective tax rates follows from different utilizations of corporate tax preferences, debt financing, and tax shelters. Certain integration models narrow that variance, but others do not. Managers of low-tax corporations rationally may support integration proposals that would not even out effective tax rates but oppose integration proposals that would; managers of high-tax corporations rationally may line up the other way.

Consider how different integration models would affect corporate tax preferences, a principal source of unevenness in corporate effective tax rates. The basic question here is whether integration should pass the benefit of a corporate tax preference through to shareholders. Perfectly sound policy arguments have been made on both sides. If the object of integration is to treat shareholders as though they had earned the corporation's business income directly, preferences should pass through,¹³⁶ if instead the object is to tax corporate business profits exactly once, preferences should not pass through.¹³⁷ The point could even be resolved on a preference-by-preference basis.¹³⁸

Different integration models imply different outcomes for corporate tax preferences. The dividend-deduction model does not

¹³⁶ Warren ALI Integration Study, *supra* note 40, at 59; Warren, *supra* note 7, at 777–78.

¹³⁷ Treasury Integration Report, *supra* note 40, at 64; Warren ALI Integration Study, *supra* note 40, at 60; Warren, *supra* note 7, at 778.

¹³⁸ See Warren ALI Integration Study, *supra* note 40, at 63–64, 108–12. For a discussion of how other tax systems have addressed the problem of tax preferences and integration, see generally Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items under an Integrated Tax System: A Comparative Analysis*, 44 *Tax Law* 195 (1990).

pass through preferences.¹³⁹ By contrast, the shareholder-allocation integration model strongly implies that pass-through is appropriate because the model is premised on the idea that shareholders should be treated as standing in the place of the corporation.¹⁴⁰ The mark-to-market model—which is conceptually similar to the shareholder-allocation model—eliminates the need to calculate taxable income at the corporate level. In turn, that eliminates the calculation of corporate tax preferences.¹⁴¹ Other models are more flexible. Allowing shareholders to exclude all dividends under the dividend-exclusion model passes corporate-level tax preferences through to shareholders;¹⁴² not allowing an exclusion for dividends attributable to income not taxed at the corporate level has the opposite effect.¹⁴³

Table 4 illustrates the significance of the pass-through question. Under the double tax, a corporation with \$100 of business profits that can be excluded at the corporate level by reason of a tax preference pays no corporate-level tax; the corporation distributes the entire \$100 to its shareholder who nets \$65 after paying the shareholder-level tax of \$35 (see Column B). By contrast, a corporation with \$100 of non-preference (fully taxable) income distributes an after-tax amount of only \$65, netting \$42.25 to the shareholder (see Column A). The corporation with preference income provides a higher after-tax return to its shareholder than does the corporation with non-preference income. That advantage is maintained under

¹³⁹ Treasury Integration Report, *supra* note 40, at 186.

¹⁴⁰ *Id.* at 30. Also, it might not even be practicable under this model not to pass preferences through. In the Treasury Integration Report, the Treasury Department noted that attempts to prevent pass-through of preferences under this method were “difficult and inconsistent with the passthrough nature” of shareholder allocation. *Id.*

¹⁴¹ Dodge, *supra* note 40, at 303–04. Although it would be possible under the mark-to-market model to track corporate taxable income so that preferences could be passed through to shareholders, doing so would leave little reason to consider the model as a distinct form of integration.

¹⁴² See Treasury Integration Report, *supra* note 40, at 17–19, 64, 186. Thus, if a corporation earns \$100 of profits that it can exclude from its income by reason of a tax preference and then distributes that \$100 to its shareholders, exclusion of the \$100 dividend by the shareholders results in no taxation of those profits at either the corporate or shareholder level.

¹⁴³ The imputation-credit method also can be used to pass through, or not pass through, tax preferences. See Warren, *supra* note 7, at 778–84; Treasury Option Papers, *supra* note 40, at 49 (describing proposal for imputation-credit integration that would pass investment tax credit through to shareholders).

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integration (shown in Table 4 using the dividend-exclusion method) as long as preferences are passed through. With pass-through, the corporation with \$100 of preference income returns a net of \$100 to its shareholder (see Column D), but the corporation with no preference income returns a net of only \$65 to its shareholder (see Column C). Without pass-through, both corporations return only \$65 to their shareholders (see Columns F and E). Thus, passing preferences through under integration preserves the *relative* advantage of the corporation with preference income; that corporation continues to provide a higher rate of return to its shareholder than a corporation with non-preference income and, accordingly, continues to benefit from a lower cost of capital. Not passing preferences through fundamentally alters the relative positions of the two corporations.

Table 4
Effects of Pass-Through of Corporate Tax Preferences

| | A | B | C | D | E | F |
|--------------------------------|---------------------------------------|------------------------------------|--|---|---|--|
| | Double Tax (Current Law) | Double Tax (Current Law) | Dividend Exclusion | Dividend Exclusion | Dividend Exclusion | Dividend Exclusion |
| | Corporation with No Preference Income | Corporation with Preference Income | Pass-Through Corporation with No Preference Income | Pass-Through Corporation with Preference Income | No Pass-Through Corporation with No Preference Income | No Pass-Through Corporation with Preference Income |
| Corporate Income (Preference) | 0 | 100 | 0 | 100 | 0 | 100 |
| Corporate Tax (Non-Preference) | 100 | 0 | 100 | 0 | 100 | 0 |
| Corporate Tax | 35 | 0 | 35 | 0 | 35 | 0 |
| Dividend | 65 | 100 | 65 | 100 | 65 | 100 |
| Shareholder Income | 65 | 100 | 0 | 0 | 0 | 100 |
| Shareholder Tax | 22.75 | 35 | 0 | 0 | 0 | 35 |
| Total Taxes | 57.75 | 35 | 35 | 0 | 35 | 35 |
| Net to Shareholder | 42.25 | 65 | 65 | 100 | 65 | 65 |

Assumptions: Corporate tax rate is 35%; individual tax rate is 35%; preference income is entirely excludable; all shareholders are individuals.

The treatment of tax preferences under integration should present a genuine concern for managers. All else equal, corporations with greater utilization of corporate tax preferences have lower effective tax rates; all else equal, corporations with lower effective

tax rates have lower costs of capital. Passing through corporate tax preferences under integration maintains these uneven results; that should make integration attractive to managers of low-tax corporations and unattractive to managers of high-tax corporations. Not passing preferences through evens out the results; that should appeal to managers of high-tax corporations (especially to those who have tried unsuccessfully to secure tax preferences through the legislative process) but not to managers of low-tax corporations. If a particular legislative proposal were pre-committed on the pass-through question—for example, if it were a proposal under the shareholder-allocation model, which automatically passes preferences through to shareholders—that point alone might divide managers. If instead the proposal put the pass-through question in play—for example, if it were a proposal under the imputation-credit model, which readily accommodates passing or not passing preferences through to shareholders—the lobbying decisions of managers might be more complex and might lead to contingent support or opposition. It is not plausible, however, that managers of corporations that are relative winners or losers under the corporate double tax would be indifferent to how integration would affect their effective tax rates relative to the effective tax rates of other companies with which they must compete for equity capital.

As the agency-cost explanation argues, different managers may have different dispositions toward the retained-earnings trap. Although the various integration models generally would remove the trap, certain models would simply remove the bias in favor of retaining earnings while others would create a new bias in favor of distributing earnings. The latter possibility is particularly likely in the case of models that condition integration on the distribution of earnings, such as the dividend-deduction, split-rate, dividend-exclusion, and imputation-credit models. By contrast, the shareholder-allocation and mark-to-market models would eliminate the double tax without regard to whether the corporation distributes profits. This difference potentially splits the interests of managers: the managers of corporations that pay regular dividends should prefer the distribution-dependent models over the other models; managers of corporations that retain their profits should (as the agency-cost explanation argues) oppose integration or, perhaps as

a fallback, support integration only if it does not require distributions. To complicate the issue, the distribution-dependent integration models generally can be modified to extend the benefits of integration to retained earnings through a dividend reinvestment plan (“DRIP”).¹⁴⁴ In the case of the dividend-exclusion model, for example, a DRIP would allow the shareholder of a corporation that retains its earnings to increase her basis, thereby reducing her gain when she sells her stock.¹⁴⁵ That removes the bias in favor of distributing earnings, although it does not restore the bias in favor of retaining earnings. Thus, the different integration models—and variations on the different integration models—likely will appeal differently to managers of corporations that distribute earnings and managers of corporations that retain earnings.

In combination, these considerations may present managers with complex decisions about whether to lobby on a particular integration proposal and, if so, what position to take. The anticipated consequences for effective tax rates, the treatment of corporate tax preferences, and the possibility of a bias for the distribution of earnings should be of concern to managers, but those factors may differ significantly from one specific proposal to another and, within the four corners of any one proposal, may be subject to modification during the legislative process. No doubt, managers must also consider the likely responses of other managers. If a manager of a low-tax, earnings-retaining corporation generally would prefer that there not be integration, her decision about whether or how to lobby may be affected by her expectations about the lobbying decisions of managers at high-tax, dividend-paying companies.

Finally, different integration models would also have different effects on manager-side collateral interests; that, in turn, could cause such collateral interests to support integration under certain models but to oppose it under others. Consider, for example, a collateral interest (such as a trade association for producers of alternative energy) that sells goods or services to corporations for which the corporations can claim a tax credit (such as a credit for invest-

¹⁴⁴ Treasury Integration Report, *supra* note 40, at 24, 87–88; see also Warren ALI Integration Study, *supra* note 40, at 116–17 (describing constructive dividend options).

¹⁴⁵ Treasury Integration Report, *supra* note 40, at 83, 87–88.

ments in alternative energy). It should matter greatly to that collateral interest whether the terms of a particular integration proposal preserve the value of the corporate-level credit. Integration under the mark-to-market model eliminates the calculation of corporate-level taxes and thus nullifies the value of the credit. The collateral interest should strongly oppose mark-to-market integration. By contrast, the shareholder-allocation model passes corporate tax preferences through to shareholders, allowing shareholders to claim those preferences directly for tax purposes. The collateral interest should strongly support integration on these terms. Depending on policy decisions, other models—such as the imputation-credit model—may pass corporate tax preferences through, and, if they do, may pass them through in whole or only in part. The lobbying decision of the collateral interest plainly should include the effect that the particular integration proposal would have on the credit.

b. Differential Effects at the Shareholder Level

Different integration models also have different effects at the shareholder level. The most prominent example is the treatment of shareholders that are exempt from federal income tax. Because tax-exempt shareholders own at least 25% of outstanding corporate equity,¹⁴⁶ they may have a strong desire to lobby on integration. For these shareholders, there are two relevant considerations: whether a particular integration proposal would increase or decrease the absolute tax burden on their stock investments; and whether a particular integration proposal would increase or decrease that tax burden relative to the tax burden on stock investments made by taxable shareholders.

Table 5 illustrates these points. Corporate non-preference income distributed to tax-exempt shareholders currently bears only the corporate-level tax, and corporate preference income distributed to tax-exempt shareholders currently bears no tax at all (see Column A). By contrast, corporate non-preference income distributed to taxable shareholders currently bears the double tax, and corporate preference income distributed to taxable shareholders

¹⁴⁶ See *supra* Subsection I.C.2.

currently bears the shareholder-level tax (see Column B). An integration model that eliminates the corporate-level tax—such as the dividend-deduction model—eliminates altogether the tax burden for dividends paid to tax-exempt shareholders when corporate non-preference income is distributed to these shareholders (see Column C).¹⁴⁷ However, the elimination of the corporate-level tax leaves unchanged the position of tax-exempt shareholders relative to the position of taxable shareholders (see Column D).¹⁴⁸ All else equal, tax-exempt shareholders could be expected to favor integration on those terms because it would leave those shareholders no worse off on either an absolute or a relative basis.

By contrast, an integration model that eliminates the shareholder-level tax—such as the dividend-exclusion method—makes tax-exempt shareholders worse off relative to taxable shareholders. Removal of the shareholder-level tax does not change the absolute treatment of tax-exempt shareholders (compare Column E to Column A).¹⁴⁹ It does, however, improve the treatment of taxable shareholders relative to the double tax (compare Column F to Column B). Therefore, it also improves the treatment of taxable shareholders relative to tax-exempt shareholders.¹⁵⁰ Many tax-exempt shareholders, such as tax-qualified retirement plans and variable annuities sold by life insurance companies, are themselves investment vehicles for taxable shareholders. Undoing the *relative* tax advantage for these tax-exempt shareholders may impair their ability to attract and retain investments. All else equal, these tax-exempt shareholders could be expected to oppose integration under models that remove the shareholder-level tax, just as they could be expected to support integration that removes the corporate-level tax.¹⁵¹

¹⁴⁷ See Treasury Integration Report, *supra* note 40, at 70, 107, 186–87; Warren ALI Integration Study, *supra* note 40, at 161; Warren, *supra* note 7, at 774, 787–88.

¹⁴⁸ Treasury Integration Report, *supra* note 40, at 187.

¹⁴⁹ *Id.* at 17, 70, 186.

¹⁵⁰ See Warren ALI Integration Study, *supra* note 40, at 161–62.

¹⁵¹ The agency-cost explanation argues that removing the shareholder-tax provides “little benefit” to tax-exempt shareholders. Arlen & Weiss, *supra* note 7, at 363–64 n.155. But that does not really capture the effect from the perspective of these shareholders: it is not simply that eliminating the shareholder-level tax leaves their *absolute* tax position unchanged, it is that eliminating the shareholder-level tax makes their *relative* tax position considerably worse.

Table 5
Comparison of Tax-Exempt and Taxable Shareholders under
Double Tax and Integration

| | A | B | C | D | E | F |
|---|---|--|--|---|--|---|
| | Double Tax Tax-Exempt Shareholder | Double Tax Taxable Shareholder | Dividend Deduction Tax-Exempt Shareholder | Dividend Deduction Taxable Shareholder | Dividend Exclusion Tax-Exempt Shareholder | Dividend Exclusion Taxable Shareholder |
| Business Profits Not Subject to Corporate Tax Preference | Corporate- Level Tax | Double Tax | No Tax | Shareholder- Level Tax | Corporate- Level Tax | Corporate- Level Tax |
| Business Profits Subject to Corporate Tax Preference | No Tax | Shareholder- Level Tax | No Tax | Shareholder- Level Tax | No Tax | Shareholder- Level Tax |

Assumptions: Preference income is entirely excludable; preferences do not pass through to shareholders; all shareholders are individuals.

Under other integration models, the outcomes for tax-exempt shareholders depend on a further policy decision about whether to make shareholder-level credits fully or partially refundable. Both the shareholder-allocation and the imputation-credit models, for example, retain the corporate-level tax but give shareholders a credit for the taxes paid by the corporation. Tax-exempt shareholders benefit from the credit only if it is refundable. A fully refundable credit under these models replicates the effects of eliminating the corporate-level tax: dividends paid to taxable shareholders bear the corporate-level tax, but dividends paid to tax-exempt shareholders bear neither the corporate-level nor

shareholder-level tax.¹⁵² A nonrefundable credit replicates the effects of eliminating the shareholder-level tax: dividends paid to taxable and tax-exempt shareholders both bear the corporate-level tax.¹⁵³ Partially refundable credits produce results between these extremes. The interests and lobbying positions of tax-exempt shareholders under these types of integration models should be strongly affected by the prospects that the shareholder-level credit will be made refundable in whole or in part.

The same point can be generalized for rate differences among taxable shareholders.¹⁵⁴ Individual shareholders pay tax at different tax rates, and their tax rates need not line up with the corporate tax rate. The variance in tax rates implies that different integration models produce different outcomes among individual shareholders. Integration models that eliminate the corporate-level tax subject corporate profits to the various shareholder rates, whereas integration models that eliminate the shareholder-level tax subject corporate profits to the uniform corporate rate.¹⁵⁵ And integration models that convert the corporate-level tax into a withholding mechanism for the shareholder-level tax subject corporate profits either to shareholder rates if the shareholder-level credit is refundable or to the corporate rate if the credit is nonrefundable.¹⁵⁶ This implies that different individual shareholders may take different positions on integration. Higher-income shareholders may prefer, all else equal, the elimination of the shareholder-level tax when (as has ordinarily been the case but is not the case now) individual rates exceed the corporate rate. Lower-income shareholders may prefer, all else equal, the elimination of the corporate-level tax; in this respect, the interests of lower-income shareholders should align with those of tax-exempt shareholders.¹⁵⁷

¹⁵² Treasury Integration Report, *supra* note 40, at 93, 187.

¹⁵³ *Id.* at 93, 95, 103, 187; Warren ALI Integration Study, *supra* note 40, at 164–66; Warren, *supra* note 7, at 774.

¹⁵⁴ See Treasury Integration Report, *supra* note 40, at 185–86.

¹⁵⁵ See *id.* at 185; Warren ALI Integration Study, *supra* note 40, at 10.

¹⁵⁶ See Treasury Integration Report, *supra* note 40, at 185–86.

¹⁵⁷ Although different integration models may also have differential effects on foreign shareholders, it seems unlikely that such shareholders generally would wield substantial lobbying influence in Congress. It may be, however, that integration models that subject corporate business profits to taxation at shareholder rates would reduce the use of corporate tax shelters. See generally Mark P. Gergen, *How Corporate In-*

Different integration models also may affect collateral interests on the shareholder side differently. Consider two trade associations: one that represents service providers for tax-qualified retirement plans and one that represents brokerage firms. A proposal for integration that eliminates the shareholder-level tax—such as the dividend-exclusion model—could be expected to cause individuals to shift investments away from tax-qualified plans. That should draw the opposition of the trade association representing plan service providers and the support of the trade association representing brokerage firms. By contrast, an integration proposal that eliminates the corporate-level tax without affecting the shareholder-level tax might not draw the strong support or opposition of either trade association.

c. Differential Transition Effects

Legislative proposals to integrate the corporate and individual income taxes present transition issues, and the resolution of those issues may have varied effects on different managers, different shareholders, and different collateral interests.¹⁵⁸ The agency-cost explanation generally assumes that integration would apply to all corporate equity, producing a windfall increase in the value of shares held at the time of enactment.¹⁵⁹ But that assumes away much of the complexity that transition issues present in the tax legislative process.

It is certainly possible that integration legislation would not grandfather stock investments made before enactment, thereby

egration Could Kill the Market for Corporate Tax Shelters, 61 Tax L. Rev. 145 (2008).

¹⁵⁸ See generally Treasury Integration Report, *supra* note 40, at 89–92; Daniel Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* 158–70 (2000) (analysis of potential transition issues under corporate integration).

¹⁵⁹ Arlen & Weiss, *supra* note 7, at 338. There are, of course, other possible transition effects. Holders of other financial instruments—such as corporate bonds—may suffer a windfall loss if investors respond to integration by selling bonds in order to buy stock. McLure & Surrey, *supra* note 78, at 178. And holders of stock in corporations that make extensive use of tax preferences may suffer a windfall loss if integration does not pass corporate tax preferences through to shareholders. Warren, *supra* note 7, at 778.

conferring the potential windfall transition gain that the agency-cost explanation assumes.¹⁶⁰ That outcome, however, is not inevitable. If integration were to grandfather existing stock investments, shareholders would not experience any windfall gain.¹⁶¹ Alternatively, integration could include a one-time tax on any windfall gains.¹⁶² That may encourage managers to favor integration and shareholders to be indifferent to integration (assuming this part of the agency-cost explanation were otherwise correct). And, of course, the plasticity of transition treatment allows legislators to buy off manager or shareholder interests otherwise opposed to integration. For example, an integration proposal that provokes opposition from tax-exempt shareholders because it eliminates the shareholder-level tax might become more attractive (or at least less objectionable) to those shareholders if they were promised a substantial windfall transition gain. Or the absence of a windfall transition gain for taxable shareholders might be softened, for example, by a decision to pass corporate tax preferences through to them. Similar adjustments could make integration more or less appealing to managers as well.

The transition issues are still more nuanced. Congress often mitigates transition gains and transition losses by delaying new rules, phasing them in over time, or grandfathering only select investments held by specified taxpayers.¹⁶³ Any combination of those policy instruments would be available for integration legislation.

¹⁶⁰ See Warren ALI Integration Study, *supra* note 40, at 205–07. An effective date that does not distinguish between existing stock investments and new investments may cause the market value of existing investments to increase if the pre-enactment market value of the investments incorporates a discount for the double tax. As indicated above, however, there is debate on that point. Thus, whether there would be such windfall transition gains and, if so, how large those gains would be, remains uncertain. See Treasury Integration Report, *supra* note 40, at 223 n.2.

¹⁶¹ See Andrews ALI Supplemental Study, *supra* note 40, at 89–97. Cf. Treasury Integration Report, *supra* note 40, at 90 (considering and rejecting grandfathering of existing stock investments as mechanism for eliminating windfall transition gains).

¹⁶² See, e.g., Alan J. Auerbach, *Debt, Equity, and the Taxation of Corporate Cash Flows*, in *Debt, Taxes, and Corporate Restructuring* 91, 115 (John B. Shoven & Joel Waldfogel eds., 1990).

¹⁶³ Shavito, *supra* note 158, at 216–17; see also Treasury Integration Report, *supra* note 40, at 90 (recommending phase-in for integration in general and describing phase-in for the dividend-exclusion model); Warren ALI Integration Study, *supra* note 40, at 209–11 (recommending and describing phase-in for the imputation-credit model).

Congress could give tailored transition gains and losses to particular interests: it might, for example, want to allow the pass-through of certain tax preferences held by some corporations but deny pass-through in all other cases; it might want to give a windfall gain to existing investments held by certain taxable shareholders but not to existing investments held by other taxable shareholders or by tax-exempt shareholders; or it might want to treat all owners of existing investments the same but allow only a partial windfall in all cases. The precise terms of the transition treatment under integration are, if anything, more likely to be determined by the lobbying positions of affected parties than they are to be determinants of those positions. Legislators who favor or oppose integration will use transition relief as currency for buying and selling support for the legislation.¹⁶⁴

In short, one cannot assume that straightforward and predetermined transition effects will drive the lobbying positions of either managers or shareholders on integration. It may be that integration legislation would confer windfall gains on shareholders with existing stock investments, but grandfathering and other transition mechanisms could eliminate or reduce those gains. Congress can calibrate transition gains and losses with considerable precision, effectively hand-picking transition winners and losers in order to secure support for pending integration legislation. Most importantly, the anticipated transition effects may be markedly uneven among managers, among shareholders, and among collateral interests, resulting in various lobbying positions within these groups.

II. EVIDENCE FROM THE BUSH ADMINISTRATION'S DIVIDEND-EXCLUSION PROPOSAL

The recent effort by President George W. Bush to integrate the corporate and individual income taxes illustrates how the heterogeneous interests of managers, shareholders, and third parties contribute to the stubborn persistence of the corporate double tax. In 2003, President Bush proposed integration under the dividend-

¹⁶⁴ See, e.g., Martin, *supra* note 79, at 94 (describing a change to the effective date of suspension of investment tax credit made specifically to accommodate Trans World Airlines).

exclusion model. The proposal set off furious lobbying activity among potential winners and losers, and Congress ultimately rejected outright integration in favor of reducing the tax rate on dividends.¹⁶⁵ Consistent with the heterogeneity analysis outlined above, managers divided sharply on the proposal; so too did shareholders. Additionally, the proposal elicited both support and opposition from collateral interests that had much to win or lose under the specific integration terms setting out the dividend exclusion. In short, the evidence from the Bush administration's dividend-exclusion proposal reveals a complex and nuanced story of political interests and political positioning, with certain managers, shareholders, and third parties giving strong support and other managers, shareholders, and third parties presenting strong opposition. The complex interests put into play by the proposal simply cannot be reduced to a single dimension (such as a divergence between manager interests and shareholder interests, as suggested by the agency-cost explanation).¹⁶⁶

A. The Divided-Exclusion Proposal

The Bush administration's dividend-exclusion proposal was a reasonably straightforward integration plan.¹⁶⁷ President Bush announced the proposal in early January 2003¹⁶⁸ and he submitted it to Congress in February 2003¹⁶⁹ with a pledge that the proposal would tax corporate profits "once and only once."¹⁷⁰ The proposal included two mechanisms for eliminating the shareholder-level tax

¹⁶⁵ As described in Section I.A, *supra*, the Jobs and Growth Act made dividends generally taxable at (lower) capital-gains rates rather than (higher) ordinary-income rates; the capital-gains rates apply through 2010.

¹⁶⁶ The author was an attorney in the Office of Tax Policy at the U.S. Treasury Department throughout the pendency of the dividend-exclusion proposal. The analysis of the political activity described in this Part (II) is based on documents in the public record, interviews with former government officials in the executive and legislative branches, and the author's own experience with the dividend-exclusion proposal and the lobbying positions that it generated.

¹⁶⁷ The description of the proposal set forth here omits certain technical details. For a full description, see Treasury 2003 Bluebook, *supra* note 10, at 11–22, and Staff of Joint Comm. on Taxation, 108th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal 18–33 (Comm. Print 2003).

¹⁶⁸ Press Release, The White House, *supra* note 9.

¹⁶⁹ See Treasury 2003 Bluebook, *supra* note 10, at 11–22.

¹⁷⁰ *Id.* at 12.

on corporate profits: a shareholder dividend exclusion for distributed profits, and a shareholder basis adjustment for retained profits. Any corporate profits taxed at the corporate level and then distributed as dividends would be excludable from shareholder income.¹⁷¹ For example, a corporation that earned \$100 of taxable income and paid \$35 in tax could distribute \$65 to its shareholders as an excludable dividend.¹⁷² Any corporate profits taxed at the corporate level and then retained by the corporation would increase the shareholders' basis in their stock; that, in turn, would decrease any taxable gain realized by the shareholders upon sale of the stock.¹⁷³ For example, the shareholders of a corporation that earned \$100 of taxable income, paid \$35 in tax, and retained the \$65 after-tax amount would increase their stock basis by \$65. On a subsequent sale of their stock, the basis increase would reduce the shareholders' taxable gain by \$65.¹⁷⁴ This basis adjustment effectively would allow a corporation's shareholders to obtain a tax benefit for the retained earnings.¹⁷⁵

Several features of the proposal deserve note. First, because the proposal did not condition integration on the actual distribution of corporate profits, it would have removed the bias in favor of retaining profits without creating a bias in favor of distributing profits. Second, the proposal did condition integration on the payment of corporate-level tax: shareholders of a corporation that successfully sheltered its profits from corporate-level tax would get neither a dividend exclusion nor a basis adjustment for the sheltered profits. Third, the proposal potentially reduced the value of corporate

¹⁷¹ *Id.*

¹⁷² The proposal required each corporation to track an "excludable dividend amount" ("EDA") to determine the portion of its profits for a year that had been taxed and, as such, could be distributed to shareholders tax-free. *Id.* at 12–14.

¹⁷³ *Id.* at 12, 19.

¹⁷⁴ Any EDA not distributed to shareholders during a year would be credited to the corporation's "retained earnings basis adjustments." *Id.* at 14–15.

¹⁷⁵ To put it another way, the basis adjustment ensured that shareholders would not be taxable on the appreciation of their stock attributable to profits that had been taxed at the corporate level. *Id.* at 19. A third way to put the point is that the basis adjustment had the effect of a DRIP. See *supra* notes 144–145 and accompanying text. But see Yin, *supra* note 124, at 470–71 (arguing that DRIPs may not achieve full equivalence for taxation of distributed and retained earnings under the dividend-exclusion model).

tax preferences because utilization of those preferences would reduce the shareholder-level excludable dividends and basis adjustments.¹⁷⁶ Fourth, the proposal did not change the tax treatment of shareholders that themselves were exempt from tax.¹⁷⁷ Finally, the effective date of the proposal would have applied the new rules to distributions and basis adjustments made after 2002 with respect to corporate taxes paid for taxable years ending on or after April 1, 2001.¹⁷⁸ In other words, the proposal would have applied integration to amounts already invested in corporate stock at the time of enactment.

B. Lobbying Positions of Managers and Collateral Interests

Consistent with the heterogeneity analysis set forth in Part I, corporate managers lined up on both sides of the dividend-exclusion proposal. Influential lobbying groups representing managers pushed the Bush administration to make the proposal in the first place and then dedicated substantial resources to promoting it in Congress. But other managers opposed the proposal. Part of that opposition stemmed from concerns about shareholder pressure to distribute earnings, and part was driven by concerns about protecting tax preferences. However, the strongest opposition on the management side came from non-manager third parties: collateral interests—specifically, those selling tax-preferenced investments to corporations—raised serious concerns about the effects of the proposal on their industries. Those concerns clearly resonated with legislators.¹⁷⁹

¹⁷⁶ See Staff of Joint Comm. on Taxation, *supra* note 167, at 30–31.

¹⁷⁷ See Treasury 2003 Bluebook, *supra* note 10, at 21. Certain private foundations, otherwise exempt from tax, pay a small tax on their investment income. See I.R.C. § 4940 (West 2008). The proposal would have extended the shareholder-level benefits to those foundations. Treasury 2003 Bluebook, *supra* note 10, at 21.

¹⁷⁸ Staff of Joint Comm. on Taxation, *supra* note 167, at 27. See also President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 78–79 (2003) (question-and-answer between Rep. E. Clay Shaw, Jr. and William Gale of the Brookings Institute).

¹⁷⁹ The agency-cost explanation did not predict many of these manager positions and it did not account for the existence and influence of collateral interests on the management side. The agency-cost explanation predicted that managers would adopt one of two positions in response to integration proposals. The larger group of managers would show “diffidence” toward integration. Although these managers are not hostile to integration, they regard it largely as a windfall for existing investments, and they

Managers generally showed strong support for the dividend-exclusion proposal both directly and through their lobbying groups.¹⁸⁰ Perhaps no group was as influential as The Business Roundtable (“BRT”), an association of chief executive officers. The BRT claimed credit for having urged the Bush administration to make an integration proposal.¹⁸¹ Once President Bush released his dividend-exclusion proposal, the BRT expressed unqualified support for it on Capitol Hill¹⁸² and in press

prefer tax subsidies for new investments. Because the dividend-exclusion proposal applied to existing stock investments, the agency-cost explanation predicted that managers would show unenthusiastic support for the proposal. The smaller group of managers is hostile to integration because it undermines the retained-earnings trap. The dividend-exclusion proposal generally equalized the tax treatment of distributed and retained earnings, so the agency-cost explanation predicted opposition from this group. Interestingly, the agency-cost explanation specifically predicted that managers benefitting from the retained-earnings trap could be mollified by an integration proposal that does not pass corporate tax preferences through to shareholders and that includes a DRIP. As demonstrated below, the inclusion of a DRIP in the dividend-exclusion proposal does appear to have deflected arguments that the proposal would force managers to distribute earnings. The fact, however, that the proposal did not provide for the pass-through of corporate tax preferences provoked strong opposition from both managers and influential collateral interests.

¹⁸⁰ A red-herring issue should be addressed up front. While the dividend-exclusion proposal was pending, the press reported that the White House was pressuring lobbyists to support the proposal. See, e.g., Laurence McQuillan, *Investors Targeted in Tax-Cut Push*, USA Today, Mar. 4, 2003, at 1A; Patti Mohr & Warren Rojas, *Treasury to Extend Benefit of Dividend Exclusion to Annuities*, Snow Says, Tax Notes Today, Mar. 5, 2003, LEXIS, 2003 TNT 43-1; Jonathan Weisman & Mike Allen, *Bush Seeks to Enlist Economists’ Support*, Wash. Post, Jan. 22, 2003, at A7; Jonathan Weisman, *Bush Wins Business Support for Growth Plan*, Wash. Post, Feb. 20, 2003, at E1, E14 [hereinafter Weisman, *Bush Wins Business Support*]; Jonathan Weisman, *White House Intensifies Push for Tax Plan*, Wash. Post, Jan. 16, 2003, at E1, E7 [hereinafter Weisman, *White House Intensifies Push*]. It would be a mistake, however, to infer from those reports that the support provided for the proposal by managers was not sincere. See Interview with Hon. Pamela F. Olson, former Assistant Treasury Sec’y, Tax Policy, in Wash., D.C. (Sept. 22, 2008); Interview with Robert Winters, former Chief Tax Counsel of the House Ways & Means Comm., in Wash., D.C. (Sept. 22, 2008).

¹⁸¹ Press Release, *The Business Roundtable, The Business Roundtable Releases Study Showing Positive GDP and Job Growth Impact of President’s Economic Package* (Jan. 30, 2003) (“Last November, the CEOs of The Business Roundtable called for enactment of a significant economic growth package that included eliminating the double taxation of dividends for individuals.”).

¹⁸² *President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 62* (2003) (statement of John J. Castellani, President of The Business Roundtable) [hereinafter Castellani, *Ways & Means*].

statements.¹⁸³ The BRT assured Congress that the Administration's legislative package would "provide[] exactly the kind of boost our economy needs" and that the "dividend component of the plan will have the single most positive impact on economic growth in both the short term and the long term."¹⁸⁴ The group emphasized that it was "preparing to reach into its deep pockets to fund a diverse lobbying, advertising and grassroots campaign"; it considered the dividend-exclusion proposal to be as important as free-trade legislation.¹⁸⁵

Other corporate lobbying groups did not want to be left off the bandwagon. The Tax Relief Coalition ("TRC"), an umbrella group of more than 1,000 lobbying organizations that collectively represented more than 1.8 million businesses, formed a task force "to launch a concerted campaign to promote the economic benefits of [the] dividend proposal."¹⁸⁶ The American Forest & Paper Association "strongly support[ed]" the dividend-exclusion proposal to address the high effective tax rates on corporate forestry operations and paper manufacturing.¹⁸⁷ The U.S. Chamber of Commerce called the dividend-exclusion proposal "important" and argued that "[w]hile the direct benefits go to stockholders, indirect benefits will accrue to the entire economy."¹⁸⁸ The National Association of Manufacturers ("NAM") "strongly support[ed]" the Administration's legislative package and argued that "[t]he dividends-exclusion proposal is particularly important to manufacturers."¹⁸⁹

¹⁸³ Janet Hook, *Bush Plan to End Dividend Tax in for Changes*, L.A. Times, Feb. 2, 2003, at A30.

¹⁸⁴ Castellani, *Ways & Means*, supra note 182, at 63–64.

¹⁸⁵ BRT Prepared to Dig Deep in Support of Bush Tax Plan, Nat'l J.'s Congress-Daily, Apr. 25, 2003 [hereinafter BRT Prepared to Dig Deep].

¹⁸⁶ Patti Mohr & Warren Rojas, *Interest Groups Line Up on All Sides of Debate on Bush's Tax Cut*, Tax Notes Today, Mar. 4, 2003, LEXIS, 2003 TNT 42-1; see also Weisman, *Bush Wins Business Support*, supra note 180, at E1; Weisman, *White House Intensifies Push*, supra note 180, at E1.

¹⁸⁷ *President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means*, 108th Cong. 240 (2003) (statement of the American Forest & Paper Association).

¹⁸⁸ *President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means*, 108th Cong. 338 (2003) (statement of the U.S. Chamber of Commerce).

¹⁸⁹ *President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means*, 108th Cong. 308–09 (2003) (statement of Michael E. Baroody, National Association of Manufacturers).

Managers of individual companies also spoke publicly in favor of the proposal.¹⁹⁰

Interestingly, the BRT identified the expected windfall to existing investments as a reason for *supporting* the dividend-exclusion proposal.¹⁹¹ Several managers even asked that the anticipated windfall be enlarged.¹⁹² It may be that, on this point, managers were particularly mindful of their own status as shareholders; any rise in the values of existing shares would both increase the value of their own stock holdings and increase the value of their unexercised stock options.¹⁹³ In fact, it may well be that it was precisely this expected windfall for existing equity investments that drove the ardent sup-

¹⁹⁰ See Ariana Eunjung Cha, Companies Mobilize to Save Bush Plan to Scrap Dividend Tax, Wash. Post, Mar. 27, 2003, at E1, E5; Weisman, White House Intensifies Push, *supra* note 180, at E1; Verizon, Other Firms Rally Behind Bush's Tax-Cut Plan, Nat'l J.'s Technology Daily, Feb. 20, 2003. For additional statements of managers in favor of the proposal, see, e.g., Letter from Robert L. Nardelli, Chairman, President, and Chief Executive Officer of The Home Depot, to John Snow, Treasury Sec'y (Feb. 7, 2003), *reprinted in* Tax Notes Today, Feb. 27, 2003, LEXIS, 2003 TNT 39-170.

¹⁹¹ See Castellani, Ways & Means, *supra* note 182, at 62, 64 (supporting the proposal because of its ability to increase the value of existing equity); see also Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 38-39 (2003) (statement of John J. Castellani, President of The Business Roundtable) (same). This, of course, contrasts with the argument of the agency-cost explanation that the potential windfall for existing investments makes managers diffident with respect to integration and that "[m]ost managers . . . should support" an integration proposal that would "minimize windfalls by implementing integration in stages." Arlen & Weiss, *supra* note 7, at 365.

¹⁹² After the dividend exclusion was proposed, the Bush administration agreed to modify it to treat income sheltered by certain alternative minimum tax credits as eligible for tax-free distributions. Jonathan Weisman, GOP Aides Revise Bill to Help Big Firms, Wash. Post, Mar. 1, 2003, at E1 [hereinafter Weisman, GOP Aides Revise Bill]. This enlarged the potential integration windfall (assuming such a windfall would result) for existing shares of "such blue-chip giants as International Business Machines Corp., Ford Motor Co. and General Electric Co." *Id.* The change apparently was met with the approval of management at Ford Motor Co.; in May 2003, the company's chief executive officer published commentary supporting the dividend-exclusion proposal. Bill Ford, Op-Ed., Accelerate the Recovery, Wall St. J., May 13, 2003, at A18. The Edison Electric Institute sought to enlarge the anticipated windfall through the treatment of income sheltered by other tax credits as eligible for tax-free distributions. President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 258 (2003) (statement of Edison Electric Institute).

¹⁹³ Ben White, Bush's Tax-Cut Proposal Would Benefit Some CEOs, L.A. Times, Jan. 13, 2003, at C5.

port of managers and manager lobbying groups such as the BRT. But if managers were in fact determining the lobbying positions of their companies on the basis of how the dividend-exclusion proposal would affect them in their capacity as individual shareholders, they understandably did not call attention to that as they lobbied for the proposal.

Additionally, managers supporting the dividend-exclusion proposal made it clear that they preferred integration to the enactment of targeted tax preferences. For example, NAM mentioned only at the end of its written testimony—after having already expressed unqualified support to the dividend-exclusion proposal—that it “also believe[d]” that measures such as accelerated depreciation and the research-and-development credit “would benefit the American economy.”¹⁹⁴ The BRT went even further: in response to a question during his testimony before the House Ways and Means Committee, the president of the BRT specifically said that the BRT members preferred integration to accelerated depreciation and similar targeted tax subsidies.¹⁹⁵

Managers expressed few concerns about the effect of the dividend-exclusion proposal on the retained-earnings trap. There were weak suggestions that the proposal would benefit only shareholders of corporations paying regular dividends.¹⁹⁶ That, of course, was not accurate: the basis-adjustment feature of the proposal ensured

¹⁹⁴ Hearing, *supra* note 189, at 309. The strong pitch for integration and the weak pitch for targeted preferences is exactly the opposite of what the agency-cost explanation predicts.

¹⁹⁵ Castellani, *Ways & Means*, *supra* note 182, at 87; see also BRT Prepared to Dig Deep, *supra* note 185 (reporting that the BRT president “showed little enthusiasm for moves to add increased bonus depreciation” to dividend-exclusion proposal). As predicted by the agency-cost explanation, there were other managers who argued for targeted tax preferences over the dividend-exclusion proposal, although the extent of that sentiment among managers is not clear. One news article suggested that “many companies want to scale back the dividend cut in exchange for other tax breaks, such as accelerated depreciation.” Howard Gleckman & Richard S. Dunham, *Taxes: How Many Arms Can One President Twist?* *Bus. Wk.*, Mar. 10, 2003, at 45. The suggestion that “many companies” took this position is difficult to reconcile with the public statements of the BRT and NAM; it may well be that the reporters on the news story, consistent with industry practice, simply generalized a point made to them by only one or two sources.

¹⁹⁶ See Cha, *supra* note 190, at E5 (reporting that small technology companies that did not pay regular dividends “have kept quiet or urged legislators to consider other tax breaks”).

that integration would not be conditioned on the actual distribution of corporate profits. More to the point, some managers objected that the proposal would interfere with their discretion to retain or distribute earnings.¹⁹⁷ Nonetheless, this position was not widely argued.¹⁹⁸ It may be that (just as the agency-cost explanation suggests) the retained-earnings trap benefits only a few managers; or it may be that managers find it difficult to defend the retained-earnings trap in public.

More prominent than the soft protests from managers of earnings-trapping corporations was the strong support from managers of dividend-paying corporations. Even though the dividend-exclusion proposal would not have created a bias for or against dividends, many managers of corporations that paid regular dividends lobbied hard for the proposal precisely because it would have removed the double-tax bias against dividends. For example, the American Gas Association, representing companies with more than 80% of the market share for natural gas, said that its members regularly paid out nearly two-thirds of their net income as dividends and that the proposal “would provide [them] a unique benefit.”¹⁹⁹ Similarly, the Edison Electric Institute, representing companies with 70% of the market share for electricity, said that its members usually paid out about 58% of their earnings as dividends and urged Congress to “act quickly to eliminate the double taxation of corporate dividends.”²⁰⁰ The chief executive officer of Exelon Corporation, who said that his company normally paid out about 50% of its earnings as dividends, and a vice president of Texas Instruments Incorporated, who said that her company had paid quarterly dividends for decades, both testified in strong sup-

¹⁹⁷ Howard Gleckman & Richard S. Dunham, *From All Sides*, Bus. Wk., Feb. 24, 2003, at 34, 36; Jonathan Krim, *Tech Companies See Bush Plan on Dividends as Troublesome*, Wash. Post, Jan. 8, 2003, at E1, E2.

¹⁹⁸ This is consistent with the prediction of the agency-cost explanation.

¹⁹⁹ *President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means*, 108th Cong. 246–250 (2003) (Statement of American Gas Association); see also *AGA Sees Potential Boost to Gas Utilities in President Bush's Proposal to Lift Taxes on Corporate Dividends*, *Foster Nat. Gas Rep.*, Jan. 9, 2003, at 14 (describing the benefits of the proposal to high dividend-paying gas companies).

²⁰⁰ *Hearing*, supra note 192, at 255–56.

port of the proposal.²⁰¹ These statements apparently reflected broad sentiment among dividend-paying companies.²⁰²

Managers in particular industries did express definite concerns, however, about the effects of the dividend-exclusion proposal on corporate tax preferences.²⁰³ Those concerns resonated with legislators,²⁰⁴ including the powerful Chairman of the Ways and Means Committee, who ultimately changed the dividend exclusion into a reduced tax rate on dividends.²⁰⁵ The concerns centered on the fact

²⁰¹ Promoting Corporate Responsibility Through the Reduction of Dividend Taxes: Hearing Before the Subcomm. on Consumer Aff. & Product Safety of the S. Comm. on Com., Sci., and Transp., 108th Cong. 17–21(2003) (statement of John W. Rowe, Chairman and Chief Executive Officer, Exelon Corporation); Promoting Corporate Responsibility Through the Reduction of Dividend Taxes: Hearing Before the Subcomm. on Consumer Aff. & Product Safety of the S. Comm. on Com., Sci., and Transp., 108th Cong. 13–17 (2003) (statement of Elizabeth W. Bull, Treasurer and Vice President, Texas Instruments Incorporated).

²⁰² See Dividend Tax Repeal Proposal May Be Boon for Utility Shares, Nat. Gas Wk., Jan. 10, 2003 (describing the benefits of the dividends-exclusion proposal to the utilities industry). For examples of particular high dividend-paying companies that supported the dividend-exclusion proposal, see Letter from Richard R. Grigg, Executive Vice President of Wisconsin Energy Corporation, to John Snow, Treasury Sec'y Designate (Jan. 15, 2003), *reprinted in* Tax Notes Today, Jan. 30, 2003, LEXIS, 2003 TNT 20-68; Letter from David N. Parker, American Gas Association, to John Snow, Treasury Sec'y Designate (Dec. 18, 2002), *reprinted in* Tax Notes Today, Jan. 23, 2003, LEXIS, 2003 TNT 15-32; Letter from Martin A. White, MDU Resources Group, Inc., to John Snow, Treasury Sec'y Designate (Jan. 2, 2003), *reprinted in* Tax Notes Today, Jan. 23, 2003, LEXIS, 2003 TNT 15-38.

²⁰³ See Martin A. Sullivan, Dividend Déjà Vu: Will Double Tax Relief Get Canned—Again?, 98 Tax Notes 645, 646 (2003) (“A dividend exclusion would have varied effects on different industries, so it would be a mistake to think there is unanimity [about the proposal] in the business community.”); Lee Walczak, Howard Gleckman, & Rich Miller, The Critics: A Fight Already Lost?, Bus. Wk., Jan 20, 2003, at 32, 33 (reporting that tech companies, real estate, and pension-fund managers favored redirecting tax benefits toward their particular industries). Remarkably, the agency-cost explanation predicted that denying pass-through to corporate tax preferences would make integration *more attractive* to managers. Arlen & Weiss, *supra* note 7, at 366–67. The experience with the Bush administration’s dividend-exclusion proposal demonstrated exactly the opposite.

²⁰⁴ See Jonathan Weisman, Tax Credits Lose Appeal in Bush Plan, Wash. Post, Feb. 26, 2003, at E1, E10 [hereinafter Weisman, Tax Credits Lose Appeal].

²⁰⁵ See John D. McKinnon & Shailagh Murray, Washington Wrestles with Tax Bill: Tensions Increase as House Proposes Options at Odds with White House, Senate, Wall St. J., May 2, 2003, at A2 (reporting that Chairman Thomas supported a version of the proposal that would benefit “[c]ompanies with lots of tax breaks”); Patti Mohr & Warren Rojas, Interest Groups Test Bush Idea of ‘Single Tax’ on Dividends, 98 Tax Notes 1471 (2003); Jonathan Weisman, In House, Fight Brews over Bush Tax Plan, Wash. Post, Apr. 27, 2003, at A5; Jonathan Weisman, Thomas Questions Divi-

that the proposal conditioned the shareholder-level benefits of integration on the payment of corporate-level taxes. Managers argued that this requirement would create a bias in favor of taxable corporate income over tax-preferenced corporate income and would undermine the value of corporate tax preferences.²⁰⁶ The high-technology and pharmaceutical industries, for example, expressed concerns about the effect of the proposal on the research-and-development credit; the energy industry objected to the effects on tax preferences for oil exploration and the use of wind and other renewable energy; and the construction industry objected to the effects on the low-income housing tax credit and similar preferences.²⁰⁷

dend Tax Cuts, Wash. Post, Jan. 28, 2003, at A4; see also President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 96–97, 110 (2003) (remarks of Rep. Bill Thomas). At least one account argues that Chairman Thomas changed the proposal at the suggestion of Vice President Cheney. See Barton Gellman, Angler: The Cheney Vice Presidency 255–57, 269–75 (2008).

²⁰⁶ The agency-cost explanation suggests that managers may be leery of integration if they believe that the revenue loss from eliminating the double tax would be made up through repeal of specific corporate tax preferences. As proposed, however, the Bush administration's dividend-exclusion proposal would not have been paid for by any offsetting tax increases.

²⁰⁷ See Mohr & Rojas, *supra* note 205, at 1472 (describing the potential impact on the low-income housing tax credit program); Dividend Break Might Undercut Federal Incentives, Tax Incentives Alert, Feb. 2003, at 19 (noting objections from companies that benefit from R&D credits); Gleckman & Dunham, *supra* note 197, at 36 (describing objections from tech companies); Gleckman & Dunham, *supra* note 195, at 45 (noting objections from companies that benefit from accelerated depreciation); Greg Hitt & John D. McKinnon, Business Fears Dividend Tax Cut Could Undermine Popular Breaks, Wall St. J., Jan. 17, 2003, at B4 (describing potential objections from companies involved in research and development, school construction, and renewable energy); Krim, *supra* note 197, at E5; Mohr & Rojas, *supra* note 186 (describing the efforts of the National Council of State Housing Agencies in opposing the dividend-exclusion proposal because of its potentially “severe[] adverse impact” on low-income housing tax credits); Weisman, Tax Credits Lose Appeal, *supra* note 204, at E1 (describing the impact of the dividends exclusion proposal on low-income housing, alternative energy, and research and development credits); Weisman, White House Intensifies Push, *supra* note 180, at E1 (describing the opposition of the American Electronics Association); see also Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 28 (2003) (remarks of Rep. Joseph Crowley) (expressing concern regarding the effects of the dividends-exclusion proposal on R&D tax credits).

All else equal, conditioning the shareholder-level exclusion and basis adjustment on the payment of corporate-level tax would have had the effect of making a corporation with low utilization of corporate tax preferences a more attractive investment, in relative terms, than it is under the status quo. The dividend-exclusion proposal would have reduced the value of corporate tax preferences and, correspondingly, would have raised the cost of capital for corporations relying on those preferences. This concern, however, was not universal among managers. The unqualified support for the proposal from the BRT, the TRC, NAM, and other lobbying groups indicates that, in many cases, managers were willing to trade the anticipated benefits of integration off against the anticipated costs of weakened tax preferences. But that baseline of managerial support only underscores the importance that other managers attached to their tax preferences. They defied both their corporate counterparts and the Bush administration to press their opposition. The status quo put them at the higher end of an uneven playing field, and they fought to defend the advantage.

Importantly, the potential of the dividend-exclusion proposal to reduce the value of corporate tax preferences drew collateral interests on the management side directly into the fray.²⁰⁸ Lobbying groups from the low-income housing industry were the most visible, forceful, and relentless.²⁰⁹ These groups did not represent managers; they represented interests dependent on the ability to sell low-income housing tax credits to corporations. They flooded Capitol Hill,²¹⁰ the Treasury

²⁰⁸ As indicated above, the agency-cost explanation does not account at all for the role of collateral interests.

²⁰⁹ See Sandra Fleishman, *Dividend Plan Called Threat to Affordable Housing*, *Wash. Post*, Feb. 11, 2003, at A4; Weisman, *GOP Aides Revise Bill*, *supra* note 192, at E3; Weisman, *Tax Credits Lose Appeal*, *supra* note 204, at E1.

²¹⁰ For legislative testimony, see *Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 101-11 (2003)* (statement of James R. Rayburn, First Vice President, National Association of Home Builders); *Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 42-44 (2003)* (statement of William E. Spriggs, Executive Director, National Urban League Institute for Opportunity and Equality); *President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th*

Department,²¹¹ and the press²¹² with their argument that the dividend-exclusion proposal would cause a serious contraction in the supply of affordable housing. The case was straightforward. Corporations effectively constitute the market for the purchase of low-income housing tax credits; those corporate investments in turn finance the construction of affordable housing.²¹³ The dividend-exclusion proposal, however, would have caused corporate manag-

Cong. 236–39 (2003) (statement of the Affordable Housing Tax Credit Coalition); President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 185–96 (2003) (statement of Richard H. Godfrey, Jr., Executive Director, Rhode Island Housing and Mortgage Finance Corporation, and Vice President, National Council of State Housing Agencies); President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 258–61 (2003) (statement of F. Barton Harvey, III, Enterprise Foundation); President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 301–07 (2004) (statement of National Association of Home Builders); President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 313–19 (2003) (statement of New Markets Tax Credit Coalition); President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 309–12 (2003) (statement of Raul Yzaguirre, National Council of La Raza).

²¹¹ For correspondence with the Treasury Department, see President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 104–05 (2003) (letter from Barbara J. Thompson, Executive Director, National Council of State Housing Agencies, to John W. Snow, Treasury Sec’y (Feb. 25, 2003)); Letter from Susan G. Baker, Co-Chairman, National Alliance to End Homelessness and Trustee, The Enterprise Foundation, to John W. Snow, Treasury Sec’y (Feb. 19, 2003), *reprinted in* Tax Notes Today, Feb. 27, 2003, LEXIS, 2003 TNT 39-169; Letter from Conrad Egan, Executive Director, National Housing Conference, to John W. Snow, Treasury Sec’y (Mar. 3, 2003), *reprinted in* Tax Notes Today, Mar. 14, 2003, LEXIS, 2003 TNT 50-35; Letter from Judith A. Kennedy, President, National Association of Affordable Housing Lenders, to Pamela F. Olson, Asst. Treasury Sec’y (Jan. 20, 2003), *reprinted in* Tax Notes Today, Feb. 6, 2003, LEXIS, 2003 TNT 25-80; Letter from Frank Schubert, Chairman, Cowlitz-Wahkiakum Housing Advisory Committee, to Pamela F. Olson, Asst. Treasury Sec’y (Jan. 22, 2003), *reprinted in* Tax Notes Today, Feb. 13, 2003, LEXIS, 2003 TNT 30-40.

²¹² For statements in the press, see Jan Breidenbach & Gordon Conway, *A Cloud Over Low-Cost Housing*, L.A. Times, Mar. 6, 2003, at B17 (commentary by low-income housing advocates); Richard Moe, *White House Plan on Dividends Needs Renovation*, Wall St. J., Mar. 18, 2003, at D8 (commentary by the president of the National Trust for Historic Preservation).

²¹³ In the question-and-answer part of his testimony before the Ways and Means Committee, one lobbyist flatly asserted that “[a]ffordable housing is a noneconomic activity” and that “[i]f we are going to bring the private sector in, then the Tax Code is the way to do it.” Hearings, *supra* note 210, at 194 (statement of Richard H. Godfrey, Jr.).

ers to prefer taxable profits over tax-preferenced profits so that they could pass along excludable dividends and basis adjustments to their shareholders. In effect, the proposal might have caused managers to scale back corporate investments in low-income housing tax credits, raising construction costs in that industry. Although it was generally assumed that these consequences had not been intended by the Bush administration, the lobbying groups representing the industry predicted very adverse consequences for affordable housing—and few in Congress wanted to identify themselves with that outcome.²¹⁴ State and local governments issuing tax-exempt bonds and investment firms trading and dealing those bonds objected to the proposal for similar reasons.²¹⁵ They argued

²¹⁴ See *Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets*: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 21–22 (2003) (remarks of Rep. Rubén Hinojosa (R-Tex.)); *President's Economic Growth Proposals*: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 221–24 (2003) (statement of Rep. Robert W. Ney (R-Ohio)); *President's Economic Growth Proposals*: Hearing Before the H. Comm. on Ways & Means, 108th Cong. (2003) at 13, 210 (remarks of Rep. Nancy Johnson (R-Conn.)); *id.* at 41 (remarks of Rep. Kenny Hulshof (R-Mo.)); *id.* at 44, 127 (remarks of Rep. Stephanie Tubbs Jones (R-Ohio)); *id.* at 100 (remarks of Rep. Richard Neal (R-Mass.)); *id.* at 233 (remarks of Rep. Paul Ryan (R-Wis.)); see also Mohr & Rojas, *supra* note 180 (“Several taxwriters from both sides of the aisle complained that the proposal would reduce the value of the low-income housing tax credit program.”).

²¹⁵ See *President's Economic Growth Proposals*: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 155–72 (2003) (statement of Alan G. Hevesi, New York State Comptroller); *President's Economic Growth Proposals*: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 312–13 (2003) (statement of National Education Association); Letter from John R. Vogt, Executive Vice President, Bond Market Ass'n, to Pamela F. Olson, Asst. Treasury Sec'y (Jan. 27, 2003), *reprinted in* Tax Notes Today, Feb. 6, 2003, LEXIS, 2003 TNT 25-91; see also Greg Hitt, *Bush Faces New Tax-Relief Foe: Municipal-Bond Adherents Mount a Lobbying Effort*, Wall St. J., Apr. 15, 2003, at A4; Christina Ling, *Bush Retirement Proposals Worry Municipal Issuers*, Reuters News, Feb. 11, 2003; Tom Petrino, *California Pays Costly Yields on Tobacco Bonds*, L.A. Times, Jan. 16, 2003, at C1 (reporting concerns expressed by municipal bond fund managers in California); Weisman, *Tax Credits Lose Appeal*, *supra* note 204, at E1, E5 (discussing the concerns of the Bond Market Association); William M. Welch, *Bush Faces Bipartisan Opposition to Repeal of Dividends Tax*, USA Today, Mar. 4, 2003, at 6A. Similar concerns were expressed, although less intensely, about the effects of the dividend-exclusion proposal on credit unions and banks. See Letter from America's Community Bankers, American Bankers Association, and Independent Community Bankers of America, to William M. Thomas, Chairman, H. Comm. on Ways & Means (Mar. 31, 2003), *reprinted in* Tax Notes Today, Apr. 3, 2003, LEXIS, 2003 TNT 64-29; Ed Roberts, *Bush Stimulus Package Could Effect CU Shares*, Credit Union J., Jan. 13, 2003, at 8.

that the expected shift by managers from tax-preferenced income to taxable income would cause corporations to purchase fewer tax-exempt bonds. The concern was particularly acute as to property and casualty insurance companies, which ordinarily invest heavily in tax-exempt bonds.²¹⁶ Reduced corporate investment in tax-exempt bonds, of course, would drive up the interest rates on those bonds, thereby increasing the costs of borrowing for state and local governments.

The lobbying positions on the management side, then, reflected the heterogeneity of interests attributable to the unevenness of the corporate-level tax. Many managers strongly supported the dividend-exclusion proposal; they even stated publicly that they wanted integration more than they wanted targeted tax preferences. Other managers objected to the proposal because of their concerns about pressure to distribute earnings or in defense of their corporate tax preferences. The strongest opposition on the management side, however, came not from managers, but from collateral interests that claimed they would be seriously harmed by the proposal. These interests elicited sympathy and support from legislators and influenced the legislative outcome.

C. Lobbying Positions of Shareholders and Collateral Interests

A similar pattern of heterogeneous positions emerged in the lobbying activities on the shareholder side.²¹⁷ Support for the divi-

²¹⁶ President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 250–52 (2003) (statement of American Insurance Association); President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 152–55 (2003) (statement of Ronald Stack, Managing Director and Head of Finance, Lehman Brothers, and Chairman, Municipal Securities Division, Bond Market Association).

²¹⁷ The lobbying positions of shareholders occupy an almost inconsequential role in the agency-cost explanation. The explanation identifies the anticipated windfall to existing investments as a significant (although not inevitable) characteristic of integration, and it predicts that individual shareholders therefore will favor eliminating the double tax. See Arlen & Weiss, *supra* note 7, at 338, 347. The account argues, however, that individual shareholders face substantial collective-action problems that prevent them from lobbying effectively. By contrast, institutional shareholders do not face the same collective-action problems, but many (such as retirement plans) may be stifled by federal prohibitions on lobbying. See *id.* at 363–65. As applied to the Bush administration's dividend-exclusion proposal, the predictions of the agency-cost ex-

dend-exclusion proposal was almost non-existent among individual shareholders.²¹⁸ One retiree testified for the proposal at an inconsequential hearing,²¹⁹ and a few individuals²²⁰ wrote letters supporting the exclusion of dividends. The scarcity of individual support was highlighted by the fact that several large corporations—including Verizon,²²¹ AT&T,²²² and General Motors²²³—sent letters to tens of thousands of their shareholders extolling the benefits of the dividend-exclusion proposal. Financial institutions and their lobbying groups—such as Morgan Stanley²²⁴ and the Securities Industry Association²²⁵—made similar appeals to investors in addition to supporting the proposal through direct lobbying efforts.²²⁶ But

planation regarding shareholders were in part correct, particularly as to individual shareholders. However, the agency-cost explanation did not accurately predict either the interests or lobbying ability of certain institutional shareholders, nor did it account at all for collateral interests on the shareholder side.

²¹⁸ This is consistent with the predictions of the agency-cost explanation.

²¹⁹ Tax Fairness: Does Double Taxation Unfairly Target Older Americans?: Hearing Before the S. Special Comm. on Aging, 108th Cong. 55–59 (2003) (statement by Dick Buxton). The hearing was inconsequential because the committee lacked any jurisdiction over legislation concerning the dividend-exclusion proposal.

²²⁰ See, e.g., Letter from Dewey W. Corley to John Breaux, S. from La. (Apr. 16, 2003), *reprinted in* Tax Notes Today, May 1, 2003, LEXIS, 2003 TNT 84-14; Letter from Dewey W. Corley to John W. Snow, Treasury Sec’y (Apr. 17, 2003), *reprinted in* Tax Notes Today, May 1, 2003, LEXIS, 2003 TNT 84-14; Letter from Aaron Selber, Jr. to John Breaux, S. from La. (Apr. 16, 2003), *reprinted in* Tax Notes Today, May 1, 2003, LEXIS, 2003 TNT 84-14; Letter from Jess J. Waguespack to Jim McCreery, Rep. from La. (Jan. 13, 2003), *reprinted in* Tax Notes Today, Oct. 30, 2003, LEXIS, 2003 TNT 210-37; Letter from Nedland P. Williams to Pamela F. Olson, Asst. Treasury Sec’y (Apr. 30, 2003), *reprinted in* Tax Notes Today, May 15, 2003, LEXIS, 2003 TNT 94-35.

²²¹ See Weisman, *Bush Wins Business Support*, *supra* note 180, at E1.

²²² Letter from James W. Cicconi, Gen. Counsel and Exec. Vice President, AT&T, to John W. Snow, Treasury Sec’y (May 5, 2003), *reprinted in* Tax Notes Today, May 22, 2003, LEXIS, 2003 TNT 99-29; see also George A. Plesko, *We Don’t Really Know What It Means, But We Support It Anyway*, 99 Tax Notes 1275 (2003) (summarizing an e-mail exchange with AT&T regarding the impact of the Bush proposal on AT&T shareholders).

²²³ McQuillan, *supra* note 180.

²²⁴ Gleckman & Dunham, *supra* note 195.

²²⁵ Mike McNamee, *A Love-Hate Relationship with Bush’s Tax Plan*, *Bus. Wk.*, Mar. 3, 2003, at 53.

²²⁶ See, e.g., *Examination of Proposals for Economic Growth and Job Creation: Hearing Before the S. Comm. on Fin.*, 108th Cong. 47–51 (2003) (statement of Phil Gramm, Vice Chairman and Managing Director, UBS Warburg); *Paying Dividends: How the President’s Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of*

even the enthusiasm of managers, brokerages, and investment firms apparently could not shake individual shareholders out of their indifference.²²⁷

Some institutional shareholders, however, played a reasonably prominent role in opposing the proposal. For example, certain tax-qualified retirement plans—along with closely aligned collateral interests—objected to the dividend-exclusion proposal, and organizations representing those interests lobbied against it.²²⁸ The concern was that the proposal would equalize the tax treatment of holding stock directly and holding stock through a tax-qualified retirement plan. Under the status quo of the corporate double tax, holding stock through a tax-qualified plan results in a better tax outcome because dividends are effectively exempt from tax as long as the stock remains in the plan. Although the dividend-exclusion proposal would not have changed the tax treatment of tax-qualified retirement plans, it would have extended that tax result to stock held outside a tax-qualified plan. The plans would be worse off under the proposal, as a relative matter, than they were under the corporate double tax.²²⁹

the Comm. on Fin. Services, 108th Cong. 18–35 (2003) (statement of Phil Gramm, Vice Chairman and Managing Director, UBS Warburg); Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 35–37 (2003) (statement of Rick Lazio, President and Chief Exec. Officer, Financial Services Forum); President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 269–73 (2003) (statement of the Investment Company Institute); President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 133–36 (2003) (statement of John H. Schaefer, President and Chief Operating Officer, Individual Investor Group of Morgan Stanley & Company and Chairman, Board of the Securities Industry Association); see also Sullivan, *supra* note 203, at 646 (“[B]rokerage firm head Charles Schwab . . . is widely credited with getting the President interested in this proposal . . .”).

²²⁷ An important qualification about individual shareholders: as argued above, at least some of the support for the dividend-exclusion proposal among managers may be attributable to the interests of managers as shareholders.

²²⁸ Hitt, *supra* note 215; Walczak et al., *supra* note 203, at 33.

²²⁹ At a legislative hearing on the dividend-exclusion proposal, Assistant Treasury Secretary Pamela Olson specifically referred to the effect on tax-exempt shareholders as a reason for preferring the dividend-exclusion model over the dividend-deduction model. In the exclusion model, corporate non-preferenced income payable to tax-exempt shareholders is taxed at the corporate level; in the deduction model, corpo-

This was a genuine issue for tax-qualified retirement plans. At the time of the proposal, those plans covered over forty percent of U.S. workers²³⁰ and received a substantial share of corporate dividends.²³¹ The proposal threatened to remove a primary advantage of the plans as investment vehicles for employees, and that threat was not lost on the employers sponsoring the plans or on the professionals selling investment, actuarial, and other consulting services to the plans.²³² Although the plans themselves may have been unable to lobby directly, groups representing employers and consultants mobilized to register their objections with legislators. The Profit Sharing/401(k) Council of America, which represents employers sponsoring defined contribution plans, and the American Society of Pension Actuaries, which represents plan consultants, both argued to Congress that the dividend-exclusion proposal would discourage employers from establishing and maintaining tax-qualified retirement plans and that this, in turn, would undermine retirement income security.²³³ Similarly, the Employee Benefit Research Institute, a think-tank for employee-benefit issues, agreed in legislative testimony that the proposal would weaken in-

rate non-preferenced income payable to tax-exempt shareholders is not taxed either at the corporate level or the shareholder level. President's Economic Growth Proposals: Hearing Before the Comm. on Ways & Means, 108th Cong. 9 (2003) (statement of Pamela Olson, Asst. Treasury Sec'y). Although tax-exempt investors such as tax-qualified retirement plans would benefit from any windfall to existing investments, that provided little comfort: tax-exempt investors' real concern was not the effect on existing investments but the ability to attract future investments.

²³⁰ Satyendra K. Verma, Retirement Plan Coverage of Boomers: Analysis of 2003 SIPP Data 7 (2006).

²³¹ Gale, *supra* note 116, at 839.

²³² Dividend Proposal Could Hurt 401(k) Plans, Experts Say, IOMA's Report on Managing 401(k) Plans, Feb. 2003, at 6 [hereinafter Dividend Proposal Could Hurt 401(k) Plans]; 401(k)s Less Attractive Under Bush Dividend Proposal, Fin. Executives News, Mar. 2003, at 17; Walczak et al., *supra* note 203, at 33.

²³³ President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 252-55 (2003) (statement of the American Society of Pension Actuaries); President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 319-20 (2003) (statement of the Profit Sharing/401(k) Council of America). See also Patti Mohr, Taxwriters Examine Effect of Dividend Exclusion on Housing, Retirement Savings, Tax Notes Today, Mar. 7, 2003, LEXIS, 2003 TNT 45-3.

centives for plan sponsorship.²³⁴ Although the lobbying groups for large corporate sponsors of tax-qualified plans—such as the American Benefits Council and the ERISA Industry Committee—remained neutral,²³⁵ the objections raised by the groups that did lobby drew the firm support of legislators.²³⁶

The life insurance industry objected to the dividend-exclusion proposal for similar reasons. Insurance companies sell deferred annuities to individuals as tax-favored investments; the amount paid by the individual typically is invested by the insurance company in a mutual fund, but the earnings from the mutual fund are not taxed to the individual until she receives distributions under the annuity. Thus, from the perspective of the individual, investing in a mutual fund that holds dividend-paying stock through a deferred annuity generally provides a better tax outcome than investing in such a mutual fund directly. The dividend-exclusion proposal would have reversed that outcome, making the deferred annuity disadvantaged as a tax matter. Although the life insurance industry dutifully claimed to support the Bush administration's legislative package, it nevertheless threatened to oppose the dividend-exclusion proposal unless the Treasury Department agreed to provide a basis adjustment for annuity contracts that held investments in mutual funds

²³⁴ President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 174–79 (2003) (statement of Dallas L. Salisbury, President and Chief Executive Officer, Employee Benefit Research Institute).

²³⁵ Dividend Proposal Could Hurt 401(k) Plans, *supra* note 232, at 7. The neutrality of these lobbying groups presumably can be attributed to the fact that the managers of the corporations making up those groups were actively lobbying for the proposal through the BRT and the TRC.

²³⁶ See Paying Dividends: How the President's Tax Plan Will Benefit Individual Investors and Strengthen the Capital Markets: Hearing Before the H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Services, 108th Cong. 3 (2003) (remarks of Rep. Brad Sherman); President's Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 9, 26–27, 46–47, 95–96, 105–06 (2003) (remarks of Reps. Nancy L. Johnson, Max Sandlin, Sander M. Levin, and Bill Thomas); Patrice Hill, Accelerated Tax Cuts Receive Bipartisan Support, *Wash. Times*, Jan. 29, 2003, at A1; Mohr & Rojas, *supra* note 205, at 1473 (“[Rep.] Cardin . . . expressed concern that the dividend exclusion would have the unintended consequence of reducing incentives for small business employers to sponsored savings plans for their employees.”). Cf. Glenn E. Coven, *Corporate Tax Policy for the Twenty-First Century: Integration and Redeeming Social Value*, 50 *Wash. & Lee L. Rev.* 495, 511 n.42 (1993) (implying that such objections from tax-exempt organizations would not have political traction).

receiving dividends.²³⁷ The president of the American Council of Life Insurers testified before Congress that the annuity business otherwise could be “devastated” by the dividend-exclusion proposal.²³⁸ Impressed no doubt by the lobbying muscle of the industry, legislators pressed the Secretary of the Treasury to concede special treatment for annuities.²³⁹

In short, lobbying on the shareholder side of the dividend-exclusion proposal was anything but uniform. Although individual shareholders were nearly silent, certain institutional shareholders managed to register objections to the proposal. Moreover, collateral interests on the shareholder side were very active: financial institutions, such as brokerages and investment firms, supported the proposal and tried to enlist their customers to do the same. Interests related to tax-qualified retirement plans and the insurance in-

²³⁷ See, e.g., Letter from Frank Keating, President and Chief Exec. Officer, American Council of Life Insurers, to John W. Snow, Treasury Sec’y (Apr. 14, 2003), *reprinted in* Tax Notes Today, April 24, 2003, LEXIS, 2003 TNT 79-15 [hereinafter Keating Letter to Snow]; Letter from Frank Keating, President and Chief Exec. Officer, American Council of Life Insurers, et al., to George W. Bush, President (Mar. 17, 2003), *reprinted in* Tax Notes Today, March 18, 2003, LEXIS, 2003 TNT 52-20 [hereinafter Keating Letter to Bush].

²³⁸ President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 129–32 (2003) (statement of Frank Keating, President and Chief Executive Officer, American Council of Life Insurers). The insurance industry reportedly took their objections directly to cabinet members and other presidential advisors, issuing thinly veiled threats to unleash the lobbying power of individual insurance agents if the dividend-exclusion proposal was not modified to accommodate the industry. McNamee, *supra* note 225. On the concerns of insurance companies regarding annuities, see Mohr & Rojas, *supra* note 186 (describing the concerns of the American Council of Life Insurers); Letter from Steve Bartlett, President, Financial Services Roundtable, to Members of the Ways and Means Committee (Mar. 5, 2003), *reprinted in* Tax Notes Today, March 6, 2003, LEXIS, 2003 TNT 44-46; Letter from Maurice R. Greenberg, Chairman and Chief Exec. Officer, American Int’l Group, Inc., to John Snow, Treasury Sec’y (Feb. 26, 2003), *reprinted in* Tax Notes Today, March 7, 2003, LEXIS, 2003 TNT 45-56; Letter from Rick A. Lazio, President and Chief Exec. Officer, Financial Services Forum, to John Snow, Treasury Sec’y (May 21, 2003), *reprinted in* Tax Notes Today, May 29, 2003, LEXIS, 2003 TNT 103-88.

²³⁹ President’s Economic Growth Proposals: Hearing Before the H. Comm. on Ways & Means, 108th Cong. 19 (2003) (remarks of Rep. Jim McCrery); Mohr & Rojas, *supra* note 180 (reporting that Treasury Secretary Snow announced a revision of the proposal to accommodate the concerns of the annuities industry). The insurance industry had another objection to the dividend-exclusion proposal: because of special rules applicable to insurance companies, they would have been entitled to only a pro-rated exclusion for dividends that they received as shareholders. See Keating Letter to Snow, *supra* note 237; Out in the Cold?, Life Insurance Int’l, Feb. 28, 2003, at 11.

dustry, however, fought to defend their status as tax-advantaged investments, a status that required either special treatment under the proposal or the continued existence of the corporate double tax.

III. GENERAL IMPLICATIONS AND PROSPECTS FOR INTEGRATION

The analysis set out above demonstrates how the persistence of the corporate double tax, at least within the recent past, can be attributed to the equipoise of interests favoring and opposing specific integration proposals.²⁴⁰ The failure of the Bush administration's dividend-exclusion proposal underscores the magnitude of the legislative obstacles to integration. Even in the case of a proposal made by a president whose party held majorities in both houses of Congress, the support of certain managers, shareholders, and collateral interests could not overcome the opposition of other managers, shareholders, and collateral interests who preferred retaining the double tax.

The analysis also demonstrates the inevitability of those legislative obstacles and the doubtful prospects for integration. The corporate double tax imposes uneven burdens on managers and shareholders, and it creates uneven opportunities for collateral interests. *Any* integration proposal necessarily creates winners and losers among each of these groups. Legislative proponents of integration must either roll the losers or, to the extent possible, buy them off with legislative concessions; it simply is not possible to structure legislation that would eliminate the double tax without provoking rational opposition from affected parties. In short, politically successful integration will be as messy and as imperfect as

²⁴⁰ Other scholars interpret the legislative failure of the dividend-exclusion proposal differently. Dan Shaviro argues that manager "support for the Bush administration's corporate integration proposal was less than defeating." Shaviro, *supra* note 18, at 20. Karen Burke and Grayson McCouch argue that the dividend-exclusion proposal "failed to attract support from any major political constituency." Karen C. Burke & Grayson M.P. McCouch, *Turning Slogans into Tax Policy*, 27 *Va. Tax Rev.* 747, 773 (2008). Shaviro, however, points to no evidence supporting his assertion. Although Burke and McCouch cite a handful of sources for their position, they take into account very little of the legislative record set out in Part II.

any successful tax legislation that changes the status quo for entrenched interests.

A. Implications of the Heterogeneity Analysis

In contrast to the agency-cost explanation, which crisply identifies “managerial diffidence” as the “key” to explaining the failure of integration,²⁴¹ the heterogeneity analysis does not imply that the persistence of the double tax should be attributed to a particular motivation or lobbying strategy of a particular interest group. Rather, there are many and varied interests implicated by integration of the individual income tax and the corporate income tax, and different integration proposals will affect those interests differently. One cannot say with confidence that managers generally will oppose or support integration, or even that a particular group of managers who oppose or support a particular integration proposal would adopt the same position on a different integration proposal. There is far too much heterogeneity to justify such categorical conclusions.

In the case of the Bush administration’s dividend-exclusion proposal, the basic story was that the strong support of many corporate managers ran directly into the opposition of other corporate managers and, importantly, of influential and sympathetic collateral interests. Indeed, it appears that the collateral interests opposed to the dividend-exclusion proposal—such as groups dependent on the low-income housing tax credit, tax-qualified retirement plans, and the insurance industry—were even more influential than the corporate managers who raised concerns about the proposal. The objections of these collateral interests, the “ripple effects,” as the Chairman of the Ways and Means Committee called them,²⁴² struck sympathetic chords with legislators. No one in Congress wanted to undermine the construction of affordable housing or the protection of retirement income security. By framing the dividend-exclusion proposal as inimical to those policy objectives, the collateral interests positioned themselves as formidable barriers to integration. By failing to accommodate the objections of those interests, the Bush administration effectively presented legislators with

²⁴¹ Arlen & Weiss, *supra* note 7, at 327.

²⁴² Mohr & Rojas, *supra* note 205, at 1473.

an integration proposal that they could not support. This experience suggests rather clearly that supporters of integration ignore the effects on collateral interests at their peril.

A different integration proposal made under different circumstances surely could produce different results. Perhaps such a proposal would accommodate the concerns of the low-income housing industry and the retirement-plan industry very well, but perhaps it would not be as attractive to corporate managers. Perhaps it would draw the active opposition of groups that supported the Bush administration's proposal and the support of groups that opposed it. The point is that any integration proposal is certain to benefit someone and certain to harm someone else. The simple fact that potential losers have been able to beat back potential winners in the past does not imply that integration cannot succeed, but it does imply that different approaches may have different prospects for success.

B. A General Approach to Integration

Predicting what approach to integration might be more or less successful is inherently problematic. The decisions of managers, shareholders, and collateral interests to support or oppose a specific legislative proposal to eliminate the double tax likely will turn on very fine considerations, such as whether a particular tax preference does or does not pass through to shareholders or whether particular equity investments are or are not grandfathered. Such details are not always determined *ex ante*; they can be modified during the legislative process specifically for the purpose of attracting support and heading off opposition. The positions of managers, shareholders, and collateral interests on any specific integration proposal, then, potentially remain fluid as the legislative process unfolds. Nonetheless, the heterogeneity analysis and the experience with the Bush administration's proposal suggest that certain integration models might be more promising than others as a starting point for future legislative efforts.

Any successful integration proposal must accept the inevitability of winners and losers. The marked unevenness of the corporate double tax ensures that integration will change both the absolute and relative positions of managers, shareholders, and collateral in-

terests; policymakers interested in advancing integration therefore should craft proposals that build on core constituencies of potential winners but allow sufficient flexibility to accommodate potential losers, at least on a selective basis. This implies that integration models pre-committing legislators on critical policy points generally will have worse prospects for success than models allowing legislators to maintain flexibility during the legislative process. Compromise is unavoidable, and any specific legislative proposal should allow for that.

Policymakers also must bear in mind that the end point of a successful integration proposal likely will bear little resemblance to the starting point. Even if one begins with a theoretically pure, internally consistent integration model, the relentless and often vigorous pushing and pulling of the legislative process almost surely will yield an impure, inconsistent product. Actual integration may have to draw ad hoc distinctions among otherwise similar transactions, corporations, shareholders, and industries—distinctions justifiable with nothing better than an appeal to political necessity. There is no good reason to suppose that the legislative process that has produced the uneven and internally inconsistent corporate double tax would transcend itself to produce a theoretically pure and internally consistent integration of the corporate and individual income taxes.

A general strategy of trying to contain integration losers suggests rather strongly that policymakers should not pursue integration under the comprehensive business income tax model. That model does considerably more than simply integrate corporate-level and shareholder-level taxes: it fundamentally changes the tax treatment of non-corporate business by imposing an entity-level tax on all but the smallest business enterprises.²⁴³ In devising the comprehensive business income tax, the Treasury Department acknowledged the broad and deep adjustments that the tax would require, and the government suggested that, for this reason, the tax should be phased in over a very long period.²⁴⁴ That cautiousness underscores the basic political point that the comprehensive business income tax—or any other legislative proposal that links elimination of the

²⁴³ Treasury Integration Report, *supra* note 40, at 39–41.

²⁴⁴ *Id.* at 90–91.

corporate double tax to reform of non-corporate taxes—unavoidably draws additional interests into the legislative fray.

This is not to imply that the comprehensive business income tax is not a sensible approach to general business tax reform or that its political implications are so complex that Congress could not conceivably enact it. But if the legislative objective were simply to integrate the corporate and individual income taxes, the political complications introduced by the comprehensive business income tax would seem unnecessary and counter-productive. As though contending with managers, shareholders, and collateral interests were not enough, proposing the comprehensive business income tax would provoke both support and opposition from owners and managers of partnerships, limited liability companies, sole proprietorships, and all the third parties that have interests in the current taxation of non-corporate businesses. Unless one made the policy judgment that integration would be pointless without such general business tax reform, it is difficult to justify a political decision to pursue integration through that model.²⁴⁵

A second significant inflection point is the treatment of corporate tax preferences. As demonstrated by the experience with the Bush administration's dividend-exclusion proposal, this issue drives a wedge among managers. Corporations with lower effective tax rates, which include those making greater use of tax preferences, have lower costs of capital than corporations with higher effective tax rates, which include those making less use of tax preferences. The pass-through of corporate tax preferences to shareholders

²⁴⁵ Of course, even a straightforward integration proposal might provoke support or opposition from non-corporate businesses if, for example, they believe that removing the bias against the corporate form would adversely affect their ability to raise capital. Consider, for example, the effects of integration on the privately held corporations eligible for pass-through taxation (that is, S corporations). See generally Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 *Tax L. Rev.* 665 (1992); John K. McNulty, *Commentary, Preserving the Virtues of Subchapter S in an Integrated World*, 47 *Tax L. Rev.* 681 (1992); Deborah H. Schenk, *Commentary, Complete Integration in a Partial Integration World*, 47 *Tax L. Rev.* 697 (1992). The experience with the Bush administration's dividend-exclusion proposal suggests, however, that many non-corporate businesses (and corporate businesses taxed as though they were non-corporate businesses) prefer to sit out the fight over integration. It is difficult to imagine a similar outcome if the tax treatment of non-corporate businesses were openly put in play.

helps preserve the relative advantage of low-tax corporations over high-tax corporations, making integration more attractive to managers of low-tax corporations. Similarly, collateral interests that capture returns from corporate tax preferences (such as builders of low-income housing) generally oppose integration not providing for pass-through.

That suggests that the dividend-deduction and mark-to-market models—neither of which readily accommodates pass-through—are not likely to be successful. A legislative proposal under either model would indicate to managers of low-tax corporations and sympathetic collateral interests that the intended endgame for integration is a leveling of effective tax burdens and a dilution of the economic value of preferences. A legislator who proposed the dividend-deduction model or the mark-to-market model likely would be seen as pre-committed on this point. But there is no way to please everyone. Managers of high-tax corporations should prefer the leveling effect of integration without pass-through, and competitors of the collateral interests that profit from corporate tax preferences also should want integration without pass-through. Both groups, therefore, should oppose the shareholder-allocation model because it effectively results in the pass-through of corporate tax preferences.

In the end, integration either will pass corporate tax preferences through, raising the objections of high-tax corporations and sympathetic collateral interests, or it will not pass preferences through, raising the objections of low-tax corporations and sympathetic collateral interests. The former approach is probably the more likely to succeed, if only because low-tax corporations presumably have more political power (as evidenced by their past success in securing preferences). But the more promising starting point for policymakers likely would be to leave the point open and accommodate objections as they arise. Both the dividend-exclusion model and the imputation-credit model allow integration with or without the pass-through of corporate tax preferences; both therefore allow policymakers the flexibility to make adjustments during the legislative process. The experience with the Bush administration's dividend-exclusion proposal is instructive: although the dividend-exclusion model can allow the pass-through of tax preferences, the Bush administration steadfastly refused to accommodate requests for pass-

through, even in the politically sympathetic case of the low-income housing tax credit. Had the Bush administration made adjustments—even ad hoc adjustments to allow pass-through of certain preferences but not others—the outcome of the proposal might have been different. Of course, it is also possible that selective pass-through cannot be contained as a political matter. Once an exception has been made for a particular preference, policymakers may find they cannot deny similar treatment for other preferences.

Legislators should also preserve flexibility about whether to condition relief from double taxation on distributions of corporate profits. Although integration generally would remove the bias in favor of retaining earnings, it may or may not introduce a bias in favor of distributing earnings. Managers of dividend-paying corporations likely would prefer integration that requires distributions, but managers of other corporations likely would object strongly if tax policy swung sharply from an earnings-retention bias to an earnings-distribution bias. Neither the shareholder-allocation model nor the mark-to-market model conditions integration on the actual distribution of corporate profits. However, as noted above, both models effectively pre-commit to the pass-through of tax preferences. The dividend-deduction model, the dividend-exclusion model, and the imputation-credit model do, in the first instance, condition integration on distributions; but all three models readily accommodate a dividend-reinvestment plan that—as the Bush administration’s dividend-exclusion proposal showed—extends the benefit of integration to shareholders without requiring actual distributions of earnings. As with the shareholder-allocation model, the dividend-deduction model remains problematic on the treatment of corporate tax preferences; that leaves the dividend-exclusion and credit-imputation models with greater promise for success.

The next inflection point for policymakers is to determine whether integration should eliminate the corporate-level tax or the shareholder-level tax. There are potential political considerations on both sides. Elimination of the shareholder-level tax generally removes the relative advantage that tax-exempt shareholders have over taxable shareholders (and, more generally, the relative advantage that lower-tax shareholders have over higher-tax sharehold-

ers). The experience under the Bush administration's dividend-exclusion proposal demonstrated that this is no small consideration: tax-exempt shareholders that are themselves investment vehicles (such as tax-qualified retirement plans and tax-deferred annuities) will resist integration if it does not preserve their advantage relative to taxable shareholders. Importantly, the concerns of these interests—even though they are, at their core, simply concerns about a level playing field—resonated with lawmakers. That suggests that the dividend-exclusion model is more likely to encounter political turbulence here than is the imputation-credit model, because the imputation-credit model can extend the benefit of integration to tax-exempt shareholders by providing refundable credits for corporate-level tax.²⁴⁶ Indeed, the imputation-credit model offers a high degree of flexibility on this point: under the model, shareholder-level credits can be made entirely or only partially refundable, allowing the government to extend the full benefit of integration to tax-exempt shareholders or only so much of the benefit as is necessary to buy their non-opposition.

Still, the imputation-credit model may present its own difficulties. Over the past decade, European countries generally have moved away from integration based on the imputation-credit model to integration based on the dividend-exclusion model (or at least reduced taxation of dividends).²⁴⁷ Although the driver of that movement generally is internal to the law of the European Union,²⁴⁸ the fact remains that integration on the imputation-credit model would put the United States out of step with the integration approach now taken by significant U.S. trading partners. Certainly that asymmetry is a cause of potential *policy* concern. Whether it would also be a cause for potential *political* concern would depend, in part, on whether U.S. corporations with international operations consider asymmetric integration to be sufficiently troubling to oppose it outright. The experience with the Bush administration's

²⁴⁶ Although the dividend-deduction and the mark-to-market models both eliminate the corporate-level tax, they are problematic on the question of passing through tax preferences. The shareholder-allocation model, like the imputation-credit model, can extend the benefits of integration to tax-exempt shareholders. Again, though, the shareholder-allocation model is problematic on pass-through.

²⁴⁷ Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 *Yale L.J.* 1186, 1208–12 (2006).

²⁴⁸ *Id.*

dividend-exclusion proposal provides little guidance on that point: the proposed non-taxation of dividends generally would have harmonized with the newer European approach to integration.²⁴⁹ It is at least possible that managers who otherwise would support integration might prefer the dividend-exclusion model to the imputation-credit model but nonetheless might prefer the imputation-credit model to the continuation of the corporate double tax.

Finally, policymakers would need to consider the effective date of any viable integration proposal. Although the agency-cost explanation argues that successful integration could co-opt managers by precluding windfall transition gains,²⁵⁰ the experience under the Bush administration's dividend-exclusion proposal indicates otherwise. Of all the managers, shareholders, and collateral interests that committed lobbying resources on the dividend-exclusion proposal in 2003, no one appears to have objected to the possibility that existing investments would experience a windfall gain. Rather, managers pointed to the expected windfall as a reason for supporting the proposal and even asked in certain cases that the windfall be enlarged. Politically successful integration, then, apparently would extend both to post-enactment and pre-enactment investments in corporate equity.

C. The Policy-Politics Tradeoff

Contemplating the terms under which integration legislation may be more or less likely to succeed draws into the forefront the inevitability of a tradeoff between policy considerations and political considerations. Both theory and experience suggest that enactment of integration legislation would require Congress to minimize the losses and maximize the gains among managers, shareholders, and other parties with a stake in the corporate double tax. That, in turn, suggests that policymakers should be prepared to pass corporate tax preferences through to shareholders, maintain the relative advantage of tax-exempt and lower-bracket shareholders, and oth-

²⁴⁹ Graetz & Warren suggest that the European movement away from the imputation-credit model "may have influenced" the Bush administration's decision to propose integration under the dividend-exclusion model. *Id.* at 1252.

²⁵⁰ Arlen & Weiss, *supra* note 7, at 365.

erwise preserve or even exacerbate the uneven effects of the status quo for managers, shareholders, and collateral interests. The inherent flexibility of the imputation-credit model makes it a promising vehicle for political concessions and compromises: one can readily envision a gerrymandered imputation-credit system that passes through certain tax preferences but not others, that allows refundable credits to certain shareholders but not others, and that confers substantial windfall transition gains. In short, one can imagine an integration system that looks as imperfect as any successful tax legislation that fuses sound theory with political expediency.

That raises the further question of whether integration would be worth the effort. The strong consensus among academics and policymakers in favor of integrating the corporate and individual income taxes depends heavily on the argument that integration would remove significant distortions caused by the corporate double tax. Perhaps successful integration would remove or at least ease certain distortions under current law—for example, the preference for debt financing over equity financing—but the compromises and concessions required by the political process likely would introduce new distortions. It is hardly clear that, on balance, an actual system of integration that could emerge from the legislative process would be comparable to any of the theoretical systems of integration that would enter the legislative process. The experience of the Bush administration's dividend-exclusion proposal might be most instructive on that simple point: there may be too many entrenched and heterogeneous interests affected by integration to permit enactment of any system that academics and policymakers would consider a clear improvement over the corporate double tax. Actual integration may be nothing more than a difficult step sideways.

CONCLUSION

Analysis of the corporate double tax reveals uneven burdens on corporations, uneven burdens on shareholders, and uneven effects on third parties that provide goods and services to corporations and shareholders. The heterogeneity of existing interests directly implies that elimination or mitigation of the corporate double tax would affect different managers, shareholders, and collateral interests differently. Very simply, winners under the status quo should

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be resistant to integration, and losers under the status quo should be supportive of the change. However, the analysis of potential winners and losers becomes complicated once the widely varied models of integration are considered. These models have heterogeneous effects on managers, shareholders, and collateral interests, implying that any particular proposal for integration inevitably will draw both support and opposition. The lobbying experience under the Bush administration's dividend-exclusion proposal confirms the importance of these considerations. This implies that successful integration—as with any successful tax legislation having significant effects on entrenched interests—would require extensive political compromises. In the end, actual integration may be as unattractive as the existing corporate double tax.