ARTICLES

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The Effects of Tax Laws on the Choice of Organizational Form and Structure: A Comparison of Integrated and Nonintegrated Tax Systems**

I. Taxation of Corporations, Partnerships, and Limited Liability Companies

The choice of form for a business involves complex and often conflicting questions of economics, law, and taxation. For example, the simplicity and flexibility of the partnership are offset by the problems of partners' exposure to personal liability for business debts. Conversely, the corporate shareholders' immunity from exposure to business liability comes at the expense of a more complex and structured legal organization. In the U.S. legal systems (federal and state) both the problems and virtues of these forms may be heavily modified by structural arrangements made by the parties.

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To these inherent economic and legal difficulties of choice of organizational form must be added the differences in tax treatment between partnerships and their partners, on the one hand, and corporations and their shareholders, on the other. In the United States, where separate taxation of corporations and shareholders remains firmly imbedded in the law, these differences are so great as in many instances to dictate the choice of form. By contrast, in nations where the income tax systems of corporations and individuals are integrated in any form or degree, the differences in tax treatment may be reduced, but are unlikely to be eliminated.[1]

This article analyzes these issues primarily from the viewpoint of the noncorporate investor faced with the choice of structuring an investment in the United States as a corporation or a noncorporate entity. Different and equally significant issues are presented when these choices must be made by a corporate investor.

A. Corporations Are Taxed as Separate Taxable Entities

Corporations are, within the structure of the Internal Revenue Code of 1986, separate taxable entities.[2] Corporations are taxed, at a maximum rate of 35 percent,[3] on a basis largely consistent with Generally Accepted Accounting Principles, with some important exceptions and limitations. Ordinary and necessary business expenses, such as cost of goods sold,[4] salaries,[5] and interest on debt,[6] are deductible in determining taxable income. Dividends, whether in cash, other assets, stock, or securities, are not deductible. No credit or other tax allowance is allowed to the corporation with respect to dividend distribution.

Individuals who receive corporate dividends must report the amount thereof for tax purposes just as they report all other ordinary taxable income.[7] Accordingly, the dividends received are taxed at progressive rates, up to a maximum rate of 39.6 percent for the 1993 tax year.[8]

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1. Many of the important trading nations of the world have adopted so-called integrated income-tax systems, in which the double-tax effects described below are mitigated by any of a variety of mechanisms. The systems of Australia, New Zealand, Canada, France, Germany, and the United Kingdom are described and analyzed in UNITED STATES DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 159-184 (1992) [hereinafter the TREASURY INTEGRATION REPORT].

2. Internal Revenue Code § 11(a) (1986, as amended) [hereinafter I.R.C.].

3. I.R.C. § 11(b). The applicable tax rates vary from 15% (taxable income $50,000 or less) to 35% (taxable income in excess of $10 million). For determination of income and deductions, see generally I.R.C. §§ 61(a), 161-196.

4. *See* I.R.C. §§ 64, 162(a).

5. I.R.C. § 162(a)(1). *But see* I.R.C. § 162(m) (disallowance of deduction for excessive employee remuneration).

6. I.R.C. § 163(a). The exceptions to the general rule of deductibility of interest are not discussed here.

7. I.R.C. § 61(a)(7). For the definition of "dividend," see I.R.C. § 316.

8. I.R.C. § 1. The rates, which vary based on taxable income, apply to different income brackets for individuals, married couples filing joint income tax returns, and heads-of-households. For the tax year 1993, the rate brackets for married couples filing jointly were as follows:

The combined effect of the corporate and individual income taxes is that the effective tax rate on distributed corporate income is 60.74 percent, assuming maximum tax rates, leaving only 39.26 percent net income after federal taxes.[9]

A limited exception to double taxation once existed in the federal tax structure under the *General Utilities*[10] doctrine: properly structured sales of appreciated assets as part of a plan of corporate liquidation could escape gains taxation at the corporate level.[11] Also, certain direct (in kind) distributions of corporate assets could be made without taxation of the gain thereon to the corporation.[12] This exception no longer exists: sales or distributions of appreciated corporate assets, whether or not in pursuance of a plan of liquidation, will give rise to recognition of gain by both the corporation and its shareholders.[13]

Despite the repeal of the *General Utilities* doctrine, other methods for avoidance or deferral of double taxation remain available. These methods include debt financing, salary payments, corporate entity dispositions and corporate reorganizations, and stock retention until death.

The federal income tax structure is mirrored in many, though not all, state income tax laws. Corporations are subject to an additional state income tax in most of the states in which they do business, the allocation of income among the states being subject to a variety of formulas. Further, most states impose upon their individual residents a personal income tax, which includes within its base of taxable income dividends received from corporations. This additional layer of state taxation significantly increases the effective double-tax burden on distributed corporate income, despite the fact that the state income taxes paid

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Up to $36,900	15.0%
$36,901-$89,150	28.0%
$89,151-$140,000	31.0%
$140,001-$250,000	36.0%
In excess of $250,000	39.6%

9. The 60.74% tax rate is calculated as follows:

Net corporate income before tax	100.00%
Corporate tax (35% tax rate)	35.00
Amount distributed to stockholders	65.00%
Individual tax (39.6% tax rate)	25.74
Net stockholder income after taxes	39.26%
Total corporate & individual tax	60.74%

10. General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

11. *See* I.R.C. § 336(a) as in effect prior to the Tax Reform Act of 1986.

12. *See* I.R.C. § 311(a)(2) as in effect prior to the Tax Reform Act of 1986. The recipient shareholders, however, recognized gain equal to the fair market value of the distributed assets less their basis in the stock given up (if the distribution qualified as a redemption), or alternatively recognized ordinary dividend income in an amount equal to the fair market value of the distributed assets. *See* I.R.C. §§ 301-302.

13. I.R.C. § 311(b)(1) (gain recognized by corporation on nonliquidating distribution of appreciated assets; I.R.C. § 336(a) (gain recognized by corporation on distribution in liquidation of appreciated assets); I.R.C. § 302(a) (gain or loss recognized by stockholder on redemption of stock); I.R.C. § 331 (gain or loss recognized by stockholder on complete liquidation of corporation).

are deductible in calculating the federal taxable income of both the corporation and its shareholders.[14] For example, if the state income tax rate is 10 percent on both corporate and individual income, the total income tax on distributed corporate income would be 68.2 percent, leaving less than one-third of the net income available after taxes.[15]

B. Partnerships and Limited Liability Companies Pay No Income Taxes

Like corporations, partnerships must file federal income tax returns. However, partnerships pay no federal or state income taxes. Instead, their partners are treated as though they directly earn and incur their allocable share of each of the items of partnership income and expense. The most direct implications of this structure are that partnership income is taxed only at the partner level,[16] and is taxed when it is earned by the partnership,[17] not when the income is distributed to the partners.[18]

One important effect of this tax structure is that distributed partnership income is taxed only once. For ordinary partnership income, the effective maximum tax rate is therefore 39.6 percent, a savings of more than 21 percent over the combined corporate and individual taxes for distributed corporate income. Moreover, since partnership income, gains, expenses, and losses retain their character in the hands of the partners, the tax on capital gains (as, for example, on sale of land or other capital or productive assets) is only 28 percent.[19]

An equally important effect of this tax structure is that gains on sales of partnership assets made in the course of partnership liquidation are similarly taxed only once. Moreover, if in liquidation the partnership distributes assets in kind (i.e., without sale), gain is ordinarily not realized by the recipient partners, who simply

14. I.R.C. § 164(a)(1).

15. The 68.2% tax rate is calculated as follows:

Net corporate income before tax	100.00%
State corporate income tax (10% rate)	10.00
Net income subject to federal tax	90.00%
Federal corporate income tax (35% rate)	31.50
Amount distributed to stockholders	58.50%
State personal income tax (10% rate)	5.85%
Net income subject to federal tax	52.65%
Federal personal income tax (39.6% rate)	20.85
Net stockholder income after taxes	31.80%
Total corporate & individual tax	68.20%

16. I.R.C. §§ 701, 702.

17. I.R.C. § 706(a).

18. I.R.C. § 731(a)(1).

19. By contrast, capital gains of a corporation (including partnership capital gains allocated to a corporate partner) are taxed at the same rate as ordinary income. I.R.C. § 1201. Corporate stockholders are therefore not only effectively subject to a double tax, but may be taxed at higher rates as well.

take the assets with a carryover basis.[20] This arrangement, unavailable in corporate form, allows any gain or loss on the distributed assets to be deferred until the time when the recipient partners decide to dispose of those assets.

A further potential tax virtue of partnership form is that the losses as well as the profits of a partnership are passed through to the partners.[21] Depending upon the character of the losses and the nature of the partners' participation in the partnership, there may, however, be limits imposed on the use of these losses.[22]

The pass-through of items of partnership income, gain, expense, and loss may be allocated and distributed according to detailed provisions of the partnership agreement. Although these allocation and distribution provisions will generally be respected for tax purposes, the provisions offer considerable potential for tax shifting and avoidance, and therefore are subject to extensive and detailed regulations.[23]

These tax virtues are not entirely without cost. As noted earlier, the allocable shares of partnership income and loss are reportable by the partners as earned or incurred, regardless of whether distribution has taken place.[24] As a result, a partnership may need to make periodic distributions of income to provide the partners with the necessary funds to pay the taxes for which they are liable. However, the maximum ordinary tax rate is, at this writing, 39.6 percent for noncorporate partners, as compared with the 35 percent maximum corporate income tax rate. Thus, periodic distributions of the amounts needed to pay taxes would not substantially exceed the taxes that would otherwise be payable in corporate form. And no further tax would be payable by the partners upon distribution from the partnership.

Partnership form involves other complexities of tax qualification, record-keeping, and filing. Other potentially problematical aspects of partnership form, such as personal liability of partners for debts of the partnership, are not tax-related. Appropriate planning can mitigate some of these problems as well.

C. The Resulting Tax Structure Creates an Incentive to Use Partnership Form in the United States When Feasible

The difference between the effective tax rate imposed on income earned and distributed by a corporation and the effective tax rate imposed on income earned and distributed by a partnership is too great to ignore. The disparity creates a

20. I.R.C. § 731 (no recognition of gain or loss); I.R.C. § 732 (carryover of basis).

21. I.R.C. § 704.

22. A partner may take losses only to the extent of the basis in the partnership interest. I.R.C. § 704(d). Complex rules govern basis of the partner in the partnership, including a limitation that basis for loss purposes generally excludes amounts not considered "at risk" in the business. I.R.C. § 465. Further, the Code contains elaborate rules limiting the extent to which an individual may utilize "passive activity losses," including those arising from a partnership. I.R.C. § 469.

23. *See generally* Treas. Reg. § 1.704-1(b) (1986).

24. I.R.C. § 706(a).

strong incentive to use the partnership form whenever feasible. The partnership form is extensively and almost exclusively used for forms of business enterprise that expect primarily to distribute rather than reinvest earnings. Similarly, partnership is the preferred form for enterprises that have limited planned life, that are expected to be sold or liquidated in the short term. Thus, the partnership form is now used in the United States for most real estate businesses (for example, commercial and residential rental buildings, shopping centers, and real estate development companies), natural resource exploration ventures (such as oil and gas exploration), motion picture productions, and personal service enterprises.

Problems in adopting the structures of the classic partnership form to the economic needs of the parties have resulted in substantial legal development of U.S. partnership law in the last few decades. Personal liability is readily avoided by use of the limited partnership form of business, but American limited partnership law traditionally precluded limited partners from participating in the control of the business, relegating them to the role of purely passive investors.[25] The revision of the Uniform Limited Partnership Act in 1976 and thereafter addressed this problem and others by greatly extending the permissible participation by limited partners in control and operation of the business and significantly increasing their protection against firm debts.[26] The requirement that at least one partner of the limited partnership be a general partner who is unlimitedly liable for the partnership debts is now routinely addressed by naming a corporation as the general partner.[27] This device is not forbidden by either the corporate or the partnership laws.[28]

More complex questions are raised as the number of investors in the partnership increases. Nothing in the substantive law of general or limited partnerships limits the number of partners that may be admitted. However, maintenance of the required accounting records, especially the tax accounting records, of partner-

25. The structural law of business associations—corporations, partnerships, limited partnerships, limited liability companies, and other forms—is found in state statutes. Although the form, content, and drafting of corporate laws varies widely among the states, partnership law has been essentially uniform throughout the 20th century. The general law of partnerships is governed by the Uniform Partnership Act, which has been adopted in all but one state. The law of limited partnerships is governed by the Uniform Limited Partnership Act which, prior to its revision, was in effect in all the states. The original Uniform Limited Partnership Act prohibited participation by limited partners in the control of the business; their participation rendered them fully liable for debts as general partners.

26. *See* REV. UNIF. LIMITED PARTNERSHIP ACT § 303, 6 U.L.A. 441 (Supp 1994) [hereinafter RULPA]. The RULPA, occasionally with variations, has been adopted in nearly all of the states as of this writing.

27. The requirement that there be a general partner appears in several sections of the Revised Uniform Limited Partnership Act. *See* RULPA §§ 101(7), 201(3), 801(4).

28. *See* RULPA §§ 101(5), 101(11) (corporation as general partner); REVISED MODEL BUSINESS CORP. ACT § 3.02(9) (1984) (corporate power to act as a partner). The Internal Revenue Service requires, as a condition of ruling in favor of partnership status, that the corporate general partner satisfy certain minimum requirements of capitalization and ownership. *See* Rev. Proc. 89-12, 89-1 C.B. 798; Rev. Proc. 92-88, 1992-42 I.R.B. 39.

ships with many partners can become quite complex,[29] particularly if partners withdraw or new partners join during the year. Despite these problems, several large-scale limited partnerships provide for public trading of their partnership interests or depositary receipts.[30]

These features of partnership law and partnership drafting have often made the resulting enterprise look very much like a corporation. This resemblance has not escaped the attention of the Internal Revenue Service. The Internal Revenue Code grants authority to the Commissioner to characterize enterprises in accordance with their substance, and in the widely cited decision of *Larson v. Commissioner*[31] the United States Tax Court set forth the criteria for determining that characterization. *Larson* holds that the presence of a majority (i.e., three) of the following factors will result in characterization as a corporation for tax purposes: (1) limitation of liability, (2) continuity of life, (3) centralized management, and (4) free transferability of interests.

General partnerships formed in the United States will invariably be treated as partnerships for tax purposes, since they will ordinarily have none of the listed criteria. Limited partnerships, however, will often meet several of the criteria for taxation as a corporation. Most will have centralized management, and many, by virtue of having a corporate general partner, will be treated as having limitation of liability. The terms of some limited partnership agreements may establish freely transferable interests. Therefore, careful planning and drafting of limited partnership agreements are necessary to assure that no more than two of these criteria are met and thereby to assure taxation as a partnership.

In an attempt to achieve the tax virtues of partnership form while more closely approximating the character of a corporation, many states enacted legislation authorizing the formation of a new form of organization, the limited liability company. The first limited liability company statute in the United States was enacted in 1977 in Wyoming.[32] At least thirty-six other states have enacted similar statutes since then, and limited liability legislation is pending in many of the remaining states. A committee of the American Bar Association drafted a prototype limited liability company act, and the National Conference of Commissioners on Uniform State Laws is currently completing work on a Uniform Limited Liability Company Act.[33]

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29. The Treasury Regulations require that capital accounts be maintained for each partner, and that ultimate allocations and distributions be in accordance with these capital accounts. *See* the "substantial economic effect" requirement of Treas. Reg. § 1.704-1(b)(2) (1986). For each partner, the partnership must file with its annual federal income tax return a Form K-1, detailing that partner's allocable share of items of income, gain, expense, and loss for the year.

30. However, with some exceptions, publicly traded partnerships are treated as corporations for tax purposes. *See* I.R.C. § 7704 and the discussion below.

31. 66 T.C. 159 (1976).

32. *See* WYO. STAT. §§ 17-15-101 to -136 (1977).

33. The contemporary limited liability company has early antecedents in the United States. These include the Pennsylvania partnership association, created in 1874, PA. STAT. ANN. tit. 59, §§ 341-361 (repealed 1970); the Michigan partnership association, created in 1877, MICH. COMP. LAWS ANN.

The Internal Revenue Service has ruled that these limited liability companies will be treated for tax purposes as partnerships if they, like limited partnerships, do not meet a majority of the *Larson* criteria.[34] The limited liability company statutes generally provide sufficient flexibility that the entity may be structured to be treated either as a corporation or as a partnership for tax purposes.

Nevertheless, the combined effect of the *Larson* criteria and the practical limitations on the use of the partnership or limited liability company is that continuing business enterprises with many owners, and in particular those with transferable share interests, will usually remain in corporate form, despite the tax disadvantages thereof.[35]

II. Tax Incentives to Issue Debt Rather than Stock

A. The Income Tax Effects of the Receipt of Dividends or of Interest Are Basically Equivalent

For individual investors, both dividends on corporate stock and interest on corporate bonds are taxable as ordinary income.[36] The tax equivalence of dividends and interest is independent of the fixed, variable, contingent, or participating character of the payments. Moreover, gains and losses on the purchase and sale of stocks and bonds are taxed comparably, generally as capital gains and losses subject to a favorable lower tax rate.[37] Therefore, the investment choice between stocks and bonds will normally be governed by economic, financial, and legal considerations such as risk, security, return rate, liquidation rights, and voting, having no relationship to taxation.

The tax equivalence of these investments generally remains for institutional investors, such as mutual funds, insurance companies, pension funds, and certain trusts. For some of these investors, both forms of income, as well as gains and losses on sale of stocks and bonds, are exempt from income taxation.[38]

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§§ 449.301-.373 (West 1989); and the New Jersey and Ohio limited partnership associations, N.J. Stat. Ann. §§ 342:31-29 (West 1992), Ohio Rev. Code Ann. §§ 1783.01-.08 (Baldwin 1992), created in 1880 and 1881, respectively.

34. The first favorable ruling was with respect to the Wyoming limited liability company, Rev. Rul. 88-76, 1988-2 C.B. 360. Since then, numerous published and private rulings have been issued, each with reference to a particular statute.

35. Mitigation of the shareholder-level tax burden of corporations may be (and often is) achieved through a combination of minimum dividend distributions, tax-free mergers, other corporate reorganizations, and retention of stock until death. Detailed discussion of the implementation of these arrangements is beyond the scope of this paper, but their effect in brief is the avoidance of gain taxation despite change in the character of the investment and (in the case of death) transmission of the stock to heirs with increased tax basis.

36. I.R.C. § 61(a)(4) (interest); I.R.C. § 61(a)(7) (dividends).

37. *See* I.R.C. § 1(h) (28% maximum rate).

38. For example, pension trusts qualified under I.R.C. § 401(a) are exempt from taxation under I.R.C. § 501(a). Also exempt from taxation under § 501(a) are organizations described in § 501(c), including charities and foundations. These pension trusts and nonprofit organizations are among the important institutional investors, accounting for a substantial part of the investment in publicly traded stocks and bonds in the United States.

While gains or losses on the sale of stock or bonds are generally treated equivalently as capital gains or losses, this equivalent treatment is not extended to redemption, repurchase, or repayment by the issuing corporation. Payment or purchase of a bond by the issuing corporation in whatever form is treated by all bondholders as repayment of the debt principal. The resulting gain or loss, if any, is recognized only to the extent that the payment is greater or less than the bondholder's basis in the bond.[39] Equivalent tax treatment is given to corporate stock repurchase, but only when the repurchase meets statutory standards qualifying it as a redemption[40] or partial liquidation.[41] When the repurchase does not meet these standards, it will be subject to dividend taxation on the entire amount received in the distribution.[42]

These rules apply equally to corporate investors, with one important exception. Dividends paid by one corporation to another *corporation* that are otherwise taxable are normally subject to partial or full deduction from income.[43] This deduction avoids triple or further multiple tax on the distributed income of corporations that are, in turn, owned by other corporations.

The overall effect of these rules on investors is that, with some exceptions, the tax effects of receiving income on stock or bonds will be equivalent. The tax effects of disposition of the investment will generally also be equivalent, except when corporate redemption is treated as equivalent to a dividend.

B. Corporate Income Taxation Effects of Dividend Payment and Interest Payment Are Different

Equivalent tax treatment does not extend to the corporation that issues the stock or debt instruments. Dividends on corporate stock, in whatever form and however determined, are not deducted in determining corporate taxable income or credited in calculating income taxes payable. By contrast, interest on corporate debt is normally fully deductible in calculating corporate taxable income.

The effects of this tax difference on the cost of raising capital in various forms are obvious and readily calculable. For example, in today's market the market dividend rate on the preferred stock of a well rated corporation would likely be in the range of perhaps 10 percent to 12 percent per year. The same corporation should be able to issue medium or long-term bonds carrying an annual interest rate in the range of 8 percent or less. Since the interest is deductible, the taxes of the corporation will be reduced by 35 percent of the interest payment, or 2.8 percent. As a result, the true interest cost, in both expense and cash flow, will be 5.2 percent.

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39. *See* I.R.C. § 1221 (defining capital assets).
40. *See* I.R.C. § 302(b)(1)-(b)(3).
41. *See* I.R.C. § 302(b)(4).
42. I.R.C. § 301(a).
43. *See* I.R.C. §§ 243-247 for rules on the dividend received deduction.

As a matter of basic corporate finance, the cost of raising capital by issuance of stock should be, and nearly always is, greater than the cost of raising capital by issuance of debt since the higher risk of stock requires a higher return. In the U.S. tax system, this already present difference is amplified by the deductibility of interest versus the nondeductibility of dividends.

As might be expected, this tax structure creates incentives to issue more debt than might otherwise be issued in a system in which dividends and interest were treated equivalently. Debt issuance is affected by these tax incentives, and the incentive to issue corporate debt increases as corporate tax rates increase.

Given the corporate tax advantages of debt, some corporations have issued equity-like instruments that purport to be debt for tax purposes. Other corporations have created capital structures in which shareholders own debt in proportion to their equity, with the object of providing additional tax deductions to the corporation. Indeed, an entire tax jurisprudence has developed around the issue of distinguishing debt from equity.[44] For purposes of this article, it is sufficient to suggest that while true debt is clearly entitled to the tax advantage of deductibility of interest, debt of mixed character and excessive or proportionately owned debt will be questioned by the Internal Revenue Service.

C. Substantial Debt Issuance Changes the Character of Corporate Securities

The tax incentive to form a partnership (when it is feasible) instead of a corporation appears to have had little effect on the U.S. economy, apart from directing some business to lawyers and accountants specializing in tax law. The corporate incentive to issue debt in preference to equity is another story. As the proportion of debt in the capital structure of a corporation increases, the risk of both the debt and the equity increases; and, indeed, the likelihood of bankruptcy or lesser financial distress based on inability to meet debt service requirements also increases.

The theory that the corporation's shareholders would be motivated to limit the amount of debt because the value of their shares would decline with increased risk has recently been questioned. The stock of corporations with very substantial debt is, in theory, more akin to an option than to a pure equity interest. The holders of the corporate debt are entitled to be paid only out of the corporate assets, and they bear the risk that those assets will be insufficient to pay the entire debt. If the corporation's assets are insufficient to pay its debts, the shareholders simply walk away from their investments. By contrast, if the corporation's assets are sufficient to pay its debts, the shareholders own the entire remaining value in excess of the debt. The shareholders are therefore, in economic terms, in the

44. *See* I.R.C. § 385 (delegation of authority to the Internal Revenue Service to recharacterize debt or equity instruments in accordance with their substance; listing of criteria).

position of holders of a call option.[45] Contemporary option theory suggests that the value of such stock may increase with increased risk.[46] In effect, the shareholders may have an incentive to increase, rather than limit, the amount of corporate debt. This analysis suggests that the U.S. tax incentives may be promoting an excessive and unhealthy expansion of debt. This argument is not without controversy and remains to be definitively explored by empirical study.

III. The Effects of Tax Integration

A. Integration Proposals for the U.S. Income Tax System

Tax integration is a broad concept, encompassing a variety of structures designed to approximate a single, integrated tax on corporate income. Integration of individual and corporate income has been studied[47] and implemented in a variety of forms[48] in many of the developed nations of the world. In the United States, the subject has also been widely studied,[49] and debate has most recently focused on two proposals.

The Treasury Department has proposed a dividend exclusion approach as a short-term measure and a comprehensive business income tax as a long-range goal.[50] In its basic structure, a dividend exclusion model calls for corporate income

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45. *See* J. Weston & T. Copeland, Managerial Finance 500-02 (8th ed. 1989).

46. One of the surprising implications of considering equity in a levered firm as a call option is that investments which increase the idiosyncratic, or diversifiable, risk of a firm without changing its expected return will benefit shareholders at the expense of bondholders even though the value of the firm is unaffected. . . . The reason is that higher variance [in returns] will increase the value of the call option held by shareholders.

Id. at 502.

A similar result may be achieved by increasing the risk of the stock through increasing the proportion of debt financing of the firm: the increased risk of the stock increases its value as a call option.

47. *See* Commission of the European Community, Report of the Committee of Independent Experts on Company Taxation (1992) [hereinafter Ruding Committee Report]. For commentary on the international aspects of tax integration, see, e.g., Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565 (1992).

48. The adopted integration systems vary significantly. For example, imputation credit systems have been included in the tax integration structures of such nations as Australia, New Zealand, France, and Germany. Germany also applies a split tax rate, differentiating between the tax payable on distributed as opposed to retained corporate earnings. Other nations, such as Canada, have adopted straight dividend credits. *See* Treasury Integration Report, *supra* note 1, at 159-84.

49. A distinguished early study is William D. Andrews, *Out of Its Earnings and Profits: Some Reflections on the Taxation of Dividends*, 69 Harv. L. Rev. 1403 (1956). Among recent articles are William D. Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 Wayne L. Rev. 1057 (1984), and Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719 (1981). A Colloquium on Corporate Integration was sponsored by the *Tax Law Review* in 1992, the papers of which are collected in 47 Tax L. Rev. 427-723 (1992).

50. *See* Treasury Integration Report, *supra* note 1, at viii; *see also* Treasury Department, A Recommendation for Integration of the Individual and Corporate Tax Systems (1992), *reprinted in* Daily Tax Rep. (BNA), Dec. 14, 1992, at L-7.

to be taxed fully at the corporate level, but for dividends to be excluded from the taxable income of the shareholders who receive them. The Treasury's proposed comprehensive business income tax extends a similar rule to corporate interest payments, denying them as deductions to the corporation but excluding them from income by the recipients.[51] In each of these models, the tax paid on corporate income is, therefore, at the corporate income tax rate.

By contrast, the American Law Institute (ALI) has proposed a complex imputation credit system, providing shareholders with a refundable credit for taxes paid by the distributing corporation.[52] Under this structure the corporation would pay a dividend withholding tax at the highest individual tax rate, and each shareholder receiving a dividend would be entitled to a tax refund credit equal to the excess of the amount withheld over the actual tax the shareholder would pay on the dividend received.[53] Under this system, the tax paid on corporate income is, therefore, at the individual tax rate of each shareholder.

Not all tax integration models will approximate the same tax effects for corporations and partnerships, and none are likely to produce identical tax effects for the two forms of enterprise. Some, but not all, integration approaches mitigate the tax differences between debt and equity. To illustrate these points, the tax planning issues involved in choice of enterprise form and structure are analyzed below under the basic integration models proposed by the Treasury Department and the ALI.

B. The Choice of Partnership or Corporate Form Under the Integration Proposals

The Treasury and ALI proposals would mitigate in varying degrees the sharp differences between partnership and corporate income taxation in the United States. Both would basically tax corporate income only once. Moreover, the ALI proposal would achieve taxation of corporate income at the same individual rates as taxation of partnership income. However, the Treasury proposal would retain taxation of corporate income at corporate rates, thereby retaining an incentive to use the partnership form whenever investors in the enterprise have lower marginal tax rates than the corporate tax rate.

Both proposals leave intact many of the existing tax incentives for use of

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51. *See* Treasury Integration Report, *supra* note 1, at 17, 40. In the Treasury proposals, as well as in any enacted implementation structure, these basic rules must be implemented by detailed provisions covering such matters as tax-exempt and foreign investors, tax preferences, corporate shareholders, and tax abuse.

52. *See* American Law Institute, Federal Income Tax Project, Tax Advisory Group Draft No. 21, Reporter's Study (1992) [hereinafter ALI Reporter's Study]. For analysis of the planning implications of these proposals, 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).

53. *See* ALI Reporter's Study, *supra* note 52, at 79-87.

the partnership. Neither proposal gives a corporate shareholder certain of the important tax benefits of being a partner, including pass-through of enterprise losses, pass-through of the tax character of the enterprise income, and nonrecognition of gain on the distribution of appreciated assets.[54]

C. Debt and Equity Financing Under the Integration Proposals

The Treasury dividend exclusion proposal appears on its face to continue the corporation's incentive to issue debt rather than equity, since interest would remain deductible and dividends would remain nondeductible by the corporation. However, the exclusion of dividends would increase the net return to shareholders, and the corporation should therefore be able to raise equity capital at a lower net cost. The calculations in the illustration in part II.B, above, would change. Given a market dividend rate on the corporation's preferred stock, prior to integration by dividend exclusion, of 10 percent, the corporation should be able to issue the same stock with a post-integration dividend rate of approximately 6 percent.[55] If the same corporation pays approximately 8 percent annual interest on its medium or long-term bonds and if the interest remains deductible, the taxes of the corporation will be reduced by 35 percent of the interest payment, or 2.8 percent. As a result, the true interest cost, in both expense and cash flow, will be 5.2 percent. Although the cost of debt likely remains lower than the cost of equity, the difference is reduced by the Treasury's dividend exclusion proposal.

The tax incentive to issue debt rather than equity would on its face be eliminated by the long-range Treasury proposal of a comprehensive business income tax in which both dividends and interest would be nondeductible by the corporation and excluded from income by the recipients. But the problems raised by this proposal are considerable and are not subject to easy solution. Among the most noteworthy problems would be the creation of a new corporate incentive to switch from nondeductible debt financing to financing in the form of leases, resulting in deductible rent or royalty payments.[56] The ALI proposal, which in effect would tax all dividends and interest equivalently, but based on the tax rate of the investor, also poses special problems. The ALI proposal to tax all interest income contemplates the possibility of taxing even the interest income of tax-exempt investors.[57]

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54. These issues are analyzed in Schler, *supra* note 52, at 509, 522-24, 527-29.

55. Prior to integration, a maximum tax-bracket individual shareholder receiving a 10% dividend would pay federal income tax thereon at the rate of 39.6%, leaving a net after-tax return of slightly more than 6%. For the same investor, therefore, an excludible dividend of 6% would represent an equivalent investment return. This calculation, apart from its simplified arithmetic, does not take into account a series of economic factors that might alter the relative market returns of stock in a post-integration setting. These factors include variations in the marginal tax rates of investors, investment practices of taxable and nontaxable investors, and the implications of likely unavailability of the dividend exclusion to foreign investors.

56. *See* TREASURY INTEGRATION REPORT, *supra* note 1, at 53-54.

57. *See* ALI REPORTER'S STUDY, *supra* note 52, at 138-39.

IV. Conclusion

This article has described some of the major corporate tax planning opportunities created by the classical system of double taxation of corporate income in the United States. These opportunities include tax-motivated choice of enterprise form and tax-motivated choice of methods of raising capital. While the economic implications of tax-motivated choice of form are important, the tax incentives to issue debt in preference to equity may be of even greater consequence, affecting the financial stability of many enterprises.

Although these incentives may be reduced under certain integration proposals in the United States as well as certain integration structures adopted in other nations of the world, they will probably not be eliminated. The complex provisions required in the actual implementation of a workable tax integration plan will continue to offer opportunities to reduce taxes by altering enterprise form and structure.