WRITTEN TESTIMONY OF JOHN L. BUCKLEY

COMMITTEE ON FINANCE

UNITED STATES SENATE

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INTRODUCTION

Chairman Hatch, Ranking Member Wyden, I want to thank you and the other Members of the Committee for the opportunity to appear before you today.

Mister Chairman, I believe that you should be commended for the way in which this Committee has approached the issue of tax reform. Bipartisan working groups foster understanding across party lines, a necessary component of a successful tax reform effort. The hearings that you are conducting reflect a commitment to a careful examination of the issues. As you continue the process of developing tax reform legislation, you may want to take into account comments once made by a former Chairman of this Committee, Senator Moynihan. “The idea of a new set of simple rules is always appealing. However, any time a change of this magnitude is under consideration with huge potential risks to the economy and shifts of fortune in the balance, we must approach proponents’ claims with caution and healthy skepticism.”

The subject of today’s hearing, the double taxation of corporate income, has been the subject of debate for an extremely long time. Based on my experience, interest in the topic has been much greater within the academic community than the corporate community. Indifference or outright opposition from the corporate

community played a large role in the defeat of the corporate integration proposals made by the Reagan, George H.W Bush and George W. Bush Administrations. During my career as a Congressional staffer, the only lobbying that I experienced on this issue occurred when individuals representing several large corporations came in to express opposition to the George W. Bush Administration proposal.

I have to acknowledge that details matter and that the opposition to the Bush Administration proposal was based on opposition to its method of delivering the relief, a shareholder exemption for dividends paid out of fully taxed earnings. Press reports indicate that a quite different proposal is now being considered. That proposal would provide a deduction for corporate dividend payments similar to the current deduction for corporate interest payments. The cost of the new dividends-paid deduction would be offset by the imposition of a 35%, nonrefundable, withholding tax on the payment of corporate dividends and interest. The proposal could effectively repeal the corporate income tax for most corporations, as they shift funds allocated for stock buybacks to increased dividend distributions. It is likely the only corporations that would continue to have significant liability would be corporations which need to retain earnings to fund future growth or which for regulatory purposes are required to increase their equity capital (banks and other financial institutions are an example). The proposal promises far greater benefits to corporations than previous ones and it is possible that it may receive a different reaction from the corporate community. But, details matter and I believe that the new withholding taxes will be problematic for many corporations and their shareholders.

I believe that politics will, and more importantly should, play a large role in the development of tax reform legislation. I mean to include both the politics necessary to assemble the Congressional majorities required for enactment and the more difficult task of assessing the potential for negative public response after enactment. Tax proposals enacted without regard to politics can have a fairly short life span. For example, in 1982 the Congress enacted a withholding

tax on dividends and interest. It was a small withholding tax with a 10% rate. It was fully refundable and only applied to payments made to individuals, exempting payments to corporations, individual retirement funds, pension funds, other tax-exempt organizations, and foreign investors. It was repealed before it took effect as a result of the public outcry.

The proposal being discussed today includes a far greater and more expansive withholding tax of 35% on all corporate dividend and interest payments, without regard to whether the recipient is tax-exempt. It would be nonrefundable. As a result, individuals would face at least a 35% rate on dividend and interest income, even if they were in a lower marginal tax rate bracket. Tax-exempt entities, including pension funds and individual retirement plans, would effectively pay tax notwithstanding their exempt status.

If the proposal were enacted, individuals with individual retirement or 401(k) plans would receive statements showing a reduction in their investment income due to the withholding tax, but no corresponding benefit, as is the case with other withholding taxes. In the case of dividend income, you could argue that the proposal merely substitutes direct tax liability for the indirect burden of the corporate tax. No such argument would be available in the case of interest payments due to the current deduction for interest at the corporate level. The merits of the argument probably would not matter; I doubt that you will be successful in convincing angry constituents. I believe that the holders of Roth IRAs will be particularly incensed since they essentially waived an immediate tax reduction for contributions to the account in return for the promise of no taxation of the account's earnings in the future.

Essentially, the proposal would impose taxes directly on your constituents and a long list of tax-exempt entities in lieu of the indirect burdens of the current corporate tax. Before legislating, you should consider whether that approach would be able to withstand the attacks that may follow enactment.

Finally, the potential disruptions and distortions that could result from the proposal could dwarf the problems caused by the current double taxation of corporate earnings. For example, corporations may use costly and less efficient leasing transactions involving a non-corporate lessor to avoid the withholding tax on corporate interest payments. The fact that dividends received by tax-exempt entities would be subject to tax at a 35% rate, but capital gains would remain exempt, could create a new set of distortions in the case of the growing number of corporations with dividend distributions in excess of their fully taxed income. For you, the question is not whether there are issues under current law. The more important question is whether the cure is worse than the disease.

CRITIQUES OF CURRENT CORPORATE TAX

In the past, proponents of corporate integration have focused on two economic distortions arguably caused by the double taxation of corporate income: the incentive to operate in pass-through form rather than as a taxable corporation and the bias for debt financing that could result in over-leveraging at the corporate level.

Incentive for Pass-Through Organizations

I have to admit that I have always been puzzled by the focus on increased use of pass-through entities like partnerships, limited liability companies, and subchapter S corporations. If you think that the double taxation of corporate earnings is a serious problem, why would you object to the use of a business structure that avoids the double tax?

I recognize that there has been a steady increase in the use of pass-through entities over the past 30 years. That increase has occurred even though there has been a large reduction in the level of double taxation due to large individual

and corporate rate reductions in 1986 and the special dividend rates enacted in 2003 and the sharp decline in the portion of stock ownership representing taxable accounts. Clearly, factors other the double taxation of corporate income have played a role.

Again, the question is whether the proposal being discussed would increase or decrease the use of pass-through entities. There are two aspects of the proposal that would substantially increase incentives to operate in a non-corporate form. First, small businesses, without access to the public equity markets, often rely on debt financing for their capital needs. As explained below, the proposal could increase the cost of debt financing for corporate borrowers, eliminating any temptation for a small business to use the corporate form even with an unlimited dividend-paid deduction. Second, a pass-through entity can make tax-free distributions of cash flow sheltered from tax by reason of accelerated depreciation or other tax benefits. Under the proposal, investors in a taxable corporation would face a 35% withholding tax on dividends funded with similar cash flows, even though the corporation received no benefit from the new dividend-paid deduction.

Bias for Debt Financing

Many proponents of corporate integration argue that the current favorable tax treatment for corporate debt financing leads to excess use of debt at the corporate level and greater risk of bankruptcy or other financial distress among corporations. An article by Jonathan Talisman, former Treasury Assistant Secretary for Tax Policy, makes the important, but often ignored, point that there are substantial nontax reasons for using debt rather than equity to raise investment capital and thus they are not pure substitutes for each other. Debt does not dilute the interests of existing shareholders. Debt is a less risky investment than stock, which means that debt generally has a lower cost. Also, issuing stock can involve much larger underwriting fees than debt financing provided by a bank or other financial institution. In short, corporations will

continue to have significant debt levels and it is very unlikely that they will issue additional stock to reduce current levels of debt.[1]

The Talisman article also cites several well-respected academics to support the proposition that "any tax-driven bias for debt may be exaggerated and, to the extent it exists, it does not contribute substantially to overleveraging or distress." I am not in the position to judge whether the experts cited in the Talisman article or other experts on the issue are correct. But, I am confident that a dividend-paid deduction is the wrong approach if you are concerned about excess debt in the corporate sector.

Retained earnings are one of the largest sources of capital available to corporations for purposes of investment and debt reduction. That is not surprising; there are no fees for retaining earnings and no tax at the shareholder level. The dividend-paid deduction will create enormous pressure to increase corporate dividend distributions and fund future investments with debt. That pressure could be irresistible since some academic studies indicate that corporations have been conservative in using debt and have the capacity to increase borrowing.

Originally, I thought that the withholding tax on interest was without justification and a mere "money grab." Now, I think that it may be a necessary component of the proposal designed to counteract the incentive to debt finance caused by the dividend-paid deduction. Also, a withholding tax on dividends, but not on interest, could create a new set of distortions. Hybrid debt securities that have both debt and equity features could be used to create deductible returns on equity without being subject to withholding tax liability.

Increased Cost of Corporate Borrowing

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[1] Jonathan Talisman, " Do No Harm: Keep Corporate Interest Fully Deductible," Tax Notes, 2013.

Withholding taxes are often compliance tools forcing both reporting and prepayment of the tax. If the amount withheld exceeds the actual liability, the excess is refunded. The withholding tax in this proposal is quite different; it is nonrefundable and bears little relationship to the tax that would actually be imposed on the recipient.

For individuals with marginal rates of 35% or higher and corporations that are not financial intermediaries, the proposed withholding tax on interest has the same effect as a traditional withholding tax and would not cause those investors to demand a higher interest rate. However, those investors are a very small part of the corporate bond market.

The bulk of investors in the corporate bond market are tax-indifferent investors, investors whose interest income is otherwise exempt from tax. Tax-indifferent investors include retirement plans; pension funds; religious, charitable, and other tax-exempt organizations; life insurance companies using corporate bonds to fund life reserves; and foreign investors. Banks and other financial intermediaries also could be included in this group because a 35% withholding tax on their gross interest income normally would be dramatically larger than the tax on their net interest income, namely the spread between the interest income and their cost of funds. Tax-indifferent investors are the group whose demand for corporate bonds is necessary to clear the market, that means having a willing buyer for all bonds being offered for sale in the market. The interest rate demanded by that group of investors will set the rate for the entire market. For those investors, the withholding tax is simply a reduction in their yield on the bonds. The withholding tax will increase corporate bond rates unless that group is willing to accept yields 35% lower than they currently receive.

Currently, interest rates on corporate bonds reflect the sum of the risk-free

interest rate (the rate on Treasury bonds) plus a risk premium. In the future, a new element will be added, the amount of the new withholding tax. There is no reason to believe that the withholding tax will cause tax-indifferent investors to accept a lower risk premium because they have alternatives to U.S. corporate bonds if they are seeking an interest rate return. They could simply invest in Treasury bonds, rather than receiving little additional income for accepting the higher risk of corporate bonds. The withholding tax would make the U.S. an "outlier" in world capital markets causing foreign investors simply to avoid the U.S. and domestic investors to invest in overseas markets. As a result, I believe market rates will increase to reflect the withholding tax in order to keep tax-indifferent investors in the U.S. corporate bond market. With the current level of corporate debt issuance, that implies an increase of slightly more than 50%. An example using the simplifying assumption that the withholding tax has a rate of 33% is useful. Assume that the current interest rate on the bond is 4%, the rate would have to go up to 6% to make the tax-indifferent investor whole for the withholding tax (6 minus the withholding tax of 2).

Clearly, there would be a market response to the prospect of increased interest rates. Corporations could reduce the issuance of bonds by reducing planned investments, using alternative financing arrangements like leases, or replacing debt with equity. The reduced supply would tend to reduce the otherwise large increase in rates. Offsetting the reduced supply, there could be reduced demand as tax-indifferent investors unwilling to accept lower returns decide to make their interest-bearing investments in overseas markets or through structures like leasing. In summary, it seems clear that there will be an increase in rates due to the withholding tax; the amount of the increase could be as much as 50%, and there will be a period of volatility in the credit markets as market participants attempt to measure the respective sizes of changes in the supply of, and demand for, corporate bonds.

Some economic models may assume that the corporate bond market will adjust,

with no increase in interest rates as fully taxable investors replace tax-indifferent investors. I do not believe that there are enough taxable investors to replace tax-indifferent investors and believe that many market participants would agree.

Lessons from 2003

In 2003, the George W. Bush Administration proposed a version of corporate integration. Under that proposal, a corporation would establish an exempt dividend account to which the corporation would add its fully taxable income for each year. Dividends paid out of that account would be exempt from tax at the shareholder level. The proposal was greeted with opposition from the corporate community and was not enacted. The opposition came from a group of corporations whose dividends exceeded their fully taxed income. That group included capital-intensive companies whose income was sheltered from tax by accelerated depreciation and other benefits like the research credit, multinationals not repatriating the income from large operations overseas, and multinational energy companies repatriating income on which there was no US tax because of foreign tax credits. If anything, the number of those corporations has grown as companies have expanded their operations overseas since 2003 and the Congress has provided larger depreciation and other benefits.

Those companies had two concerns. First, they felt that the value of their shares in the market would suffer if their shareholders only received a partial exclusion while shareholders of other companies enjoyed a full exclusion. Second, they argued that the value of tax incentives was reduced due to the fact that the use of those incentives would result in increased tax at the shareholder level. The impact of the corporate integration proposal being discussed today on those companies and their shareholders would be far worse.

That proposal would substantially increase taxes at the shareholder level, seemingly based on the assumption that all dividends are paid out of corporate

earnings that would otherwise be taxed at the full 35% rate and the assumption that shareholders would not be harmed because corporations would pass on the value of the dividend-paid deduction by increasing dividends. Those assumptions are simply incorrect in many instances and where they are incorrect the total tax on dividends will be substantially greater than under current law. Corporations that currently distribute dividends in excess of their fully taxed income would do their shareholders a favor by reducing the dividend rate. Any attempt by those corporations to pass on the benefit of the dividend-paid deduction through increased dividends would result in more over taxation at the shareholder level.

Just like the Bush Administration proposal, any distribution out of tax-favored income would result in a recapture of the tax benefit by increased tax at the shareholder level. For example, if the US adopted a territorial system of international taxation, any distribution out of exempt foreign income would be recaptured by a 35% tax at the shareholder level.

CONCLUSION

In my opinion, tax reform should be designed with the goal of increasing economic growth and expanding employment in the United States. Our tax system should be based on principles of economic neutrality as long as that neutrality tilts the playing field in favor of investment and job growth in the U.S.

I am not an economist so I am not going to offer an opinion concerning the impact of double taxation on the economy, but there is no question that it, combined with incentives like accelerated depreciation and the research credit, create a bias for retention of corporate earnings and reinvestment in our domestic economy. I would note that unprecedented period of economic growth and expansion of the middle-class in the 1950's and 1960's occurred when the

level of double taxation was dramatically greater than today due to corporate rates in excess of 50% and a maximum tax rate of 70% on dividends.

However, you do not need to be an economist to conclude that the corporate integration proposal being discussed today could have large, negative implications for our economy.

- The proposal would eliminate the bias for retention of corporate earnings and substitute a bias for distribution of those earnings. It would dramatically reduce the benefit of, if not effectively repeal, incentives like accelerated depreciation and the research credit. Simply increasing dividend distributions would provide a larger tax reduction than accelerated depreciation would provide for an investment in plant and equipment. The research credit would be effectively repealed for many corporations that could simply eliminate all corporate tax liability by converting stock buybacks into dividend distributions.
- The proposal could dramatically increase the interest cost of corporate borrowing. You do not have to "love" debt to recognize that debt financing is the lowest-cost and most flexible source of external capital for corporate investment. U.S companies, but not their foreign competitors, would face that cost increase.
- The proposal could result in complex and inefficient financial transactions designed to take advantage of the fact that the rate on non-corporate debt could be substantially lower than the rate on corporate debt and the fact that the capital gain income of tax-indifferent investors would remain tax-exempt while dividends received by those investors would be subject to a 35% tax rate.
- The imposition of new withholding taxes on foreign investors is at best inconsistent with, if not in direct violation of, tax treaties, perhaps inviting retaliatory action affecting U.S. investment overseas.

In short, the cure would be worse than the disease. Again, thank you for the

opportunity to testify today. I would be happy to answer any questions you may have.