August 1, 2017

The Honorable Orrin Hatch
Chairman
Senate Finance Committee
219 Dirksen Building
Washington, D.C. 20510

Dear Chairman Hatch:

This letter is in response to your request for comments and recommendations on issues surrounding the tax reform legislation that you are developing with your Senate colleagues. We are grateful for your leadership on this issue and your willingness to receive input from a wide range of stakeholders as the Senate considers how to construct tax reform that promotes economic growth and job creation in the United States, and international competitiveness for U.S. companies operating at home and abroad.

The Alliance for Savings and Investment (ASI) is a diverse coalition of dividend-paying companies, investor organizations, and trade associations, formed to support the common goal of promoting economic recovery, growth, and job creation through policies that foster private savings and capital investment.

ASI is writing to comment on the issue of corporate tax integration, and specifically, integration of the individual and corporate rates through a corporate-level deduction for dividends paid to shareholders, including a partial deduction for such dividends.

The U.S. Integrated Corporate Tax Rate

In 2014, ASI commissioned an economic report which found that the top U.S. integrated tax rate on corporate profits, which combines corporate-level taxes with investor-level taxes on dividends and capital gains, is the second highest rate among developed nations.[1] There are several reasons for this undesirable distinction.

The United States imposes a 35 percent corporate rate, which is the highest corporate statutory tax rate of any industrialized nation. The Organization for Economic Cooperation and Development (OECD) reports that the combined average corporate tax rate of OECD member countries is 24.6 percent. Many industrialized nations that compete with the U.S. for investment capital have rates of less than 20 percent. The 2014 study noted that the top integrated corporate tax rate has fallen in many other countries since 2000, in large part, due to reductions in statutory corporate income tax rates.

The top U.S. integrated tax rate has increased over the past several years due to the 3.8% tax on investment income enacted under the 2010 Affordable Care Act for individuals and married couples filing jointly whose adjusted gross incomes exceed $200,000, and $250,000 respectively. In addition, the American Taxpayer Relief Act of 2012 made permanent the 15% rate for both long-term capital gains and qualified dividend

[1] We have attached a copy of our report, entitled “Corporate dividend and capital gains taxation: A comparison of the United States to other developed nations.”

rates for those with taxable income below $400,000 (single filers), $425,000 (heads of households) or $450,000 (married couples filing jointly), and increased the tax on capital gains and qualified dividends to 20% for taxpayers above those income thresh holds. For taxpayers who are subject both to the 20% rate and the net investment income tax, capital gains and qualified dividends are subject to a combined 23.8% rate.

Taking into account both the corporate and investor-level taxes on corporate profits at the national and subnational level, the top U.S. integrated dividend tax rate is 56.2%,[2] while the average integrated tax rate among OECD and BRIC countries (weighted by GDP and excluding the United States) is 44.5%. The U.S. rate is nearly 12 percentage points higher than the prevailing average among OECD and BRIC countries.

The top U.S. integrated long-term capital gains tax rate is 56.3%, while the average integrated tax rate among OECD and BRIC countries (weighted by GDP and excluding the United States) is 40.3%. The U.S. rate is 16 percentage points higher than the prevailing average among OECD and BRIC countries.

Most developed countries provide relief from the double tax on corporate profits because it distorts important economic decisions that waste economic resources and adversely affect economic performance. Double taxation discourages capital investment, particularly in the corporate sector, reducing capital formation and, ultimately, living standards. Moreover, the high U.S. integrated tax rate favors debt over equity financing, which may result in greater reliance on debt financing and leave certain sectors and companies more at risk during periods of economic weakness. These high rates discourage the payment of dividends and, consequently, can impact corporate governance as investors' decisions about how to allocate capital are disrupted by the absence of signals dividend payments would normally provide.

For these reasons, we support your Committee's interest in mitigating the double taxation of corporate income and applaud you for holding Finance Committee's hearing on May 17, 2016: "Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered." We also commend your staff for the attention and analysis given to corporate integration in their December 2014 report entitled "Comprehensive Tax Reform for 2015 and Beyond."

We now turn to a more detailed discussion of our views on corporate integration through a dividends paid deduction (DPD), including a partial deduction for dividends paid to shareholders.

<u>Interaction of the Corporate Rate and a DPD</u>

As noted above, the primary reason the integrated corporate tax rate has fallen in many other countries is due to reductions in statutory corporate income tax rates. ASI believes that reduction of the U.S. corporate rate is one of the most important changes Congress can enact in tax reform. A dramatic reduction of the corporate rate may cure many of the ills of our current tax system, such as base erosion, inversions, and disincentives for foreign direct investment.

ASI recognizes, however, that reduction of the corporate rate to internationally competitive levels in the context of revenue neutral legislation presents a formidable challenge. During a recent Finance Committee

---

[2] The top integrated tax rates on dividends and capital gains include the top federal-state combined statutory corporate income tax rate of 39.0%, the federal rate on dividends and capital gains of 20%, and the average top state income tax rate on dividends (4.4% including federal deductibility) and capital gains (4.5% including. federal deductibility).

hearing, one senator noted for the record that each point of a corporate rate cut may lose $100 billion in revenues over a 10-year scoring window. Some external estimates place the revenue loss per point as high as $120 billion over 10 years.

In 2014, then-Ways & Means Chairman Dave Camp introduced H.R. 1, "The Tax Reform Act of 2014," which demonstrated the difficult policy choices that must be made in order to achieve a 25% corporate rate on a revenue neutral basis. In today's world, a 25% rate is barely competitive. It is above the average for most OECD member countries and does not include the average U.S. state and local income tax rate of 4.4%. As noted above, many developed nations that compete with the U.S. for investment capital have rates much lower that than 20 percent.

It is vitally important that the United States enact a corporate rate that is competitive with those of other industrialized countries. To that end, Congress could consider a partial DPD as an additional method to reduce the overall tax burden on U.S. corporate operations. A partial DPD should be a complimentary and supplemental to a corporate rate reduction to the lowest possible statutory rate. A partial DPD can be used to reduce the *effective* corporate tax rate to the goals set out by the House Republican Blueprint and the Trump Administration of 20% and 15%, respectively. The operation of a DPD on a company's effective corporate tax rate is explained in the example below.

If we assume that Chairman Camp's bill is the base architecture for tax reform and that Congress is able to reduce the statutory rate to 25%, the addition of a partial dividends paid deduction of 40% could allow Congress to achieve an effective rate of 15% called for by President Trump. Our example assumes that 100% of a company's earnings for the year are paid to its shareholders. At a 40% deduction for every dollar of dividends paid, only 60% of the company's earnings would remain taxable at the 25% corporate rate, resulting in a 15% tax imposed on the company's total income before dividend distributions. These percentages could be varied according to the enacted statutory rate and the effective rate targeted by Congress, but the basic mathematical architecture would not change.

Moreover, a partial DPD, when added to the lowest possible statutory rate reduction, will result in a reduction of the U.S. integrated corporate tax rate imposed on shareholder investment.

In addition, there should be significant cash tax and financial statement benefits from lowering the rate and adding a partial DPD. Under our example, a partial DPD should represent a permanent difference between income for tax purposes and income for financial accounting purposes. As a result, both cash tax paid and the tax expense reflected in a company's financial statements should be reduced by a partial DPD to reflect the *effective* tax rate imposed on income at the corporate level, which in our example, would be 15 percent.

ASI notes that special rules may be necessary for certain industry sectors, such as insurance and financial services, to ensure that a partial DPD does not create inadvertent adverse tax consequences for these sectors or their customers.

<u>Special Considerations for a Partial DPD</u>

During its May 17th hearing, the Committee received testimony on a fully integrated 100% deduction for dividends paid to shareholders. A partial DPD presents an additional alternative to consider, and it relieves some of the concerns associated with a 100% DPD because a partial DPD ensures that tax will continue to be imposed at the corporate level. Our specific observations are set forth below.

Retention of the Current Dividend and Capital Gains Rates

ASI has long advocated a reduced rate of tax for dividends and capital gains as an incentive for new investors to purchase stock and as a means to offset the high U.S integrated rate on corporate earnings. Our view remains unchanged under a partial DPD because double-taxation will continue, albeit at a lower overall burden. Double taxation will be exacerbated if the dividend tax rate increases or the tax rates for dividends and capital gains are "decoupled." If Congress wishes to significantly reduce the integrated rate on corporate earnings, the 3.8% net investment income tax should be repealed either in healthcare legislation or in tax reform.

Withholding Taxes

ASI does not support imposing withholding taxes on dividends under a partial DPD regime. Academic literature and Treasury policy reports have long advocated imposition of withholding taxes in conjunction with a 100% DPD integration scheme, to ensure that at least one level of tax is imposed on that income. In the context of a partial DPD, corporate income will continue to be taxed at the corporate level and that income will remain double-taxed at both the corporate and shareholder levels. For taxable shareholders, ASI believes that the current dividend income reporting regime is sufficient to ensure that dividend income is included in the shareholder's return and withholding on those shareholders is not necessary. ASI also does not support imposing withholding taxes on dividend payments to retirement plans or other tax-exempt organizations. ASI and its members are strong advocates for preserving tax incentives that are critical to encouraging Americans to save for retirement and to businesses sponsoring plans for employees. Employer-provided retirement plans are a key component of our nation's retirement system. By implementing a partial DPD without a withholding tax, tax-exempt organizations will become more "tax-exempt" because these organizations indirectly bear corporate income tax on their investment.

Also, during the May 17th hearing, the Committee received testimony from a representative of small business retirement plans expressing concern that employers paying one level of tax under full corporate integration would have no incentive to establish and invest in retirement plans for their employees. ASI believes that a partial DPD regime should alleviate those concerns because it retains a level of double taxation.

In a hearing on May 24, 2016, "Debt Versus Equity: Corporate Integration Considerations," the Committee received extensive testimony regarding the imposition of a withholding tax on interest as a means to equalize the treatment of debt and equity under a dividend integration regime. ASI is firmly opposed to imposing withholding taxes on interest payments. Imposing withholding taxes on interest will disrupt international capital markets, financial service companies, insurance providers, retirement plans, charities, and innumerable other institutions that depend upon the predictable and full receipt of interest income. The ensuing disruption from interest withholding would damage the ongoing U.S. economic recovery. Moreover, as noted above, a partial DPD system does not necessitate withholding on dividends and should not serve as a predicate for withholding on interest.

Lastly, with respect to foreign investors owning stock in or debt of U.S. corporations, a withholding tax on either dividends or interest raises difficult issues concerning our tax treaty obligations. As noted above, a partial DPD ensures that tax will be imposed on U.S. corporate earnings, even if 100% of those earnings are distributed to a corporate parent. ASI is strictly opposed to any withholding on interest, including withholding that impedes foreign investment. Any withholding tax that arguably overrides our treaty obligations or the portfolio interest exception is not the best method to address concerns about erosion of the U.S. tax base.

Limit Earnings Eligible for the Deduction

ASI recommends that only earnings subject to U.S. corporate income tax should be eligible for the partial DPD. Tax preference items and foreign earnings that are not taxed by the U.S., whether resulting from adoption of a territorial tax system or Subpart F income that is fully covered by foreign tax credits, should not be eligible for the partial DPD. These views parallel the views expressed during the May 17th hearing concerning a 100% DPD. The combination of a significant reduction in the U.S. corporate rate and the effective rate reductions from a partial DPD should be effective in attracting investment and income into the United States. This favorable treatment of U.S. domestic earnings, relative to foreign earnings, would help to alleviate concerns that have been raised regarding whether adoption of a territorial system would encourage U.S. companies to shift profits offshore. Limiting the DPD to domestic earnings would help to take the pressure off of anti-base erosion measures by making the United States a more attractive jurisdiction in which to invest.

Maintain Full Interest Expense Deductibility

During the May 24th hearing, some witnesses suggested that the treatment of debt and equity should be equalized under a 100% DPD through either withholding on interest or by limiting interest deductibility. ASI opposes limits on net interest expense deductibility in any form. ASI opposes limits on net interest expense that are based on equalizing the treatment of debt and equity under a partial DPD. A partial DPD moves equity financing closer to the current treatment of debt financing, and the lower effective tax rate resulting from a partial DPD further reduces the value of the interest deduction. To eliminate all or a portion of the net interest deduction would simply create an issue which mirrors the current one: rather than distort towards incentivizing debt financing, such a proposal would distort towards incentivizing equity financing. The proper solution would leave both debt and equity financing on a relatively equal playing field so that corporations can make financing decisions based solely upon economic considerations and without distortions caused by our tax laws. A partial DPD combined with retention of the current dividend and capital gains rates, moves the treatment of debt and equity closer to equilibrium. With this enhanced equilibrium, there is no justification under the theory of corporate integration for limits on interest deductibility.

Conclusion

ASI appreciates this opportunity to address issues relating to the taxation of investments, including the dividend paid deduction, and we hope our comments are helpful as the Finance Committee moves forward on tax reform later this year. ASI looks forward to assisting the Administration and Congress in mitigating double taxation of corporate earnings and in pushing the effective tax rate to as low a level as possible. Should you have any questions please feel free to contact Payson Peabody at ppeabody@sifma.org or 202-962-7300, or Ed McClellan at emcclellan@cov.com or 202-662-5313.