FDIC Speeches

Integration of Corporate and Individual Income Tax Systems

L. William Seidman

remarks before

National Legal Center for the Public Interest

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Good evening ladies and gentlemen. It's an honor to be with your fine organization tonight. I remember W.C. Fields was once asked if he believed in clubs for lawyers. And he replied, "Yes, if all other means of persuasion fail."

You know, I'm really tired of talking about the Resolution Trust Corporation and the S&L disaster. So, tonight I've chosen a more cheerful topic ---- taxes and debt.

Let me state my premise: our present corporate tax system has encouraged the enormous debt burden that threatens to handicap our overall economic performance. It is time to consider changing the system.

As we look back on the 1980's, we see an economy that has grown far more dependent on debt. This growth has been shared by all sectors of the economy.

Since 1965 the total debt of the domestic nonfinancial sector has increased almost tenfold, and is now approaching $10 trillion.

How bad is it? Let me quote from a Conference Board report: "The U.S. is experiencing a debt cycle, not an ordinary business cycle. The triggers that threaten to subdue economic performance are not excessive inventories, or excessive capital outlay; instead they are the debt burden, its carrying cost, the reactions of borrowers and lenders, and the impact of slower debt formation on markets."

Here are some sobering statistics for you: From 1984 through 1987, more than $313 billion of net corporate equity was retired while in the same period corporations borrowed $613 billion.

Another measure of the corporate debt burden is the ratio of net interest payments to the cash flow available to pay interest. This debt burden ratio has increased from 19 percent in 1980 to 41 percent as we enter the 1990's.

Much of this debt was in the form of highly-leveraged transactions, also known as leveraged buyouts. These deals have created a lot of work for lawyers but they have also sent more than a few corporations into bankruptcy and created a host of other debt problems.

At the FDIC, this increased reliance on corporate debt in highly leveraged transactions is making us very debt conscious.

Herbert Hoover once said, "Blessed are the young, for they shall inherit the debt."

With all respect to President Hoover, he apparently never loaned his credit cards to his kids. I have. And I know the last thing we need to leave our kids is debt. They are perfectly capable of creating their own.

I think our children would be better served if we left them the kind of tax system that encouraged capital formation instead of debt formation.

Why? Because one of the major reasons for the increase in borrowing, at least in the corporate sector, is the fact that our tax system encourages the use of debt over equity investment. While interest paid by corporations to creditors is deductible, dividends paid to shareholders are not.

How can we create a tax system that removes the bias toward the use of debt instead of equity?

The Treasury Department has been studying various solutions to the problem. We have given them our thoughts on the matter and hope they will be useful in their deliberations.

Actually, we started thinking about the debt problem several months ago when Congressman Guy Vander Jagt asked me if I had any thoughts on how we might restructure the corporate tax system. As a former tax lawyer/accountant, I did have some ideas.

My suggestion was to impose a single tax on corporate earnings. At present, these earnings are taxed twice -- first at the corporate level and then again when distributed to shareholders in the form of dividends.

Our idea would be to impose <u>one across the board tax at the corporate level on earnings</u> --- currently at the 34 percent marginal rate.

Neither interest on debt or dividends on equity would qualify for a tax deduction. However, interest and dividends would carry with them a full credit for the corporate tax paid.

From the individual taxpayer's point of view, interest and dividends would be treated in the same way we treat salaries today.

As everyone knows, salaries are paid less a "with-holding tax" which is recoverable against tax liability when April 15 rolls around.

In the one tax on corporate income system, the taxpayer would report his full dividend or interest payment but the actual amount received would be minus the with-held corporate tax. That's the way you receive your salary -- you don't get it all, some tax is with-held.

And, just as you do with the with-holding tax on your W-2 form, you use the with-held corporate tax against your tax liability when you file your April 15th return.

From the corporation viewpoint, they pay a full tax on all earnings before dividends and interest are paid out. From the shareholder and debt holder viewpoint, they report a full credit for the tax paid just like they do with their salaries.

The effective tax rate on dividends would be lowered, while the effective tax rate on interest would be the same -- achieving parity for both interest and dividend payments.

This would effectively remove the corporate tax bias in favor of debt financing.

There are additional advantages to this system.

First, it would prevent tax avoidance because taxes on dividends and interest would be collected at the source through the corporation tax. And second, the government would get the benefit of the float just like in payroll taxes.

Both these advantages would help to offset any revenue loss that would result from the reduction of the tax rate on dividends.

Third, this proposal would move the current U.S. tax system towards one that is fully integrated and more consistent with the tax structure of other industrialized nations.

That's the basic, simplified idea. Of course, whenever you are dealing with tax matters, nothing stays simple.

There are problems that need to be ironed out. For instance, to what degree should foreign shareholders benefit from the system?

Also, how should tax-exempt shareholders and debt holders be treated? Should the tax credits created under this system be refundable for tax-exempt organizations?

And we need to consider the effects of increased stock values to shareholders because of this approach. We should take a look at how tax preferences at the corporate level should be treated under this system.

Today Congressman Vander Jagt introduced The Corporate and Individual Income Tax Systems Integration Act of 1990.

We at the FDIC think this is a fine first step in devising a system that can help reduce corporate dependence on debt financing.

Thank you