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incorporated. In that case one dollar of earnings would be subject only to the personal income tax, and the owners of the unincorporated business would get to keep 66 cents.

Double taxation of corporate earnings has long been considered a nettlesome problem of the U.S. tax system, and it is believed to affect business behavior in several ways. One that has received particular attention is the corporation's decision as to how much of its after-tax earnings to retain and how much to pay out to shareholders in dividends. Another is the corporation's decision about how to finance its investments.

Retained earnings versus dividend payout

One way corporations can reduce the sting of the double tax is to retain earnings rather than pay them out in dividends. If the retained earnings are invested wisely by the corporation, each dollar of retained earnings should increase the value of the firm, which raises its share price. Such price appreciation translates into a capital gain for shareholders; and although capital gains are ultimately subject to tax, they are taxed more lightly than dividends, mainly because of tax deferral. Although retained earnings are neither good nor bad in and of themselves, economists believe that the decision to retain earnings or pay them out should be based on nontax considerations.

Equity versus debt finance

Double taxation also makes equity finance "more costly" to the corporation than debt finance. This is because corporations are allowed to deduct interest payments on corporate taxes as a business expense but are not allowed to take a tax deduction for the costs of equity finance. As a consequence, the returns from corporate investments that are ultimately paid out to bondholders are subject to only one level of tax. In effect, this means that one dollar of investment that is financed by debt needs to earn a lower overall rate of return in order to pay bondholders their required return after tax, because this dollar is subject only to the personal income tax, than does one dollar of investment that is financed by equity, which is subject to both the corporate and personal income taxes.

Policy implications

Double taxation of corporate equity has given rise to calls for integrating the corporate and personal income taxes. This is discussed in more detail in the entry Integration, corporate tax. The tax system also has features that are designed to attenuate the effects of double taxation, including the tax treatment given to Subchapter S corporations.

Cross references: dividends-received deduction; income tax, corporate, federal; income tax, federal; integration, corporate tax; Subchapter S corporation.

Dividends-received deduction

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A deduction that corporations may take in some cases for dividends received from other corporations.

The dividends-received deduction (DRD) has been present in some form since the establishment of the corporate income tax in 1909. The rationale for the DRD is to eliminate the possibility of taxing corporate income more than twice—the traditional U.S. approach to corporate income. In the absence of a DRD, intercorporate dividends would be taxed at least three times: first as income to a corporation, then as income to the corporation receiving the distribution, and then again when the income is distributed to the individual shareholders. To the extent that there is additional intercorporate ownership, this income could be subject to even more layers of corporate taxation.

The DRD is generally governed by sections 243–246 of the Internal Revenue Code, which define the types of eligible dividends and the holding period requirements (currently 45 days). Allowable deductions vary depending on the type of stock (preferred versus common) and the type of company paying the dividend (public utility, small business, or foreign). Initially, the DRD was equal to 100 percent of all dividends received, but the deduction level has changed, or been restricted, several times since its inception, frequently since 1986. From 1913 to 1917, the DRD was eliminated, but it was reinstated at 100 percent in 1918. The DRD remained at 100 percent until 1937, when it was reduced to 90 percent and later further reduced to 85 percent. In 1965, a two-tier DRD was established, with the allowable exclusion based upon the amount of ownership. If the companies were members of an affiliated group (80% or more ownership), the DRD was 100 percent. Dividends from nonaffiliated companies were classified as "portfolio dividends" and subject to an 85 percent deduction. The Tax Reform Act of 1986 reduced the DRD to 80 percent for portfolio dividends. As part of the Omnibus Budget Reconciliation Act of 1987, the DRD for portfolio dividends received or accrued after December 31, 1987, was reduced to 70 percent in the

case of ownership of less than 20 percent of the corporation. This ownership-dependent three-tiered level of DRD continues today.

Although interest payments are more tax-favored for the paying corporation than dividends, the existence of the DRD has created opportunities for corporations to issue dividend-paying stock that closely resembles debt. Jassy (1986) has shown how the DRD creates arbitrage opportunities for firms with net operating losses.

Additional readings

Jassy, Everett L. "Issuances of Floating Rate Preferred Stock by Special Purpose Subsidiaries of Loss Corporations." *Tax Lawyer* 39 (3) (1986): 519–62.

Lind, Stephen A., Stephen Schwarz, Daniel J. Lathrope, and J.D. Rosenberg. *Fundamentals of Corporate Taxation*. Mineola, N.Y.: Foundation Press, 1987.

Schaffer, D.C. "The Income Tax on Intercorporate Dividends." *Tax Lawyer* 33 (1) (Fall 1979): 161–82.

Cross references: dividends, double taxation of; income tax, corporate, federal; integration, corporate tax.