

Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects

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Recent tax reform proposals by the American Law Institute and the United States Treasury Department have revived the debate over whether the United States should retain separate individual and corporate income taxes. Integrating the corporate and individual income taxes would present domestic and international challenges. The author analyzes the recent proposals for tax reform and recommends a course of action for the United States or any nation reconsidering its tax policy.

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FOREWORD

This article was prepared partly and assembled primarily in connection with lectures given by the author to audiences of lawyers and tax scholars in other countries on the subject indicated by this title. Consequently, it presumes little knowledge of the present United States income tax system and it starts “from the ground up.” It draws on some of the author’s previously published papers and books as will be indicated from time to time.

The first three sections provide background for the lay reader, lawyer or others interested in income tax reform, and explain the problem called “integration of the corporate and individual income taxes.” Throughout the article, basic information is provided so that a reader who is not familiar with the literature on the tax law itself can understand the problems, proposed solutions and the author’s analysis.

Sections IV through VII describe the policy problem of “integration,” sections VII through X describe and compare the two most important recent studies and proposals, those of the United States Treasury Department in 1992 and the American Law Institute Reporter in 1993. These recent proposals and the problem of integrating the individual and corporate income taxes set the stage for public policy debate and congressional tax legislation in coming years. They deserve this attention and the problem is long overdue for solution.

Sections XI through XXII offer the author’s analysis and recommendations; sections XXIII through XXV explore the international ramifications of the policy problem in the United States, and the concluding section summarizes the paper.

I.

INTRODUCTION

An understanding of the most important questions of corporate income tax policy and reform in the United States, in particular an understanding of recent proposals to integrate the corporate and individual income taxes, requires knowing something about the tax system and the United States income tax system in general. Therefore, this paper will begin with a brief survey of the United States Federal Income Tax of individuals and the United States Federal Income Tax applicable to corporations, in their setting as national taxes and as part of the overall revenue and redistribution system of the United States. After a brief description of the structure and theory of the income taxes, this paper will focus on recent studies and proposals for integration of the individual and corporate income taxes made by the United States Treasury Department and the American

Law Institute in 1992 and 1993.¹ It will analyze and evaluate these proposals and suggest a preferred course of action for the United States. This proposed course of action may also serve as an appropriate model for integration in other countries that are considering or re-evaluating the policy question. Then, it will briefly analyze the international aspects and implications of these integration proposals and offer a policy approach to the international problems.

II.

THE BASIC STRUCTURE AND CHARACTERISTICS OF THE FEDERAL INCOME TAX

The individual income tax in the United States applies to all "realized" net gains and attempts (but does not fully succeed) to be comprehensive in its coverage in order to include in the tax base all net income (realized accretions to wealth) of the individual taxpayer.²

The "base" of the tax is income. "Income" is conceived broadly (a "global" approach), as "all income from whatever source derived."³ It nearly

1. The first 1992 United States Treasury Department study, issued January 6, 1992, is: REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS—TAXING BUSINESS INCOME ONCE (1992) [hereinafter TREASURY REPORT].

In December 1992 it was followed by a brief legislative recommendation from Treasury: A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, accompanying a letter from Treasury Secretary Nicholas Brady to House Ways and Means Committee Chairman Dan Rostenkowski, Released December 11, 1992, in Daily Tax Rep. (BNA) No. 240, at L-7 (Dec. 14, 1992) [hereinafter TREASURY RECOMMENDATION].

The A.L.I. study is: ALVIN C. WARREN, JR., AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT—REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) [hereinafter A.L.I. REPORTER].

Mention also will be made of TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, INTEGRATION OF THE CORPORATE AND SHAREHOLDER TAX SYSTEMS (1993) [hereinafter A.I.C.P.A. REPORT].

2. See BORIS I. BITTKER & MARTIN J. McMAHON, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 3.2 (realization), 2.1 (tax base) (1988). After two brief attempts earlier (1862-1871; 1894-1895), the present federal income tax was first enacted in 1913, when it was constitutionally authorized by the 16th Amendment to the United States Constitution, and has been in effect since then. *Id.* ¶ 1.1 at 1-5. That amendment allowed the national government to "tax incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration," thus lifting a powerful restriction on the taxing power of the national government in the United States. *Id.*

At first, the rates were low: a normal tax of one percent and a "surtax" (on higher incomes) that progressed from one to six percent. DANIEL Q. POSIN, FEDERAL INCOME TAXATION 7 (1983). Rates went up to a top marginal rate of 65% during 1914-1924. They were reduced to a top of 20% in the 1924-1931 period. They again rose to a top rate of 91% and 92% during the 1941-1945 years and the Korean war. Since then they have gradually stepped down, most sharply in the 1980s. See *id.* at 3-8. As of 1994, the top rate for individuals has risen to 39.6% (or more) and to 35% for corporations. See I.R.C. §§ 1(a), 11 (all citations to code sections are to the I.R.C. as of 1994 unless otherwise indicated). See Section III (Corporate Income Tax) and Appendix A (Constitutional History of the Individual Income Tax) of this Article for further historical material. For a short history of the individual income tax in the United States, see JOSEPH A. PECHMAN, FEDERAL TAX POLICY 299-302 (5th ed. 1987).

State income tax rates, in contrast, usually range from about 1-10%. See M. DAVID GELFAND & PETER W. SALSICH, JR., STATE AND LOCAL TAXATION AND FINANCE 40-42 (1985).

3. I.R.C. § 61(a).

amounts to net gain or accretion to wealth, but with some important exceptions. Exceptions ("exclusions") include those for income from the ownership, occupancy and use of a personal residence, a car or other durable goods (imputed income), receipts of gifts and bequests, some "fringe benefits" from employment, interest received on municipal (state or city) bonds, and some income that is saved in special ways for retirement.⁴ These and many other exemptions and special deductions make the income tax base less than totally comprehensive.

The individual income tax rates for single persons in 1994 range from a rate of 0% on exempt income and on income below various thresholds (amounts thought to be necessary just to buy food, shelter and clothing, which include, in 1994, a standard deduction of \$3,800 and a personal exemption of \$2,450 per person), to 15% on income up to about \$22,100, 28% on income up to \$53,500, 31% on income up to \$115,000, 36% on income up to \$250,000 and 39.6% (including a 10% surtax) on income over that.⁵ An "Alternative Minimum Tax" is imposed by I.R.C. § 55 at rates of 26% and 28% on an individual's "alternative minimum taxable income," which means regular taxable income adjusted and increased over a specified exempt amount, if that is higher than the regular income tax.⁶

Thus, the tax rates are graduated or "progressive." Single (unmarried), married and other special categories of taxpayers have slightly different tax brackets, but the framework is the same. A special, preferential rate of tax on one particular kind of income, called "long-term capital gain," was repealed in 1986 but reinstated in 1990. Such a gain—as on the sale of an investment held for more than a year—now is taxed at the normal income tax rate but only up to an individual tax rate of 28% and a corporate income tax rate of 35%.⁷

From gross receipts, gross income is derived by subtracting the costs of goods sold, and deductions from gross income are allowed for costs of producing income (such as for wages, raw materials, machinery, factory or office costs, advertising and, fortunately, fees paid to lawyers for business or tax work).⁸ Such deductions are allowed so as to determine net income, or "gain," thought to provide the proper measure of ability to pay tax.

Some other deductions are allowed for personal expenditures or costs such as medical and dental expenses, charitable contributions, casualty losses, state income and property taxes or interest paid on loans incurred to purchase a home for the taxpayer.⁹ These are sometimes called "tax expenditures," tax "subsi-

4. *See id.* §§ 101-37.

5. *Id.* §§ 151(d) (personal exemption), 63(c)(1) (standard deduction), 1 (rates of tax).

6. *See id.* §§ 55-59. The 28% rate applies to alternative minimum taxable income in excess of \$175,000. *Id.* § 55(b).

7. *Id.* § 1(h); § 1201(a)(2).

8. *See id.* §§ 161-96. *See* Treasury Regulation § 1.61-3(a) (as amended in 1992) for the subtraction of costs of goods sold from "total sales" to determine gross income.

9. *See id.* §§ 211-220. *See* as to charitable contribution deductions, John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 Va. Tax Rev. 229 (1984).

dies," tax "incentives," or "relief." Revenue is foregone in order to accomplish social or economic aims.

The tax rates are applied to each individual's taxable income each year.¹⁰ Income is taxed only when it is *realized*, not when it accrues.¹¹ Income is taxed when it "comes in" as cash or property in a market transaction. All income is lumped together, as a general principle, and taxed at the same rate. (It is not a "schedular" system, at least in the first instance.) "Gross income" or "gross receipts" are reduced by deductible costs and other allowances.¹²

III.

A SHORT HISTORY OF SEPARATE CORPORATE INCOME TAXATION IN THE UNITED STATES

Since 1909 (even before the advent of the federal income tax on individuals), the United States has levied a tax on the income of corporations doing business for a profit.¹³ Corporate income was first subject to federal income tax briefly during the U.S. Civil War. Before 1864, income derived from corporations and partnerships was excluded from the definition of income. Unlike the present system, the Act of 1864 ignored the corporate entity and taxed all income directly to the shareholder.¹⁴ (This "pass-through" tax was held constitutional by the Supreme Court in *Collector of Internal Revenue v. Hubbard*,¹⁵ but later repudiated by the Supreme Court in *Eisner v. Macomber*.¹⁶)

Two years later the 1864 Act was repealed, but another corporate tax was enacted thirty years later, in 1894. However, the United States Supreme Court invalidated that Congressional effort in *Pollock v. Farmers' Loan and Trust Co.*¹⁷ The Court concluded that the entire tax scheme was so enmeshed in, and dependent upon, taxing income from real estate and personal property that it was a "direct tax" and hence, unless apportioned among the several states, unconstitutional.

In 1909, Congress tried again to levy a tax "with respect to the carrying on or doing business" by corporations.¹⁸ This change in approach led the Supreme

10. *Id.* § 1. "Taxable income" is defined in I.R.C. § 63.

11. See William D. Andrews, *The Achilles Heel of the Comprehensive Income Tax*, in *NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980s* 278, 279-83 (Charls E. Walker & Mark A. Bloomfield eds., 1984).

12. I.R.C. §§ 61(a), 1, 62, 63.

13. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.01 (5th ed. 1987); JOSEPH PECHMAN, *FEDERAL TAX POLICY* 302-07 (5th ed. 1987).

14. See BITTKER & EUSTICE, *supra* note 13, ¶ 1.10.

15. 79 U.S. 1, 18 (1870).

16. 252 U.S. 189, 217-19 (1920).

17. 158 U.S. 601, 637 (1895); see *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918). See Appendix A for more on the Constitutional limits on, and the history of, the U.S. Income Tax.

18. BITTKER & EUSTICE, *supra* note 13, ¶ 1.01, at 1-2.

Court, reviewing the legality of the tax in *Flint v. Stone Tracy Co.*,¹⁹ to uphold the tax, even though it was measured by the income of the corporation.

. . . [T]he tax is imposed not upon the franchises of the corporation irrespective of their use in business, nor upon the property of the corporation, but upon the doing of corporate or insurance business and with respect to the carrying on thereof . . . [and] when imposed in this manner it is a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organizations of the character described.²⁰

With the adoption of the 16th Amendment in 1913, Congress was able to tax corporate incomes without casting its action as an excise tax.²¹ However, the constitutional rationale of *Flint* remains available in the event the taxation of corporate income ever again becomes constitutionally restricted.

Since 1894, corporations, and some other business organizations that resemble corporations, have been regarded as distinct entities for federal income tax purposes.²² This premise has led to the separate (sometimes called "double") taxation of corporate-source income. A corporation is taxed on its income when earned, and corporate shareholders are (later) taxed separately on their income from the corporation in the form of dividends.²³

In contrast, the income of partnerships and unincorporated business enterprises in the United States is generally taxed to the owners or entrepreneurs, divided up among them according to their agreement and taxed to them at rates appropriate to the level of income they have from the business entity and from all other sources.²⁴ Some relatively closely-held corporations (35 or fewer shareholders) can now elect to be taxed on a very similar basis under the federal income tax. They are called "S Corporations," the letter "S" standing for Subchapter S (Sections 1361-1379) of the Internal Revenue Code in which the governing legal rules are found.²⁵ There are a number of conditions strictly limiting the eligibility of corporations for the Subchapter S election.²⁶

The rate of the corporate tax in the Payne-Aldrich Tariff Act in 1909 was a single, flat, uniform rate of 1% of net income, with an exemption of \$5,000 per corporation. Since then, corporate income tax rates have risen significantly. Even after the strictly proportional rate schedule was abandoned, for many years the rates were only slightly differentiated or graduated. There were only two steps: (1) a "normal tax" of 22% applied to the first \$25,000 of taxable income (the amount of the "surtax exemption" for new, small businesses, though avail-

19. 220 U.S. 107 (1911).

20. *Id.* at 145-46.

21. See BITTKER & EUSTICE, *supra* note 13, ¶ 1.01, at 1-2.

22. See BITTKER & EUSTICE, *supra* note 13, ¶ 1.05. The following six paragraphs are taken from ADRIAN A. KRAGEN & JOHN K. McNULTY, FEDERAL INCOME TAXATION 780-781 (4th ed. 1985).

23. See BITTKER & EUSTICE, *supra* note 13, ¶¶ 1.02-03, 1.05.

24. BITTKER & McMAHON, *supra* note 2, ¶ 2.4.

25. JOHN K. McNULTY, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 1.02 (1992) [hereinafter McNULTY, TAXATION OF S CORPORATIONS].

26. See I.R.C. § 1361; see also McNULTY, TAXATION OF S CORPORATIONS, *supra* note 25, ¶ 1.04.

able to all corporations), and (2) the normal tax plus a 26% surtax bore upon taxable income over \$25,000, for an effective rate of 48% on corporate income over \$25,000 per year.

Today (1994), the tax imposed on corporate income has four increasing rates on income up to a single rate on all income exceeding \$10,000,000.²⁷ The steps and rates (as of 1994) are: 15% on taxable income not exceeding \$50,000, 25% on taxable income above \$50,000 and not exceeding \$75,000, 34% on taxable income above \$75,000 and not exceeding \$10,000,000, and 35% on taxable income exceeding \$10,000,000.²⁸ Thus, there is in effect no graduation in tax on very-high-income corporations; for high-income corporations, the tax rate is effectively 35%. Legislation in 1981 imposed a flat (and hence maximum) capital gains rate of 28% for corporations, which since has been increased to 35%.²⁹ Additionally, corporations are subject to possible liability for certain "penalty" taxes, for example a tax on unreasonably accumulated earnings.³⁰ Also, like other taxpayers, corporations may incur penalties for attempting to evade taxes due, by whatever maneuvering.³¹

In addition to the regular corporate income tax, corporations are subject to the corporate alternative *minimum* tax under I.R.C. § 55. Corporations are liable for this special minimum tax, which is imposed at the rate of 20% on a base of income adjusted for items of tax preference (under § 57) to the extent it exceeds an "exemption amount" of \$40,000, if and to the extent the alternative minimum tax exceeds the regular tax.³²

27. I.R.C. § 11.

28. If a corporation has more than \$100,000 taxable income, the amount of tax due is to be increased by the lesser of (a) 5% of such excess (for, in effect, a 40% marginal rate) or (b) \$11,750. The purpose of this increase is to "recapture" the benefit of the marginal rates below 34% for a corporation with higher taxable income. Also, if a corporation has taxable income in excess of \$15,000,000, its tax is increased by an amount equal to the lesser of (a) 3% of such excess (for a marginal rate of 38%) or (b) \$100,000. *Id.* This is to remove the benefit of the 34% bracket for high income (35% rate) corporations. By virtue of § 11(b)(2), the trade income of certain personal service corporations (those principally rendering health, legal, architectural, consulting, or other services) as defined in § 448(d)(2), is taxed at a flat rate of 35% (nearly equal to the highest marginal individual income tax rate); the lower bracket rates do not apply, and there is no progression or graduation of rates.

In addition, any corporation may be subject to the alternative minimum tax of §§ 55-59 and to a special "environmental tax" of 0.12% on the excess of its modified alternative minimum taxable income over \$2,000,000 imposed by § 59A.

29. *See id.* § 1201(a).

30. *See id.* §§ 531-537.

31. *See, e.g., id.* §§ 6662, 6672, 7201, 6651-6655, 6721.

32. The items of tax preference subject to the 20% minimum tax include items such as: depreciation or amortization of real property in excess of straight-line depreciation of (§ 57(a)(6)); for certain financial institutions, excess deductions allowable for additions to bad-debt reserves over the amount that would have been allowable had the deduction been calculated according to actual experience (§ 57(a)(4)); percentage depletion taken under § 611 in excess of the adjusted basis of the property at the end of the year (§ 57(a)(1)); and some tax-exempt interest on specified private activity bonds (§ 57(a)(5)).

Section 291 reduces by 20% the corporate deduction for eight items of tax preference (including all of the above except depreciation, amortization, or cost recovery in excess of straight-line methods).

An ordinary corporation goes through much the same process as does an individual taxpayer to determine its income tax liability.³³ Some charitable and other non-profit organizations are "tax-exempt".³⁴ Even tax-exempt institutions are subject to a tax on unrelated business income, which does not include dividends on portfolio stock.³⁵ The taxable income of a taxable corporation is analogous — though not identical — to the taxable income of an individual. Both include "all income from whatever source derived," subject to exclusions and deductions, some of which are different from the allowances for individual taxpayers.³⁶

Corporations, like individuals, need not include certain prizes and awards, gifts and inheritances, interest on tax-exempt municipal bonds and other generally excludable items in their gross income. Additionally, corporations are permitted to exclude contributions to capital from their gross income.³⁷ Unrealized gain is not included.³⁸

Furthermore, corporations, like individuals, are allowed specified deductions from gross income. These include trade or business expenses which, for a corporation, include reasonable salaries, interest paid on indebtedness, and other ordinary and necessary expenditures in carrying on any business. In addition, costs or expenditures for taxes, losses, bad debts, depreciation, depletion, research and development costs, charitable gifts, trademark and trade name expenditures and several other relatively less significant deductions are allowed to corporations.³⁹ Also, corporations are allowed certain special deductions. A corporation is allowed to deduct, generally, 70%-80%-100% of dividends received from another corporation.⁴⁰

In general, the corporate tax for many years was gauged by many U.S. analysts to be basically a good and useful tax, though not without faults; for example, perhaps it exerted too much influence on investment and business planning, both within and without the corporate sector. The corporate tax has raised substantial revenue in an orderly fashion, although revenues from the corporate income tax have declined as a percentage of total tax revenues for some years.⁴¹

Yet some believe the tax should be abolished, or integrated with the individual income tax. As an additional separate tax, they believe, it is far from neutral, not fair, detrimental to investment and saving, and of uncertain inci-

33. See I.R.C. §§ 11, 63, 61(a).

34. *Id.* §§ 501-505. See note 157, *infra*, for a further description of the Federally tax-exempt status of some organizations in the United States; see generally Pechman, *supra* note 2, at 169-71.

35. *Id.* §§ 511-513.

36. See BITTKER & EUSTICE, *supra* note 13, ¶¶ 5.02-05.

37. I.R.C. § 118.

38. See *Eisner v. Macomber*, 252 U.S. 189 (1920); POSIN, *supra* note 2, § 4.02, at 146-47.

39. See BITTKER & EUSTICE, *supra* note 13, ¶¶ 5.02-04.

40. I.R.C. § 243; BITTKER & EUSTICE, *supra* note 13, ¶ 5.05; see I.R.C. §§ 245 (dividends received from certain foreign corporations), 1501-1505 (consolidated returns).

41. See PECHMAN, *supra* note 2, at 135.

dence.⁴² Further, the added, separate tax probably over-influences choice of business form, debt/equity financial structure, dividend policy, foreign investment, investment choices, growth and productivity.⁴³ More on these challenges later.

IV. INTEGRATION

There has long been controversy in the United States and abroad over the method of taxation of corporate earnings. The controversy has centered on the alleged "double taxation" of corporate profits in that the profits are taxed when earned by the corporation and "taxed again" when distributed in the form of dividends to the owners of the corporation, the shareholders. The question is whether there is sufficient justification for this "double taxation?"⁴⁴

In 1954, the United States Congress provided a partial (4%) shareholder credit against tax and a \$100 dollar annual exclusion from income for dividends in an effort to meet in part the "double taxation" argument.⁴⁵ The credit, however, was repealed effective as to dividends received after December 31, 1964.⁴⁶ The exclusion of dividends was repealed in 1986 (it could hardly have been said to have any substantial effect on the problem of "double taxation.")

The 1984 U.S. Treasury Proposals called for partial elimination of the second level of tax on distributed earnings by a deduction (allowable to the corporation) for 50% of earnings distributed to shareholders,⁴⁷ a proposal that was scaled down (in 1985) to 10%,⁴⁸ and never enacted into law.⁴⁹

42. See CHARLES E. MCLURE, MUST CORPORATE INCOME BE TAXED TWICE? 7-9, 20-42 (1979); PECHMAN, *supra* note 2, at 179-89.

43. See MCLURE, *supra* note 42; U.S. DEP'T OF THE TREASURY, 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH—THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984) [hereinafter TREASURY I]; U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 68-75 (1977) [hereinafter TREASURY BLUEPRINTS]; Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981); John K. McNulty, *Integrating the Corporate Tax?*, 31 AM. J. COMP. LAW 661 (1983) [hereinafter McNulty, *Integrating?*]; John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445 (1990) reprinted (in Japanese) in 63 KEIO HOGAKU-KENKU (Journal of Law, Politics and Sociology) No. 12 at 373-400 (1991) [hereinafter McNulty, *Reform by Integration*].

44. For a basic study of the economic effects of the corporate income taxes, see RICHARD GOODE, THE CORPORATION INCOME TAX (1951); J. GREGORY BALLENTINE, EQUITY, EFFICIENCY AND THE UNITED STATES CORPORATION INCOME TAX (1980); GARY FROMM & PAUL TAUBMAN, PUBLIC ECONOMIC THEORY AND POLICY 89-139 (1973); Arnold C. Harberger, *Corporation Income Taxes*, 15 INT'L ENCYCL. SOC. SCI. 538 (1968); PECHMAN, *supra* note 2, at 179-88. For a recent, new study and proposal for Great Britain, see CAPITAL TAXES GROUP, INSTITUTE FOR FISCAL STUDIES, SETTING SAVINGS FREE (1994).

45. I.R.C. §§ 34, 116 (1954).

46. Pub. L. 99-514 § 612(a), 100 Stat. 2250 (1964).

47. TREASURY I, *supra* note 43, at 136.

48. THE PRESIDENT'S PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 122 (1985) [hereinafter TREASURY II].

49. BITTKER & EUSTICE, *supra* note 13, ¶ 1.08; see Kevin Buchanan, *The Dividend Paid Deduction Proposal: Separating Myth From Reality*, 28 TAX NOTES 97 (1985); Karla W. Simon, *Comments on the Dividends Paid Deduction of H.R. 3838*, 31 TAX NOTES 609 (1986).

Consider the familiar structure of the tax on corporate income in the United States. A corporation, domestic or foreign, is generally treated by U.S. income tax law as a separate entity and thus a separate taxpayer, as are the individual shareholders of the corporation. Both are subject to the general income tax.

If a corporation earns \$100, it must pay tax of up to \$35 (the top corporate rate). When it wants to pay a dividend, a distribution of profits, to its investors, it consequently has only \$65 left after taxes. If it distributes the \$65 as a dividend, those shareholders who receive the payment are taxed on their dividend income of \$65, at a top normal rate of, let us say, 36% (rather than the very top or surtax rate of 39.6%).⁵⁰ So their tax will total \$23.40. As a result of tax at the corporate level at a maximum rate of 35% on \$100 and a shareholder income tax of 36% of the \$65 dividend, a total tax of \$58.40 will have been paid on \$100 of distributed corporate income. That rate is 22.4 percentage points higher than the top rate the law usually applies to an individual's income of \$100 (36%). It is more than the top *corporate* rate of 35% by 23.4 percentage points. This is simply the consequence of a classical, unintegrated system of corporate and individual income taxation.

In contrast, if the \$100 were earned by a partnership or proprietorship in the United States the total tax burden would be much lower. A partnership is *not* treated as a separate taxpayer by U.S. income tax law.⁵¹ Its income is not taxed to the partnership, but is passed through to the partners. So, \$100 of partnership income will be taxed once, at up to the 36% (or even 39.6%) rate, to the partners (whether or not the income is distributed to them). This is much lower than the 58.40% rate that applies to distributed corporate income (35% plus 23.40%). It is little more than the top corporate rate on undistributed, retained corporate earnings (35%).

Similarly, if an individual proprietor or investor received \$100 income directly, he or she would pay just 36% in tax, assuming the \$100 were taxable at the usual top rate.⁵²

Why does the United States tax distributed *corporate* profits so much more heavily? Is it because the situation resembles that of an employer who earns \$100, pays tax of \$36, then pays his employee the remaining \$64, in which event the employee is taxed (again) on the \$64 wages at 36%? This cannot be the answer, because if the employee's wages are a cost of the business or profit-seeking activity, the employer can deduct the wages from his income. The deduction of \$100 paid in wages leaves the employer with no tax liability to pay

In 1977, the U.S. Treasury Department recommended complete integration by direct attribution of corporate income to shareholders but admitted that there would be "potential administrative problems with this approach." TREASURY BLUEPRINTS, *supra* note 43, at 69-75.

50. A top 39.6% rate applies to the very highest range. I.R.C. § 1.

51. So long as it is not one of the new breed of "publicly-traded partnerships," as defined in I.R.C. § 7704, enacted in 1987, in which event it is taxed as a corporation. BITTNER & EUSTICE, *supra* note 13, ¶ 1.07.

52. See the examples in Appendix B for further elaboration of the different tax burdens on corporate earnings and distributions compared to those of proprietorships, partnerships and S Corporations.

on the income from which the wages are paid out. The income is taxed once, to the employee, at a 36% rate.

Should not the corporation be allowed to deduct its dividend? Is it not a cost of capital or funds used in the business? In fact, if the corporation has borrowed its funds and paid \$100 of its income as interest to a creditor such as a bank, or even to a shareholder who lent funds to the corporation in an arms-length transaction, the corporation would be allowed to deduct the interest.⁵³ So, the \$100 income of the corporation that it used to pay the cost of borrowed funds would be taxed only once, to the lender, at that taxpayer's normal rate.

But the corporation cannot, under U.S. law, deduct its dividend payments. Therefore, business planners sometimes avoid the corporate form and, for tax reasons, use the less desirable partnership (or limited partnership) form.⁵⁴ Or, if a corporation is formed, it borrows most of its capital, to pay interest, which is deductible, rather than dividends, which are not deductible, as a cost of its capital. This incentive causes the problem of "thin capitalization." Or, a corporation may refrain from distributing any dividends in order to save or postpone the second (shareholder) income tax, particularly if applicable shareholder rates of tax are higher than applicable corporate rates. Also, U.S. corporations seek ways to make non-dividend distributions to avoid either the corporate-level or shareholder-level tax; they attempt to use stock redemptions, liquidations, stock sales or other transactions to get assets out of corporate solution without a dividend tax.⁵⁵ Some U.S. corporations have recapitalized with increased debt or have used leveraged buyouts (or have been acquired in such transactions), in effect substituting debt for equity and thereby "eroding the corporate tax base."⁵⁶

The U.S. income tax law treats the corporation that pays dividends like the employer who earns \$100, pays \$36 in tax and then pays \$64 in wages to a personal, non-business employee such as his gardener or barber or housekeeper. No deduction is allowed for such wages because they are a personal, consumption expenditure. And, the wages are taxed again to the employee, as wage income to him.

This result does not make sense when applied to corporate dividends. It discriminates between equity and debt capital, between corporations and part-

53. I.R.C. §§ 163, 162, 212.

54. For eligible corporations having no more than 35 shareholders, it may be possible to elect S-corporation status, which means a single tax regime even on distributed corporate profits, much as with a partnership, for Federal (and sometimes also for state) income tax purposes. See *id.* §§ 1361-1379; McNULTY, TAXATION OF S CORPORATIONS, *supra* note 25; John K. McNulty, *Subchapter S and S Corporations*, in 2 CORPORATE TAXATION §§ 10.01-.110 (James T. O'Hara et. al. eds., 1992) [hereinafter McNulty, *S Corporations*].

55. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS app. at 341-55 (1982) [hereinafter A.L.I., SUBCHAPTER C STUDY].

56. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY DRAFT—SUBCHAPTER C (SUPPLEMENTAL STUDY), 4-38 (1989) [hereinafter A.L.I., REPORTER'S DRAFT]; see also sources cited *infra* notes 64 (Graetz), 73 (Warren).

nerships, and between retained and distributed earnings. It "overtaxes" \$100 of corporate income earned by low-income or tax-exempt shareholders by \$35. It overtaxes the income of even a rich, high-income shareholder by \$22.40. It leads to excessive corporate borrowing, undue retention of corporate profits for expansion, avoidance or deferral of shareholder tax, attempts to convert the income to capital gains (if and when a special, lower rate applies to capital gains), or untaxed income under the fresh-start basis at death rule.⁵⁷ It also produces costly and inefficient under-investment in the corporate sector of the United States' economy.

Often it is said that the United States has a classical, unintegrated system of corporate taxation.⁵⁸ More correctly put, the United States has that system plus an elective, complete, pass-through integration system for U.S.-owned, single-class stock companies with 35 or fewer individual shareholders.⁵⁹ Furthermore, the "corporate" second tax is imposed on publicly-traded, limited partnerships, and on other noncorporate entities that resemble corporations.⁶⁰

Why does the United States have, and retain, this unintegrated tax regime?

V.

CORPORATE TAX INCIDENCE

The U.S. separate corporate income tax is probably based on the (mistaken) notion that corporations are legal persons or aggregations of capital that can, do and should pay taxes and bear tax burdens. That is a false idea, economists tell us.⁶¹ Only humans bear taxes. Corporations do not. Only humans can consume, so only consumption by humans can be reduced by taxes. Corporations don't eat or drink, so tax burdens can't force them to eat or drink less. Corporations as such don't bear taxes and should not be taxed and cannot be taxed. Some humans must bear the corporate income tax. Who are they? The point is one of the incidence of the corporate income tax.

Perhaps the justification for the U.S. corporate income tax is based on the idea that the shareholders bear the corporate tax. But if so, it does not make sense that they are taxed at much more than the maximum rate the law generally says individual taxpayers should pay on their income, namely 36%. There is no good reason why the effective rate of 58.40% applies to an individual's income from the corporate sector and 36% on all his other income.

57. I.R.C. § 1014. See generally J. Poterba & L. Summers, *The Economic Effects of Dividend Taxation*, in (E. Altman & M. Subrahmanyam eds.) *Recent Advances In Corporate Finance* 227 (1985).

58. See, e.g., Malcolm Gammie, *Reforming Corporate Taxation: An Evaluation of the United States Treasury Integration Proposals and other Corporate Tax Systems in an International Context* (pts. 1 & 2), 1992 BRIT. TAX REV. 148, 243.

59. See I.R.C. §§ 1361-1379.

60. *Id.* §§ 7701(a)(3), 7704(a); BITTKER & EUSTICE, *supra* note 13, ¶ 2.01-06.

61. See, e.g., McLURE, *supra* note 42, at 20; BALLENTINE, *supra* note 44, at 5-7; THE TAXATION OF INCOME FROM CAPITAL (Arnold C. Harberger & Martin J. Bailey eds., 1969). See also W. Klein, *Income Taxation and Legal Entities*, 20 U.C.L.A. L. REV. 13 (1972).

Perhaps the U.S. Congress (or the public) thinks all shareholders are very rich people who should be taxed at especially high rates. However, statistics show that, in the United States, many corporate shares are held by or on behalf of low or middle-income persons or tax-exempt institutions such as charities or pension funds. They should not be taxed at extra-high rates. And as to rich, high-income shareholders, there is no policy reason given why they should be taxed at 58.40% or more on only their income from investment in dividend-paying corporations, and not on their interest income, rents, wages, royalties or capital gains. At best, this would be a very crude and inefficient effort at enhancing progressivity.

Arguably, should all U.S. corporations be treated like partnerships, their income (or loss) passed through to shareholders, to be taken into account just like any other income in their individual income tax returns? (Or should all partnerships be made taxable like corporations?⁶²)

Economists *do not* convincingly tell us who actually pays the corporate income tax. It may not be shareholders at all but employees of corporations through lower wages. Or the corporate tax may be passed on to consumers of corporate products in the form of higher prices. Possibly, in the long run, the tax may be borne by all holders of capital in the economy, not only those having capital invested in corporations. The economists do not agree or give us a definite answer.⁶³

VI.

POSSIBLE JUSTIFICATIONS FOR A SEPARATE CORPORATE INCOME TAX

Just as the question has been asked in other countries in recent years, we ask why the United States should retain a separate corporate income tax, if no one knows who bears it and if it over-taxes shareholders (if they do bear it), or if it becomes an erratic or arbitrary sales tax or payroll tax (in only the corporate sector) if it is shifted, if it biases investment, financial structures and distribution policy, or if it over-taxes all capital, when the United States needs to encourage saving and investment?

One answer is simple: it produces revenue. And it produces revenue from an ultimately uncertain or unidentifiable source, so there is no self-aware, heavily burdened person to complain about the legislators who enact it or who raise its rates. (Paradoxically, Congress lowered the top corporate rate from 46% to 34% in 1986, but raised it by one point in 1993 to 35%.)

62. Some "publicly traded partnerships" in the United States are taxable as corporations. I.R.C. § 7704.

63. See generally BALLENTINE, *supra* note 44; William A. Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, 1965 WISC. L. REV. 576; PECHMAN, *supra* note 41, at 141-46; See Appendix C below for more on the incidence of the corporate income tax.

In fact, revenue from the U.S. corporate tax has been shrinking, as a result of lower rates and investment allowances such as the investment tax credit (now repealed) and accelerated depreciation. Also, debt finance and retention of earnings have contributed to the decline in revenue from the "double tax" system for distributed corporate profits. The deduction for interest has led to highly leveraged buy-outs of corporations, which shrink the base of the corporate income tax.⁶⁴ More corporations, if eligible, elect S Corporation or "limited liability company" (conduit) treatment, to avoid higher rates and/or the double tax.

Another purpose served by the separate, entity-level corporate income tax is, in the international arena, to enable the country of residence or incorporation of the corporation to capture revenue from an enterprise when it is neither the country of source of the income nor the country of residence of the shareholders. For example, if a United States corporation is owned by foreign shareholders in Country X and it has income from sources only in Country Y, the United States nevertheless taxes the income of the corporation because it is a United States entity, as determined by the place of incorporation.⁶⁵ Not only that, the United States applies an income tax to the foreign shareholders on their dividends from this corporation, collected by a flat-rate withholding tax that the company must remit to the United States Treasury.⁶⁶ The United States asserts "jurisdiction" to tax the corporation's income even though the economic source of the income lies entirely outside United States borders. The artificial legal entity interposed between the source and the owners is a United States entity—whether or not any material benefits are received from such status. And the United States imposes income tax on the shareholders who receive a distribution of profits (or upon a foreign lender who receives an interest payment) from the corporation, regardless of the foreign location of the investor and the absence of economic activities within the United States.

64. See Michael J. Graetz, *The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions*, 42 TAX NOTES 721, 721-22 (1989); Robert A. Jacobs & Rebecca S. Rudnick, *ABA Tax Section Task Force Looks at Passthrough Entities*, 42 TAX NOTES 607 (1989); but see Michael C. Jensen et al., *Effects of LBOs on Tax Revenues of the United States' Treasury*, 42 TAX NOTES 727 (1989) ("LBOs" refers to leveraged buy-outs).

Some justification for a corporate-level tax is offered on agency-cost analysis or as a price of corporate advantages such as liquidity. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs and the Price of Incorporation*, 77 VA. L. REV. 211 (1991); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1988-89) [hereinafter Rudnick, *Who Should Pay?*]; see also Joseph Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1 (1993).

Finally, the separate corporate tax may be thought of as repaying society for some of the social costs of limited liability — the externalized costs of the enterprise, to the extent the losses of corporate enterprises exceed the capital placed at risk by their owners and are imposed on involuntary creditors. See Henry Hansmann and Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD L. REV. 80 (1991).

65. See Gammie, *supra* note 58. Even if it is the country of source and can tax corporate distributions of dividends or interest, it cannot reach capital gains realized by non-resident shareholders; the corporate-level tax helps get at profits that otherwise could be taken offshore. *Id.* at 167.

66. I.R.C. § 871.

Another good reason for retaining a separate corporate income tax is that the law can use it to control financial and economic behavior—by creating exceptions, allowances, rate differentials and penalty provisions in the tax. In addition, the corporate income tax exerts some macroeconomic control and anti-cyclical influence. With progressive rates the corporate tax, like an individual income tax, soaks up more profits in inflationary or profitable times and leaves more profits in private hands during a depression or recession.

VII.

INTEGRATING THE CORPORATE AND INDIVIDUAL INCOME TAXES: POSSIBLE TECHNIQUES

If it is desirable to leave the corporate income tax in place in the United States, what can be done to improve the situation?⁶⁷ Of course, the “double tax” aspect could be removed by eliminating the corporate tax entirely and taxing dividends when they are distributed to shareholders. Thus, there would not be any tax imposed on corporate earnings until and unless distributed. But that would not only decrease or defer revenue, it would also permit investors to delay individual tax indefinitely by causing their corporations to retain profits, an intolerable unfairness. And it would forego the regulatory and stabilization functions of the corporate-level tax.

Instead, the individual tax on dividends could be abolished, at least to the extent tax had been borne at the corporate level, leaving only the corporate tax in effect.⁶⁸ (In fact, the United States tax code had a very small dividends-received exclusion at one time, but the exclusion was limited to just \$100 per person, a tiny tax relief designed for small investors.)⁶⁹ However, corporate taxation and complete dividend exclusion usually would mean taxing the income at the “wrong” rate. For example, the low-income or tax-exempt shareholder’s share of corporate earnings would be taxed at 35% (if the top corporate rate applied), the same rate as that applied to the rich shareholder’s share of corporate earnings. What rate actually applied would depend on the aggregate *corporate* income, not the total income of each shareholder. The rate would not systematically correspond to the income or ability to pay of the individuals who would actually bear the tax. The rates would be erratic and arbitrary. When corporate income tax rates are much lower or higher than individual income tax rates, this effect would become accentuated.

Alternatively, perhaps dividends should be deductible, like interest payments, by the corporation. This would make distributed corporate earnings taxable at the “correct” rate, that of each shareholder. But, while this approach

67. See, John K. McNulty, *The United States' Individual and Corporate Income Tax: Future Reform Possibilities*, 1 BOND L. REV. 52, 67-72 (1989) (Austl.), from which some parts of this section are taken [hereinafter McNulty, *Future Reform*].

68. See Victor Thuronyi, *Tax Reform for 1989 and Beyond*, 42 TAX NOTES 981, 984-85 (1989). Such a system is in place in Columbia, where dividends are exempt to the extent of 7/3 of the (30%) corporate tax paid. *Id.* at 985 n.8.

69. See I.R.C. § 116 (1954).

would counteract the debt/equity bias, it might induce corporate managers to "overdistribute" corporate earnings so as to get the largest deduction and show maximum after-tax income. Retained profits, after all, would attract and "bear" the corporate tax. And they would continue to be taxed at the fixed corporate rate until they were distributed. A deduction for some (50% or 10%), or all dividends paid has been recommended by the U.S. Treasury Department (in 1984) and other prominent sources in the United States (in 1989), but has never been enacted.⁷⁰

There can occur a kind of "back-door integration" if capital gains on sales of stock are wholly or partially exempt from income tax. In the United States, capital gains realized upon the sale or exchange of stock in a corporation are in principle taxable as part of gross income, even if—in some years, particularly before 1986—the rate of tax was reduced by deduction of some part of the gain. Presently, rate relief is provided by the 28% ceiling or maximum rate imposed under I.R.C. § 1(h) for individuals or the 35% ceiling of I.R.C. § 1201 for corporations.

In some instances, however, the gain on sale or exchange of shares is exempted, wholly or partially, by a fresh-start basis rule, such as that of § 1014 (basis of property acquired from a decedent) or new § 1202 (50% of exclusion for gains from certain small business stock). Such a complete or partial exclusion provides "back-door integration" of the corporate and individual income tax in that corporate profits retained and having borne only the corporate-level tax are not taxed (to the extent of the exclusion) to the shareholder or his or her successor, when realized upon sale of the shares or redemption. The buyer of the shares takes a cost basis in them and can liquidate or return the shares, or resell them, without further tax due to his or her high basis.

In other countries, capital gains upon the sale of stock are not taxed at all by the income tax, sometimes on the view that they do not constitute "income." Whatever the rationale, the exemption of such capital gain relieves the shareholder investor of the second level of tax, in a way paralleling an explicit integration mechanism such as a dividend exclusion. The higher the rate of individual income tax applicable to dividends, in relationship to the rate of tax on corporate earnings to the entity, the greater the savings, since it is the individual level tax that this "back-door" integration relieves.

Another solution is the partnership or transparency method. This means taxing shareholders on corporate income, whether or not it is distributed, and not imposing any entity-level or corporate tax. This method actually is in use in the United States, on an elective basis, for corporations having no more than 35 shareholders. A regular corporation that is eligible can elect this treatment,

70. See *supra* notes 47 and 48. The House of Representatives, in 1985, passed a partial deduction for dividends to be phased in, but the bill did not become law. See H.R. 3838, 99th Cong., 2d Sess. § 311 (1985); BITTKER & EUSTICE, *supra* note 13, ¶ 1.08 n.76. A dividend deduction and a reduced rate of corporate tax for *distributed* corporate earnings (a split-rate system) are essentially equivalent.

under Subchapter S of the Internal Revenue Code, and become an "S Corporation."⁷¹

This election for a small corporation to be taxed almost exactly the same as a partnership has worked very well. It gives small businesses the opportunity to combine the non-tax advantages of using a corporation (including limited liability) and the income tax advantages of a partnership, which avoids the double layer of corporate and shareholder taxes on distributed earnings.

Subchapter S could serve as a model for mandatory conduit tax treatment of small corporations, or for elective or mandatory treatment for large corporations in the United States.⁷² For years when individual tax rates stood much above corporate rates, such transparency or partnership style taxation of shareholders would actually have increased tax revenues.

However, in the case of large corporations many new complications and difficulties would be encountered, such as how to attribute corporate earnings to shareholders in complicated capital structures that include preferred stock, participating debentures, etc., or with affiliated corporate groups, or if tax audit adjustments must be made for prior years, or if shareholders buy and sell shares during the year. It is not entirely clear whether these problems can be solved satisfactorily in the United States. And, the partnership or Subchapter S method would create a liquidity problem; shareholders would request or demand actual distribution of corporate earnings in order to have funds with which to pay the tax. This makes the partnership method unattractive to corporate managers who

71. See I.R.C. §§ 1361-1379 (Subchapter S). The U.S. Treasury Department in 1977 recommended that "the effect of subchapter S Corporation treatment . . . be extended to all corporations." TREASURY BLUEPRINTS, *supra* note 43, at 69. Nothing came of this recommendation.

Another U.S. business form taxed as a conduit is the new "limited liability company"; see section XVII below.

72. See KRAGEN & McNULTY, *supra* note 22 at 995-1012, 1241-58 (1985); Thuronyi, *supra* note 68, at 984. The United States already has experience with mandatory transparency systems in the international arena. For controlled foreign corporations with "tainted" foreign income (§§ 951-964), and foreign personal holding companies (§§ 551-558), undistributed corporate income is taxable to controlling U.S. shareholders as constructive or "deemed" dividends. The U.S. international tax system also contains some *elective* or partly *elective* transparency systems, as with foreign investment companies (§§ 1246-1247), passive foreign investment companies (§§ 1291-1297) and domestic international sales corporations (DISCs) (§§ 991-994). The Foreign Sales Corporation (FSC) legislation (§§ 921-927) includes, in contrast, an exemption from U.S. tax for part of a FSC's foreign trade income and qualification for a 100% dividend received deduction when the FSC's parent receives a dividend distribution from the FSC.

Some authors recommend integration only for small or non-publicly traded corporations, to be taxed on a flow-through method or by excluding dividends from such companies if full corporate tax had been paid. See, e.g., Thuronyi, *supra* note 68, at 984. They would repeal the corporate tax for publicly-traded corporations and tax shareholders annually on any increase in value of their shares. Others would argue that, while integration makes sense for small, closely-held corporations, in a flat-tax world publicly-held corporations should pay the extra corporate income tax, without integration, because the demand for liquidity, which characterizes investment in them, is inelastic and hence the higher tax burden will not distort economic choices or allocations. See, e.g., Rebecca S. Rudnick, *Corporate Tax Integration: Liquidity of Investment*, 42 TAX NOTES 1107 (1989); Rudnick, *Who Should Pay?*, *supra* note 64; cf. Gammie, *supra* note 58 (discussing a proposal to retain a separate corporate tax on the above-normal return on corporate equity but to allow a deduction for the "normal" imputed cost of equity capital).

want to retain earnings for expansion, and it worries economists who want the tax system to be neutral with respect to dividend distribution policies.

Probably a better solution for large corporations, or perhaps for all corporations, would be a shareholder imputation credit approach, perhaps along the lines of the system recently adopted in New Zealand or Australia. This method of integrating the corporate income tax with the individual income tax has been used, in one form or extent or another, not only in Australia and New Zealand, but also in parts of Asia, Europe, and elsewhere, and has been recommended in the United States.⁷³

Under this method, familiar by now, U.S. corporate income tax would be collected on corporate income. When and if the after-tax corporate profits were distributed to shareholders, they would be taxable on the amount of the distribution, "grossed-up" by the amount of corporate tax paid, and they would be allowed to credit the corporate tax paid against their individual tax liability on "qualifying dividends."⁷⁴

So the entire corporate earnings, say \$100, would be imputed to the shareholders when the after-tax distribution, say \$65 (\$100 minus \$35 corporate tax), was made. They then could credit the previously-paid corporate tax (\$35) against their individual income tax liability. They would have to pay any balance owing or possibly get a refund if their shareholder credit (e.g. \$35) exceeded their shareholder tax (e.g. \$28).

Their creditable amounts could be geared to the amount of corporate tax paid on the earnings out of which the dividend was paid, lest untaxed or tax preference income carry too much credit relief to shareholders. (The system, in a way, would resemble the indirect foreign tax credit given in the United States to a U.S. corporate shareholder which receives dividends from a foreign subsidiary out of foreign earnings on which a foreign tax was paid by the subsidiary.)⁷⁵

When top individual income tax rates in the United States were 91% or 70% (1940s-1960s), and corporate tax rates were 52% or 46%, this difference in rates would have discouraged actual dividend distributions by a corporation even if a shareholder imputation and credit system had been in effect, since distribution to relatively high-bracket investors would have caused a second tax much higher than the credit allowed for the corporate tax paid earlier.

The 1986 Tax Reform Act (temporarily) established a new rate relationship between top (or usual) corporate tax rates and top (or usual) individual rates in the United States. Between 1986 and 1993, with the U.S. top corporate rate higher (34%) than the usual top individual rate (28% or even 33%, with the 5%

73. Somewhat similar imputation credit integration plans have been proposed in the United States, by the Treasury Department, by Congressman Al Ullman (former Chairman of the House Ways and Means Committee) and by scholars including economists and lawyers. McLURE, *supra* note 42, at 143-50; see McNULTY, *Integrating?*, *supra* note 43; KRAGEN & McNULTY, *supra* note 22, at 1241-58; Warren, *supra* note 43; Alvin C. Warren, Jr., *Recent Corporate Restructuring and the Corporate Tax System*, 42 TAX NOTES 715, 719 (1989).

74. This system would trace the post-1987 Australian system.

75. See I.R.C. § 902; cf. I.R.C. § 960.

surtax to phase out exemptions and lower brackets) for the first time in U.S. history, a credit for corporate tax would not only have equalled, but would usually have exceeded U.S. individual tax. Shareholders would have been happy to receive dividends that were taxable at 28% to them but would give them a 34% tax credit, and hence a \$6 refund (or an excess credit of \$6 that could offset tax on their other income). Many of them would actually have preferred to invest in corporations that paid out all their profits each year as taxable dividends, or would have put pressure on their corporations to distribute all of their after-tax profits. As a consequence of an imputation credit that often would have *exceeded* shareholder tax, U.S. tax law would then have become biased *against* retention of earnings by a corporation.

One solution to this problem of a tax bias of a shareholder credit system in favor of actual distributions would be to give each corporation a right to elect to allocate, or attribute, its earnings to its shareholders, even if it did not actually distribute them to shareholders. Allocated earnings would be taxable to shareholders as if distributed, even if retained by the corporation for expansion or other reinvestment. Such "allocated" and taxable earnings would entitle the shareholders to whom they were attributed to take a credit for corporate income tax paid.

So long as the top corporate tax rate equalled or exceeded the top individual shareholder's tax rate, as it did between 1986 and 1993 in the United States, shareholders would not object to being taxed on corporate earnings that had not actually been distributed to them. This would be true because the taxability to them would entitle them to a tax credit that, assuming the corporate income was fully "franked," would at least fully offset their individual tax burden and possibly or often exceed it. They would be happy to become eligible to get the excess as a refund, or only as a credit against tax on their other income.⁷⁶ This plan would leave the corporate income tax in place for incentive or regulatory uses. When the key rate relationship between the top individual and top corporate rates was again reversed in 1993, the U.S. situation reverted somewhat to that in the pre-1986 years.

To be sure, there are some difficult problems with either a mandatory or elective shareholder imputation credit approach to integration. They include the problems of corporate tax preferences, foreign shareholders, tax-exempt shareholders, audit adjustments, foreign income and changes in shareholders during the year. Studies in the United States, and experience in Western Europe, Australia, and Asia, show that these problems probably can be solved satisfactorily,

76. This voluntary allocation technique was an inventive part of the Carter commission in Canada in 1966. ROYAL COMMISSION ON TAXATION, REPORT OF THE ROYAL COMMISSION ON TAXATION (1966) [hereinafter CARTER COMMISSION REPORT]. This technique became feasible or easy to adopt in the United States because of the new near parity between top corporate and individual rates created by the 1986 Tax Reform Act. See McNulty, *Reform by Integration*, *supra* note 43.

or at least tolerated, in the United States.⁷⁷ Admittedly, the solutions add some complexity to the system. A deduction (or split-rate of tax, as in Japan at one time, and in Germany) for dividends paid would be simpler—but also less complete and less fair.⁷⁸

Some of the proposals for reform of Subchapter C contemplate the separate corporate income tax remaining as a separate tax in a classical, non-integrated income tax system and are incompatible with, or contradict, partial or complete “integration” of the two taxes. Some, however, are compatible with integration, or could serve as an intermediate step between a pure classical system and some form of integration.

A complete proposal that could substantially reform and perfect Subchapter C, and hence is offered as a policy alternative to integration, but which could also lead into integration, is the 1982 American Law Institute Reporter’s set of proposals with respect to the taxation of corporate distributions.⁷⁹ To alleviate what it regarded as the excessive amount of taxation on corporate earnings distributed (sometimes called “double taxation”), the A.L.I. Reporter, Professor William D. Andrews, recommended that a deduction be given to corporations for dividends paid, but only for those on “new equity” (to prevent windfalls for shareholders who bought stock in a market that set a price that assumed the continued existence of a two-tier tax on distributed corporate earnings).⁸⁰ To make non-dividend distributions on stock (by redemption transactions and other distributions that now escape the ordinary income tax on dividends) carry a tax price equal to the tax on dividend distributions, the A.L.I. Reporter proposed a corporate excise tax on such non-dividend distributions on equity capital.⁸¹ This tax would be imposed in addition to whatever shareholder level tax would apply.

Such non-dividend transactions (those that would carry the new excise tax to equate them with dividends) would include a purchase by a corporation of shares of stock in any corporation other than the purchaser itself. Such an exchange, like a cash dividend or a redemption of the purchasing corporation’s own stock, can be viewed as consisting of a distribution of assets out of corporate solution into the hands of individuals (even though the individuals are not shareholders of the purchasing corporation). Hence the equalizing excise tax would apply to the purchase, much as if it were a redemption from, or a payment

77. See *id.*; MARTIN NORR, *THE TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1982); *Business Tax Reform: Ending the Double Tax on Company Dividends—Statement of the Treasurer of 10 December 1986* (Austl.), in 41 BULL. INT’L BUREAU FISCAL DOCUMENTATION 91 (1987).

78. See TREASURY REPORT, *supra* note 1, app. at 172-76; TAX BUREAU MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAXES 1991 (1991) (Japan).

79. See A.L.I., SUBCHAPTER C STUDY, *supra* note 55, at app. 356-513. For a comparison of this proposal with integration plans, see Warren, *supra* note 43 (commenting on A.L.I. TENTATIVE DRAFT No. 2 (1979)).

80. A.L.I., SUBCHAPTER C STUDY, *supra* note 55, at 330-35, 356, 367-70; see A.L.I., REPORTER’S DRAFT, *supra* note 56, at 53; cf. CAPITAL TAXES GROUP, *supra* note 44 (describing ACE (Allowance for Corporate Equity) proposals); see also Gammie, *supra* note 58.

81. A.L.I., SUBCHAPTER C STUDY, *supra* note 55, at 401.

to, the purchasing corporation's own equity-holders. The corporate level excise tax could be credited by shareholders if any of these distributions were deemed to be a dividend for individual income tax purposes. Sales and redemptions of appreciated corporate shares by individuals would continue to be taxed in a preferential manner.⁸²

This shareholder credit, like the corporate deduction for dividends on new equity, resembles shareholder imputation credit integration proposals in form. The resemblance is more than skin deep. The 1982 A.L.I. program and integration proposals both seek to remedy a perceived over-taxation of distributed corporate earnings, in comparison with retained earnings, and corporate earnings that somehow leak up to the individual shareholder level at a lower tax cost as return of capital, capital gains, or deductible interest, without bearing a tax burden comparable to that on outright dividends.

As such, the A.L.I. Reporter's recommendations should be considered as an alternative to integration, as well as a possible transition toward it (by broadening the corporate deduction for dividends or by enlarging the shareholder credit for tax paid by the corporation).⁸³ Professor Alvin Warren has made just such a comparison and has concluded that straightforward integration of some form would be preferable in theory and economic results and would be workable in practice.⁸⁴

In its 1984 Proposals, the Treasury Department recommended a deduction for 50% of the dividends paid by the corporation each year. This reform resembles the 1982 A.L.I. Reporter's suggestion, although not going as far, and also contains a limit geared to corporate taxes paid on underlying earnings.⁸⁵ As mentioned above, the 50% dividends-paid deduction was scaled back by Treasury (in "Treasury II") in 1985 to a 10% deduction that, although incorporated in a House Bill, never became law.⁸⁶

Somewhat in the same tradition as the 1982 A.L.I. Reporter's proposal, the Summary of Final Report of the Capital Taxes Group of the (London based) Institute For Fiscal Studies (the "I.F.S.") entitled "Setting Savings Free" (Proposals for the Taxation of Savings and Profits) recommends a new allowance to be used by all corporations in computing their taxable profits.⁸⁷ This allowance, termed the ACE (for "Allowance for Corporate Equity") allowance, would provide an annual deduction to be taken by a corporation when calculating its taxable profits. The allowance would be based on the amount invested and reinvested in the company by its shareholders. It would be calculated at an official rate based on the interest rate currently paid on medium-term govern-

82. *Id.* at 401-86.

83. See A.L.I., REPORTER'S STUDY DRAFT, *supra* note 56, at 49-53; A.L.I., SUBCHAPTER C STUDY, *supra* note 55, app. at 514-18.

84. See Warren, *supra* note 79; George K. Yin, *The Deficit Reduction Act of 1984: Some Small Steps Toward Corporate Reform*, 25 TAX NOTES 73 (1984).

85. See TREASURY I, *supra* note 43, at 134.

86. See *supra* note 70 and accompanying text.

87. See CAPITAL TAXES GROUP, *supra* note 44.

ment securities. The shareholders' funds, upon which the allowance would be calculated, would consist of the capital subscribed or contributed by shareholders plus retained post-tax profits, less dividends paid and less amounts invested in another corporation.

The allowance for corporate equity would more or less equalize the tax treatment of corporate income financed by equity or by debt,⁸⁸ since interest paid on corporate debt would remain deductible by the company and taxable to a recipient of its interest payment. Hence, the corporation tax system would be virtually neutral as between debt and equity. Because the ACE allowance would permit a corporation to accumulate corporate income free of tax up to the normal rate of return on shareholders' funds, it would be conducive to corporate investment in every profitable source (profitable up to the normal rate of return) and, of course, in *more* profitable sources, those producing economic rents or entrepreneurial profits. The ACE allowance ensures that pre- and post-tax rates of return on profits that are just barely viable in the absence of a tax (in that they would earn a normal market rate of return) would be the same.⁸⁹

While the I.F.S. recommends the ACE allowance in the context of sweeping plans to make savings out of after-tax dollars free of tax, it is independent of these plans and worth separate consideration.⁹⁰

An ACE allowance would eliminate corporate income tax on income consisting of a normal rate of return earned by the corporation. In this way, the treatment would mirror present treatment of debt-financed normal income, the deductible interest cost of which offsets the gross income of the earnings, leaving no taxable income. The treatment of shareholder funds left in the corporation in an ACE tax world would exactly parallel re-invested (re-lent) interest in the present tax world. If the corporation earned more than such a normal rate in

88. In a way exactly opposite to the CBIT tax system proposed by Treasury. Gammie, *supra* note 58, at 266.

89. See Gammie, *supra* note 58.

90. Under the broader proposals for "setting savings free," I.F.S. would nearly convert the realization or accrual-type income tax into a universal expenditure tax, by using tax-free savings accounts or arrangements called EXPEPs (Extended Personal Equity Plans). These would function like broad-gauge I.R.A.s or tax-exempt savings accounts. However, they would exempt savings from income tax and make the income tax into an expenditure in consumption-type income tax by a technique that reverses the I.R.A. and U.S. academic proposals.

They would require that qualifying savings come from taxed sources, for example out of current taxable income, would not allow any deduction or other relief upon contribution, but then would exempt the earnings on those invested savings from tax and also would exempt from income tax all withdrawals from the accounts. This is (more or less) the financial equivalent of allowing a deduction upon contribution, exempting earnings, and then taxing withdrawal. Use of an EXPEP could enable a shareholder who invests his or her after-tax earnings in a corporation to receive dividends tax free. Combined with the ACE allowance, dividends from a normal rate of return of corporate income would be free of corporate and individual income tax, by combining corporate tax integration with an exempt savings regime. Combining the ACE allowance and EXPEPs makes sense if one wants to exempt savings from (corporate and personal) income tax altogether. If one does not want to go so far, however, but only seeks to eliminate the double tax on savings in the corporate sector, the EXPEP or exempt savings part of the IFS proposals can be put to one side and the ACE allowance considered in the context of an income-tax system that would continue to tax income investments in corporate equities once, at the rates applicable to individual shareholders.

the form of "economic rent" or "entrepreneurial income" (or the risk premium for invested equity), that extra income would be taxable to it. If this extra income, after tax, were left in the corporation, it would contribute to the "shareholder funds account" ("SFA") and increase the ACE allowance for the next tax period.

The ACE allowance would itself *reduce* the shareholder funds account (because it is a tax-free return on invested capital), as would taxes paid and dividends paid, with the consequence that the ACE allowance for the next period would be smaller.

One happy consequence of this inter-related series of adjustments is that it doesn't much matter to a corporation if it overstates or understates its income in any given period. If the corporation makes a mistake and pays more tax than it should have, it also will have a higher shareholder funds account as a result and, consequently, it will be entitled to a higher ACE allowance in the future. If it understates income and tax, it will suffer for its acts by having a smaller shareholder funds account and ACE allowance in the future.⁹¹ (And, assuming the company can fund the overpayment of tax at the ACE rate and can earn income on funds saved by reducing its tax at that rate, the ACE system is neutral as to the deferral effects.)⁹² In general, the ACE system is neutral with regard to the timing of realization of profit.⁹³ Similarly, indexation of capital gains in the corporate sector would not be necessary to correct the taxation of capital gains for inflation because the ACE rate adjusts for inflation.

Moreover, the ACE system in effect achieves something tantamount to an accrual method of taxation for gain on assets. Since "shareholder funds" include taxable profits (minus tax) for previous periods, if the corporate taxpayer defers paying tax, it reduces the ACE allowance that it will receive in the future (it pays less tax early but more later). If it realizes the income soon, it pays more tax then but less in the future because it will be entitled to a larger ACE allowance in the future.

What happens when a corporation living in an ACE system pays a dividend? At that point, shareholders would be taxable (so long as no EXPEP, IRA, KEOGH, qualified pension plan or exempt shareholder were in the picture). The portion of the dividend paid out of ACE rate income ("normal return") would become taxed for the first and only time, at the shareholders' appropriate rates. The portion paid out of income above the ACE rate, which was taxed to the corporation, would be taxed again. Such tax would be collected partly by a withholding obligation imposed by the corporation. The distribution would reduce the future ACE allowance of the company because it would reduce the company's shareholders' funds account used to calculate its future ACE allowance.⁹⁴

91. See CAPITAL TAXES GROUP, *supra* note 44, at 34.

92. Gammie, *supra* note 58, at 268 n.81.

93. *Id.* at 268 n.80.

94. See CAPITAL TAXES GROUP, *supra* note 44, at 3.

Thus the ACE system amounts, in a way, to taxing companies at a zero rate on an initial band of profits.⁹⁵ It is loosely similar in effect to a shareholder imputation credit system in which the tax credits are limited to the tax on a rate equal to the normal commercial rate on equity capital combined with a sort of dividend reinvestment plan for undistributed profits up to that limit.

The key is that the Shareholders' Funds Account measures the after-tax dollar investment of shareholders in the corporation, and the yield on that investment, the I.F.S. Capital Taxes Group thinks, should be forever exempt from corporate income tax. Only the *extra* profits that a company earns, after paying all its costs, including the (imputed) cost of its equity capital, should be taxable to the corporation.⁹⁶ An unintegrated, separate corporate tax on economic *rents* is acceptable because it will not deter investment since it (by definition) is a level of profit higher than can be earned elsewhere.

None of these possible techniques for complete integration or partial integration (dividend relief) was adopted in the U.S.. In the U.S. the integration movement gathered energy in the late 1970s, but then the movement diminished and lay relatively quiet, until the late 1980s. Concern about excessive use of debt and the failure of over-leveraged companies in the late 1980s and the early 1990s revived the question of how to tax corporate earnings that are distributed either as dividends or as interest, and whether to "integrate" the corporate income tax with the individual income tax.⁹⁷ In a country with a low rate of investment, there was concern that the unintegrated system discouraged new equity financing of corporate investments.

As of 1994, the United States federal income tax law continues to employ the so-called "classical system" which treats corporations and their investors as separate taxable entities and imposes tax at both the corporate and shareholder levels on earnings that are distributed by the corporation as dividends. There is no relief from this double tax on individual shareholders. Dividends are not deductible by the paying corporation. In contrast, corporate earnings that are distributed to lenders as interest are deductible by the corporation and taxable to the lender. Investors who choose non-corporate forms of business, such as the sole proprietorship or partnership, or closely-held corporations that qualify to elect to be taxed as "S Corporations," are taxed on a pass-through method and the undistributed as well as distributed earnings of the business are taxable, currently, to the shareholders, at their rates and according to their relevant individual tax characteristics. For the ordinary corporation, however, the corporate income tax is not "integrated" with the individual income tax.

The double-layered, unintegrated system works to (a) discourage incorporation; (b) encourage retention of corporate earnings indefinitely or until redemption or liquidation, especially until after the death of a shareholder; (c) reward use of debt rather than equity capitalization; (d) induce sale of shares (or

95. Gammie, *supra* note 58, at 266 n.74.

96. CAPITAL TAXES GROUP, *supra* note 44, at 24.

97. See *supra* note 64 and accompanying text.

tax-free reorganization) of corporations with retained earnings rather than distribution of dividends; (e) discourage multiple corporate layers, except where a 100% dividends secured deduction or income-tax consolidation under §§ 1501-1504 can be achieved through concentration of corporate ownership; and (f) favor tax-exempt or foreign shareholders, insofar as only U.S. taxes are taken into account. Still, income tax incentives arise from the structure and relationship of the unintegrated corporate and individual taxes, rules and rates.

It is non-neutralities, inequities and complications such as these that proposals for complex integration or for partial integration (dividend relief) have been designed to reduce or eliminate. The following sections describe and explore two of the most recent and important proposals, that of the U.S. Treasury Department and that of the American Law Institute Reporter.

VIII.

THE JANUARY 1992 U.S. TREASURY DEPARTMENT STUDY

On January 6, 1992, the U.S. Treasury Department issued a report entitled "Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once."⁹⁸ This report resulted from the revival of the integration debate and helped set the agenda for the policy discussion in the ensuing years. The Secretary of the Treasury had been instructed by the Tax Reform Act of 1986 to study reforms of the taxation of corporate income.⁹⁹ It was earlier expected that the study would consider less fundamental approaches to corporate income-tax reform. The Treasury decided to undertake a more comprehensive study of integration of the corporate and individual tax and to address fundamental questions about how the corporate income tax might be restructured to reduce tax distortions of important corporate financial decisions and to achieve a more efficient system, especially given the prevalence of integrated corporate income tax systems elsewhere in the world.¹⁰⁰

The Treasury study outlined four prototypes for integration, one of which was an imputation credit prototype, but the Treasury recommended against such form of integration for the U.S. tax system. It also recommended against a dividend deduction alternative.¹⁰¹

The Treasury study concentrated on three other integration prototypes. The first was a simple proposal to exclude dividends from the income taxable to shareholders, the "dividend-exclusion prototype."¹⁰² The second was a "shareholder allocation" model, much like the partnership or transparency models discussed in many countries over the years and rather like the "Subchapter S" legislation in the United States. Under this model, corporate earnings would be allocated to shareholders, even though not distributed to them. The allocated

98. TREASURY REPORT, *supra* note 1.

99. Pub. L. No. 99-514, § 634, 100 Stat. 2282 (1986).

100. *See id.* at ix.

101. *See* TREASURY REPORT, *supra* note 1, at 93, 107.

102. *See id.* at 17.

earnings would be taxable to shareholders, either without a tax at the corporate level, or with a credit for any tax paid at the corporate level.¹⁰³ The Treasury Department recommended against this allocation approach as well.¹⁰⁴

The final prototype was the "Comprehensive Business Income Tax" or "CBIT" prototype.¹⁰⁵ The CBIT model would impose a schedular or flat rate of tax on the business earnings of any entity, not only upon the income of corporations but also upon the income of proprietorships, partnerships, and all other businesses or business associations. Distributions by such entities to shareholders or other investors would be excluded from income, much as dividends would be excluded under the dividend exclusion prototype.

Most remarkably, the CBIT proposal would deny a deduction at the business level for interest and would exclude interest from the income of recipients, just the way dividends would be excluded from the income of shareholders. Interest and dividends, both viewed as costs of capital, to this extent would be treated alike.

As Treasury recognized, the dividend exclusion model would be relatively simple to legislate and put into place, whereas the CBIT proposal represents a long-term and more comprehensive method of taxing all business associations

103. See *id.* at 27.

104. See *id.* at viii. The shareholder allocation prototype that Treasury outlined and discussed, but, unfortunately, did not recommend for further study, differs from Subchapter S in some important respects. It retains a tax on the entity which is allocated to shareholders for credit against their personal tax liabilities. Furthermore, it denies a pass-through for losses. This prototype would not be limited to closely-held or one-class-of-stock entities. Treasury disavowed this allocation prototype because it would not invariably collect at least one tier of U.S. tax on foreign source income or tax-preferred corporate income. *Id.* at 27-37.

The Treasury Report in general probably was driven by a strong impulse to close the tax differences between equity and debt, and by the over-leveraging of the 1980s. Lee A. Sheppard, *Tax Officials Discuss Integration, Future Legislation at ABA Meeting*, 46 TAX NOTES 756 (1990); see generally Graetz, *supra* note 64; J. Andrew Hoerner, *Tax Bar Prepares for Treasury's Corporate Integration Report*, 47 TAX NOTES 778 (1990); Warren, *supra* note 73.

Probably also it was very concerned with the difference between taxation of dividends and of other dividend-like distributions, such as redemption of shares. See generally Anne L. Alstott & James B. Mackie, *Approaches to Corporate Integration: The Treasury Department Report, Where's the Beef? A Review and Critique of the Treasury Integration Study*, 54 TAX NOTES 1391 (1992); Richard Goode, *Integration of Corporate and Individual Taxes: A Treasury Report*, 54 TAX NOTES 1667 (1992); Gene Steuerle, *Two Cheers for the Treasury Integration Study*, 54 TAX NOTES 331 (1992); Geraldine Gerardi et al., *Corporate Integration Puzzles*, 43 NAT'L TAX J. 307 (1990); McNulty, *Reform by Integration*, *supra* note 43; see also John K. McNulty, *The Basic Structure and Characteristics of the U.S. Income Tax and Future Reform Possibilities* (pts. 1 & 2), 1988 THE JURIST 80, 90 (Japan) (on the corporate tax integration question).

My own high regard for Subchapter S, and my notion that it might be well to retain it in a world of divided relief or anything less than complete, pass-through integration, can be found in McNULTY, *TAXATION OF S CORPORATIONS*, *supra* note 54; McNulty, *S Corporations*, *supra* note 54, ¶ 10.06; see also TREASURY BLUEPRINTS, *supra* note 43, at 68-69; KRAGEN & McNULTY, *supra* note 22, at 995-1012; McNulty, *Integrating?*, *supra* note 43; McNulty, *Future Reform*, *supra* note 67.

See also Willard B. Taylor & M. Bernard Aidinoff, *Approaches to Debt: Is Integration the Answer?*, 67 TAXES 931, 934 (1989) (listing arguments in favor of the shareholder credit method); Alvin C. Warren, Jr., *Taxing Corporate Income in the U.S. Twenty Years After the Carter Commission Report: Integration or Disintegration?*, 26 OSGOODE HALL L.J. 313 (1988).

105. See TREASURY REPORT, *supra* note 1, at 39-60.

similarly and equalizing the tax treatment of debt and equity. Treasury suggested that full implementation of CBIT might well take ten years to bring into effect by a series of phases. Unlike the other proposals for integration, the CBIT proposal would be "self-financing," and in fact would generate additional revenue, which would permit lowering the corporate rate to the same level as the (1992) maximum individual income tax rate of 31%, without loss of revenue, even if capital gains on corporate stock were fully exempt from tax when realized by shareholders.¹⁰⁶

The Treasury Department made a number of policy recommendations, which (unfortunately) acted as constraints on its study. These included the ideas that (i) integration should not result in the extension of corporate tax preferences to shareholders, (ii) integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors, (iii) integration should be extended to foreign shareholders only through treaty negotiations, not by statute, and finally (iv) foreign taxes paid by U.S. corporations should not be treated by statute identically to taxes paid to the United States government.¹⁰⁷

The January 1992 Treasury Department integration study examined and, for the near term, recommended a "dividend exclusion prototype" which could either stand alone or serve as a transition to the comprehensive business income tax (CBIT) prototype, which Treasury ultimately recommended.¹⁰⁸ The dividend exclusion prototype contemplated that U.S. corporations would continue to pay the usual corporate income tax on their income at the specified statutory rate. However, in contrast to present law, when dividends were distributed to shareholders, those dividends would be excluded from the taxable income of the shareholders. More or less the present definition of "dividend" would be retained, which incorporates the concept of "current or accumulated earnings and profits."¹⁰⁹ In other words, under the dividend exclusion approach, the corporate income tax as it stands now would substitute for the present combination of corporate and shareholder tax. The shareholder tax on distributed corporate income would be repealed.

This model tends to provide a secure source for collection of revenue, consisting of the single tax on all corporate source income. Thus, the income is taxed when realized by the legal entity that earns it, namely the corporation. By leaving this tax in effect and repealing the shareholder income tax, Treasury would have an integration plan that avoids the exceptions to, and avoidance of, the shareholder level tax. However, the corporate income tax is not completely comprehensive because of corporate income tax preferences.

106. *See id.* at viii, 111-52.

107. *See id.* at viii-ix.

108. *See id.* at viii, 17-27. The CBIT prototype includes a dividend exclusion within it and, therefore, can best be understood after a description and an examination of the dividend exclusion prototype itself.

109. *See* I.R.C. § 316.

The Treasury dividend exclusion prototype would not allow the pass-through of any such corporate income tax preferences.¹¹⁰ It would retain the current alternative minimum tax on corporations and would impose what amounts to a second minimum tax on preference income when it left corporate solution. To be specific, to the extent preference income was distributed as dividends, the distribution *would* be taxable to the recipient. This result is achieved by imposing on corporations the need to maintain an "Excludable Distributions Account" ("EDA") which would be the sum total of present and previously fully taxed corporate income from which excludable dividends could be paid. If any dividends were distributed at a time when the EDA had a zero balance, they would be taxable to the shareholder-recipient as under current law.¹¹¹ This is the sense in which preferences would not be passed through to the shareholders.

Foreign source income that has been taxed abroad would not be treated as fully taxed income and would not increase the EDA *unless* there were an agreement to that effect by international tax treaty. In other words, integration would not extend to foreign source income, even if fully taxed abroad, unless a treaty so provided. In the absence of a treaty, a distribution of foreign source income would be taxed again by the United States at the shareholder level. The foreign tax credit would not flow-through in any way.¹¹²

Dividends would be excludable to corporate shareholders as well as to individual shareholders. The corporation receiving a dividend would increase its EDA by the amount of the excludable dividend, which then would allow it to make a distribution of the same funds to its shareholders without further tax to them. The corporate shareholder would continue to be entitled to a dividends-received deduction, under I.R.C. § 243, if it received a taxable dividend.¹¹³

With respect to non-dividend distributions, Treasury's dividend exclusion prototype would retain present law.¹¹⁴ This means that a distribution that was "essentially equivalent to a dividend" would be taxable as a dividend (to the extent of earning and profits) and would be treated under the general rules for dividends outlined above. A non-dividend distribution that qualified as a redemption or payment in exchange for stock of the selling shareholder would be treated as a return of capital up to the shareholder's basis in his or her shares and as capital gain above that.¹¹⁵ If the distribution were categorized as a non-dividend distribution, no part of it would be tax-free to the shareholder even if the corporation had a positive EDA balance at the time, and the corporation would not reduce its EDA by the amount of the distribution. In other words, for these purposes it might be much more favorable to treat a distribution as a dividend, rather than as a non-dividend distribution, contrary to the position under present law.

110. See TREASURY REPORT, *supra* note 1, at 18.

111. See *id.* at 19.

112. See *id.* at 21.

113. See *id.* at 20.

114. *Id.* at 17, 24.

115. *Id.* at 24.

If a shareholder governed by the dividend exclusion prototype were to sell his or her shares, it appears (although the Treasury study is not entirely definite) that the principles of current law would apply.¹¹⁶ Consequently, the sale of shares would be a taxable event and any gain, any amount realized above basis, would be taxable in full. Capital losses would be deductible. In effect, this could produce a second or shareholder tax upon retained corporate earnings, which seems inconsistent with the theory of the dividend exclusion prototype.

Apparently the only relief from this effect would be the prototype's elective "Dividend Reinvestment Plan" ("DRIP").¹¹⁷ Under this plan the corporation could elect to declare a constructive dividend, which would be treated as a regular dividend followed by reinvestment by shareholders of an equal amount in the corporation. As a consequence, shareholders could increase their basis in their stock by the after-tax proceeds of corporate income that was retained but constructively distributed and recontributed. If all corporations made this election with respect to all their earnings, then the second tax upon the sale of all shareholders' shares would not apply to the amount of the gain resulting from retained earnings and would not reintroduce double taxation. The DRIP dividend would allow the corporation to treat the shareholders as if they had received excludable dividends up to the corporation's EDA balance, followed by a deemed recontribution of the distributed amount by the shareholders back to the corporation. The deemed distribution would not be taxable, although it would reduce the corporation's EDA balance, because the dividend would be an excludable one. It is the deemed recontribution that would entitle the shareholder to increase his or her stock basis, which then would have the effect of diminishing his or her capital gain on sale of the shares, or possibly of creating or increasing the amount of a capital loss on their sale.

The Treasury's dividend exclusion prototype was favored because Treasury believed that the most significant efficiency gains could be achieved by a schedular system in which all corporate income would be taxed at a uniform rate, at the corporate level, without regard to the tax rate of the corporate shareholder.¹¹⁸ Treasury went on to say that the neutral taxation of capital income would reduce distortions found in the present system.¹¹⁹ Economic efficiency suggests, Treasury believed, that all capital income should be taxed at the same rate.¹²⁰

Treasury also emphasized the simplification advantages of taxing corporate income only to the corporation and at corporate rates.¹²¹ Income that had been fully taxed at the corporate level would be taxed just the same whether distributed or not and would be taxed in a uniform manner, regardless of the tax brack-

116. *Id.* at 17-27.

117. *Id.* at 24.

118. *See id.* at 12.

119. *Id.*

120. *Id.* at 12, 112, 128. But one difficulty flows from the fact that some corporate income, especially in small closely-held corporations, consists of labor or entrepreneurial income.

121. *Id.* at viii, 93.

ets of the individual shareholders. Consequently, the portions of corporate income attributable to tax-exempt or foreign shareholders or low-bracket shareholders would be taxed at the same rate as would the income attributed to fully-taxable high-bracket shareholders. Therefore, whatever progressivity would be found would be inherent in the *corporate* tax rate schedule. The progressivity would depend upon the amount of income of the corporation, in the aggregate, rather than on the income, from all sources, of each individual shareholder. In contrast, corporate preference income would be taxable to the shareholders at their individual rates, rather than at the corporate rate. The progressivity and other characteristics of this tax system have been worked out interestingly by Professor George Yin.¹²²

The CBIT prototype was the most "comprehensive" of those developed by Treasury.¹²³ It would apply the same tax regime to unincorporated as well as to incorporated businesses. The income of all business entities would be taxable to the entity at a single rate, 31% in the Treasury example.¹²⁴ In other words, an entity-level corporate-like income tax would apply to all businesses, even partnerships or other "conduit" organizations, and the base would resemble the present corporate income tax. However, no deduction would be allowed to the corporation for interest or dividends paid; dividends and interest received by shareholders and lenders from CBIT entities would be excluded.¹²⁵ Neither dividends nor interest would be taxable when received by investors.¹²⁶ The CBIT model uses the dividend exclusion approach of Treasury's dividend exclusion prototype and expands this treatment to apply also to interest, which would no longer be deductible. Hence, corporate earnings would be taxable once, to the entity, at a single rate, whether distributed or not, and whether distributed as dividends or interest.

Treasury expected that such a new system would not fully be implemented at once, but perhaps would be phased in over 10 years or so.¹²⁷ It would equalize debt and equity and eliminate the second level of tax of present law and would place all, or almost all, business organizations under the same tax regime. It has many of the merits and weaknesses of the dividend exclusion approach, and can be compared with other dividend relief and complete integration proposals in much the same terms, without—however—losing sight of its greater extent, difficulty of implementation and possibly greater economic neutrality.

122. See George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 453-462 (1992).

123. See TREASURY REPORT, *supra* note 1, at 39.

124. *Id.* at 40.

125. *Id.* at 53.

126. See *id.* at 39-60.

127. See *id.*

IX.

THE DECEMBER 1992 U.S. TREASURY LEGISLATIVE
RECOMMENDATIONS

Throughout 1992, tax scholars and expert groups studied the U.S. Treasury Department proposal, and the Treasury Department promised that, before the end of 1992, it would make a legislative recommendation and thus express a choice of which form of integration should be adopted. In a December 11, 1992, letter from Treasury Secretary Nicholas F. Brady to House Ways and Means Committee Chairman Dan Rostenkowski, the Treasury Department enclosed its recommendation.¹²⁸ This recommendation is very similar to the "dividend-exclusion prototype" first put forward by Treasury on January 6, 1992. In other words, Treasury again preferred the dividend-exclusion approach to a pass-through or shareholder imputation credit model. It also preferred, for the near term at least, the simple dividend-exclusion approach to the more sweeping "comprehensive business income tax" approach that was the strongest recommendation made in January. Treasury preferred the dividend-exclusion approach because of its simplicity, because it could be relatively easily inserted into the present legal framework of the corporate income tax and easily administered, and because it could be implemented at once, without any transition or phase-in period.¹²⁹ Also, Treasury stated that the dividend-exclusion approach was preferable to the shareholder allocation and imputation-credit prototypes because it was consistent with Treasury's policy view that, over the long term, it would be "desirable to move the tax system in the direction of a schedular tax on enterprise activity," such as a tax like the CBIT prototype, or some version of a business cash-flow tax or a business transfer tax.¹³⁰

Under the dividend exclusion model recommended on December 11, 1992, a corporation would compute its taxable income and pay tax as it does under current law. Any distribution made to shareholders out of the corporation's income that remained after paying its tax and after making certain limited adjustments to "taxable income," adjustments that would produce the determination of "adjusted taxable income" or "ATI," would be treated as a dividend and would be excludable from gross income when received by the shareholders. Distributions in excess of ATI would be treated as a return of capital to the shareholders, or as capital gain to the extent the distributions exceeded their adjusted bases in their shares.¹³¹

ATI is defined by this new Treasury proposal as corporate taxable income that has been reduced by deducting federal income taxes and creditable foreign taxes paid or accrued and increased by excludable dividends received and by

128. TREASURY RECOMMENDATION, *supra* note 1, at L-7.

129. *See id.*

130. *Id.*

131. *Id.* at L-8, L-9, L-10. A shareholder's basis in the shares is a changing record of the shareholder's after-tax dollar or "capital" invested in the shares, not previously returned by corporate distributions or tax benefits. It resembles "adjusted historical cost" in Japan's income tax law.

any items of income that are permanently excluded from income under the present tax law (tax-exempt interest, percentage depletion in excess of basis, etc.).¹³² It thus resembles the present concept of "earnings and profits."¹³³ Because distributions that exceed taxable income would be treated as a return of capital to the shareholders, no distribution ever would be treated as a taxable dividend to shareholders. That is to say, a distribution would be one of the following: (1) an excludable dividend, up to ATI; (2) a return of capital; or (3) capital gain to the extent the distribution exceeded each shareholder's basis in his or her shares, which is taxable at rates that (sometimes) differ from the rates applicable to ordinary income.

The new Treasury proposal allows corporations to adopt a "dividend reinvestment plan" (again termed a "DRIP"), along the lines of the dividend reinvestment plan proposed by Treasury in January of 1992 and modeled on the "voluntary allocation" of the Carter Commission Report in Canada in 1966.¹³⁴ Under the dividend reinvestment plan, a corporation voluntarily could pretend that a cash dividend had been paid to its shareholders out of its adjusted taxable income and that such dividend was immediately reinvested by the shareholders. No money would change hands. Instead, earnings of the corporation retained by the company would be "deemed" to have been distributed and recontributed. The shareholders would not pay any tax on the constructive or "deemed" dividend (because all dividends would be excludable by shareholders), but they would increase their bases in their shares by the amount of the "deemed" dividend. The effect of this basis increase would be to reduce the capital gain, or increase any capital loss, that the shareholders would realize when they sell their shares. The gain would be reduced by an amount equal to the corporation's retained but previously taxed and "allocated" earnings.

Treasury's December ATI proposal differs in some important respects from the dividend exclusion prototype described earlier by Treasury in its integration study of January 1992. The most important differences are the following: first, all distributions in excess of "adjusted taxable income" are treated as returns of capital to the shareholders, rather than as taxable dividends;¹³⁵ second, integration is extended to foreign source income, by "flowing through" creditable foreign taxes;¹³⁶ third, the proposal would have an immediate effective date with only limited, elective transition relief for corporate shareholders.¹³⁷

The December 1992 Treasury proposal contained 23 recommendations.¹³⁸ One of the recommendations indicates that Treasury *would* retain the current

132. *Id.*

133. See Treas. Reg. § 1.312-6 (1955).

134. TREASURY RECOMMENDATION, *supra* note 1, at L-12.

135. *Id.* at L-11.

136. *Id.* at L-10.

137. *Id.* at L-16. Like the dividend-exclusion proposal of January, the ATI proposal would not be extended to foreign shareholders by statute, but Treasury contemplated that integration benefits might be granted to foreign shareholders by international income tax treaties. *Id.* at L-15.

138. These recommendations constitute the ATI proposal itself. Some of them are relatively technical and explain the extent to which the proposal would allow the present corporate income tax

U.S. treatment of "S Corporations," partnerships and other pass-through entities, such as regulated investment companies, real estate investment trusts and real estate mortgage investment conduits.¹³⁹ This would mean that investors who would prefer to have a single layer of tax imposed on business earnings at the rates dictated by the individual income tax and by the income tax situations of the shareholders could, subject to eligibility rules, form proprietorships or partnerships or other pass-through entities, or could cause their closely-held corporations, if otherwise qualified, to elect "Subchapter S" treatment.

The top individual rate of federal income tax specified in the United States is now (1994) 39.6%, and the top corporate rate is 35%. It seems quite likely, though, that rate increases in one or both taxes will be enacted in the future, at least within some income ranges, and that the relatively equivalent relationship between the top rates and the lower or intermediate rates would cease to exist. If, for example, individual rates went far higher than the corporate rates, taxpayers might prefer to use a corporation subject to the new ATI proposal. Under this proposal, business income would be taxed once, at corporate rates, and not taxed a second time, even upon distribution to high-income shareholders. On the other hand, if top corporate rates went higher than top individual income tax rates or the rates applicable to particular shareholders, investors might prefer the pass-through treatment of partnerships and S Corporations. This would result in one level of tax, at the individual shareholder rate, rather than the higher corporate rate. If taxpayers anticipate losses in their business, they might prefer the pass-through treatment of partnership or S Corporation form, which would allow those losses to be deducted from other income on their individual shareholder returns.

Treasury recognized that retaining Subchapter S and partnership treatment would be somewhat inconsistent with its long-term policy preference for a schedular tax on enterprise activity and with its goal of tax simplification. It recognized, however, that the partnership, Subchapter S, and other alternative regimes are so deeply embedded in the U.S. income tax system that any other approach would prove exceedingly disruptive and would require elaborate transition rules. Treasury implied that conversion to a Comprehensive Business Income Tax (CBIT) later would be desirable and that it would entail repealing Subchapter S.¹⁴⁰

X.

THE MAY 1993 AMERICAN LAW INSTITUTE "REPORTER'S STUDY"

During the preceding years, the prestigious American Law Institute also had begun to undertake a study of integrating the corporate and individual income taxes. By October of 1992, a final draft of the A.L.I. "Reporter's Study"

to remain in place without modification, and others indicate that some, relatively minor, alterations would have to be made in the corporate tax legislation.

139. *Id.* at L-14.

140. *Id.* at L-14.

on "Integration of Individual and Corporate Income Taxes" was made available to the Council of the American Law Institute.¹⁴¹ The A.L.I. "Reporter's Study" was completed and presented to the Institute at its Annual Meeting in May, 1993.¹⁴²

The American Law Institute Reporter's Study proposed a shareholder imputation credit method of integration of the corporate and individual income tax for the United States in a form roughly resembling that recently enacted in New Zealand, and familiar in Australia and the European Community. Under this method of integration, the corporate income tax would remain in place, and dividends would be taxable to shareholders. The shareholders would, however, receive a credit for the corporate tax paid with respect to the earnings out of which distributions were made to them as dividends.¹⁴³

The A.L.I. Reporter, Professor Alvin Warren of Harvard Law School, produced an excellent analysis and proposal for shareholder imputation credit integration in the United States, thoughtfully argued and superbly worked out, although not cast in the form of legislation. The A.L.I. proposal benefitted from the work of the "Carter Commission" of Canada, the Royal Commission which produced an attractive proposal for shareholder credit integration in 1966, including a plan for voluntary "allocation" of retained earnings.¹⁴⁴ In the United States, the income tax rate relationships newly established by the 1986 Tax Reform Act, relationships between the top individual income tax rate and the top corporate income tax, made the Carter Commission "allocation" idea, and the shareholder credit method of integration in general, especially feasible and desirable.¹⁴⁵ Taking into account the experience and legislative variations among shareholder credit integration systems in Western Europe and the rest of the world, the A.L.I. study should receive continued attention from policy analysts and the Congress of the United States.

The shareholder imputation credit model, as developed by the A.L.I. Reporter, and like that in use in many countries, comes very close to the results and virtues of a transparency or Subchapter S type integration system. It is probably the "second-best" alternative and should be adopted if true transparency integration is not feasible for legal, economic or political reasons.

The imputation credit model allows the corporate income tax to serve temporarily as the proxy for the shareholder-level tax that would arise if there had been an allocation of corporate earnings to the shareholders. Parallel treatment is provided in the A.L.I. study for corporate debt and interest payments, as described below.

141. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, COUNCIL DRAFT NO. 20 REPORTER'S STUDY—INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES (1992). Earlier drafts had been discussed by special study groups and consultants to the American Law Institute.

142. A.L.I. REPORTER, *supra* note 1.

143. *Id.* at 47.

144. CARTER COMMISSION REPORT, *supra* note 76.

145. See McNulty, *Reform by Integration*, *supra* note 43, from which some of this article is taken.

However, the corporate tax is a very imperfect proxy, and it is not sensitive to the individual tax rates applicable to the owners of the corporation. It is therefore treated as a withholding tax, creditable to the account of the shareholders upon final reconciliation of their income tax liabilities. This reconciliation does not happen until there is a dividend distribution, in other words until there has been a "realization" of the income by the shareholder. Thus, it satisfies the realization requirement of the U.S. income tax. At the time of such a distribution, the shareholder must include the distribution in his or her income and recalculate the proper tax burden on that distribution. The shareholder is then viewed as having pre-paid part or all of his tax by virtue of payment by the corporation of its corporate income tax for the account of the shareholder. This pre-payment is credited to the distributee in the form of a (possibly refundable) tax credit. If the credit equals the shareholder's tax, no further payment must be made. If the corporate tax rate is higher, there would be a refund of the excess credit to the shareholder. If the corporate tax is insufficient, the shareholder must make an additional payment.¹⁴⁶

The simple mechanism of the shareholder imputation tax credit system becomes much more complicated when it takes into account real world problems, particularly including those of "preference income" (income received by the corporation at a lower rate of tax, or tax-free, by virtue of legislative preferences granted to corporations), foreign source income (corporate income arising in a foreign country and then repatriated to the United States), and tax-exempt and foreign shareholders.¹⁴⁷ It also becomes necessary to take into account the fact that shareholders can realize their proportionate amounts of corporate source income through means other than dividend distributions, means including non-dividend and redemption distributions by the corporation and sales of stock to third parties.¹⁴⁸ The American Law Institute Reporter's proposal intelligently and elegantly deals with these special "real world" problems.

As to corporate tax preferences, the question is whether those preferences should be passed through to the shareholders, thus allowing the eventual tax on individual shareholders upon their corporate source income to be determined with the benefit of the corporate tax preference. The transparency approach of integration would suggest allowing a complete pass-through with the preferences, as if the income had been earned in non-corporate form. This seems particularly allowable if the preference was intended as an inducement to investors to perform certain economic activity, regardless of the legal form of the investor. In contrast, it may be argued that some corporate tax preferences are granted only for the benefit of corporations, sometimes in an effort to reduce the double taxation of earnings taxable to a corporation. If that is the case, eliminating double taxation would seem to imply ending the preference, or "washing it out." At present, there is no pass-through of corporate preferences for normal

146. A.L.I. REPORTER, *supra* note 1, at 50-57, 94-134.

147. *See id.* at 108-13.

148. *See id.* at 135-50.

"C" corporations because of the technical definition of corporate "earnings and profits," which does not take into account such preferences.¹⁴⁹

The A.L.I. Reporter's Study passes through some preferences but washes out certain others. The wash-out is accomplished by imposing a "Dividend Withholding Tax" ("DWT"), at the regular corporate tax rate, when a dividend is distributed, to the extent the dividend consists of an untaxed portion of preference income.¹⁵⁰ In a complicated device, the Dividend Withholding Tax is imposed on the dividend distribution of *any* income, whether out of preference sources or otherwise, but the corporation would have maintained a "Taxes Paid Account" ("TPA") to keep track of taxes paid by the corporation, and it could use its positive balance in the TPA to satisfy its DWT liability. The result is to impose the DWT only upon the distribution of previously untaxed (or preferentially taxed) preference income.¹⁵¹

Preferences allowed to be passed through would be controlled by an "Exempt Income Account" ("EIA") to keep track of those preferences. Distributions of amounts allowed from this account would not give rise to the DWT and would not be taxable to the recipient shareholder.¹⁵²

As to foreign-source income, if the income has been taxed in the foreign country, and if the United States would normally allow a foreign tax credit for the foreign tax paid, the foreign source income would resemble "preference income" because it could be received by the U.S. corporation without payment of further U.S. tax unless the U.S. tax rate was higher than the foreign tax rate.

The A.L.I. Reporter's Study treats foreign source income as exempt income that may be distributed tax free to the investors in the corporation.¹⁵³ The effect is to pass through the benefit of the foreign tax credit. However, the Reporter's study recommends that this pass-through be implemented only as part of a tax treaty with a foreign country, not by statute.¹⁵⁴ In other words, the United States would not unilaterally give up tax jurisdiction to the foreign country, to this extent, but would do so only as part of the negotiations of an international income tax treaty.

Tax-exempt and foreign shareholders present another problem. An allocation or transparency approach would seem to suggest that corporate source income that is allocable or distributable to a tax-exempt owner would not be taxed because of the tax-exempt status of that shareholder. Similarly, if a foreign shareholder would not be subject to U.S. income tax normally, then he or she should not be taxable merely because the income takes the form of a dividend from a U.S. corporation. That probably is the correct theoretical result for tax-exempt and foreign shareholders.

149. I.R.C. §§ 312, 316; Treas. Reg. § 1.312-6 (1955).

150. A.L.I. REPORTER, *supra* note 1, at 92-93, 98.

151. *See id.* at 93.

152. *Id.* at 108.

153. *Id.* at 198.

154. *Id.*

The real world problem is complicated by the fact that tax-exempt shareholders in the United States presently are, in effect, indirectly subject to a corporate-level tax when they receive dividends, even if they are not taxable on the dividends themselves.¹⁵⁵ This is because the corporation paying the dividend has been taxed on its own income, despite the tax-exempt status of the shareholder. The same is true of a foreign shareholder. Consequently, a change to what might be described as the theoretically correct result would involve a change in the current status of tax-exempt and foreign shareholders and would involve a revenue loss.

Also, it is important to note that if a tax-exempt owner earns income from a business enterprise directly, rather than through the vehicle of a corporation, the income is likely to be subjected to a tax called the "unrelated business income tax."¹⁵⁶ Arguably, the same tax burden should be imposed on dividend income as well, after integration, if the system is to disregard the corporate entity for tax purposes.¹⁵⁷

155. In contrast, in the United Kingdom the tax-exempt status of an institution holding shares is freed from the indirect corporate tax. See Gammie, *supra* note 58.

156. I.R.C. §§ 511-513.

157. Internal Revenue Code §§ 501-509 deal with organizations that are exempt from income tax. Section 501 provides for a very comprehensive range of exemption, including in its scope charities, educational institutions, chambers of commerce, labor unions, trade associations, social clubs and a score of other organizations. These organizations are required to file an application for exemption with the District Director of the Internal Revenue Service. With exceptions discussed *infra*, if the exemption is granted, the organizations are free from income tax liability as long as no substantial change takes place in their purposes, organization or operation.

There is a general provision against exemption where any portion of the net earnings of an organization inures to the benefit of any private person (other than payments which carry out its exempt function, such as payments for the benefit of the poor). See, e.g., *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969). Exemption has been denied to trade associations where a substantial portion of their activities was the rendering of services to individual members, such as obtaining credit information. See *United States v. Oklahoma Retailers Association*, 331 F.2d 328 (10th Cir. 1964); *Indiana Retail Hardware Ass'n v. United States*, 366 F.2d 998 (Ct. Cl. 1966). However, activities conducted for the general benefit of the membership of a union or trade association do not preclude it from obtaining tax-exempt status.

The exemption from income taxation of organizations described in § 501(c) is somewhat limited. Most of such organizations are subject to the provisions of §§ 511-513 which subject to the corporation income tax *unrelated business taxable income*, that is, income derived from an unrelated trade or business. An unrelated trade or business is any trade or business the conduct of which is not substantially related to the exercise or performance by an exempt organization of its exempt function. See § 513(a). Sections 511-513 were enacted to prevent the practice of exempt organizations acquiring businesses which they would then operate without income tax liability. (The most notorious example was the acquisition by New York University of the Mueller Macaroni Company.) A further result of the application of §§ 511-513 is that the expenses of conducting an organization's exempt-function activities may not be deducted from unrelated business taxable income. The effects of §§ 511-513 may make exemption unattractive to a membership organization rendering services to its members, such as a social club or a business league, if the costs of membership services are met in part by income derived from an unrelated trade or business.

With some modifications, organizations exempt under § 527 (political organizations) or § 528 (homeowners associations) are taxable under the usual rules affecting corporations on income which is not exempt-function income. The scope of exemptions is therefore much narrower than for organizations exempt under § 501(c).

The tax-exempt organizations that have attracted the greatest attention from Congress are those described in § 501(c)(3): organizations organized and operated exclusively for religious, charitable,

As to foreign shareholders, there is a similar problem because they are affected by withholding taxes imposed on dividends paid to foreign shareholders.¹⁵⁸ And U.S. shareholders are subject to foreign withholding taxes on their dividend income paid by foreign corporations. The issue can be viewed as raising the question whether pass-through integration is the goal or whether it is simply enough to eliminate "double taxation."

The A.L.I. Reporter's Study maintains the single level of tax on corporate income received by tax-exempt investors.¹⁵⁹ The study takes a similar approach to foreign investors.¹⁶⁰ The study recommends an explicit new tax on certain categories of investment income, including dividends and stock gains for tax-exempt and foreign shareholders.¹⁶¹ When a distribution is made to such an investor, the integration credit (for dividend withholding tax) could be used to offset this new tax and any excess credit would be refundable to the distributee. For foreign shareholders, this new tax would replace the existing withholding tax. It would be subject to mutual reduction in tax treaties.¹⁶²

Finally, there is the problem of corporate shareholders and parent-subsidiary situations. Distributions between corporations should not involve additional tax burdens. The A.L.I. Reporter's Study achieves this by including dividends in the income of the corporate recipient but allowing the recipient a refundable integration credit.¹⁶³ The tax rates at the time of the distribution would govern both the amount of the tax due and the amount of the credit. Therefore, the dividend could be distributed free of any tax. There would be a reduction in the distributing corporation's taxes-paid account and an increase in the corporate shareholder's taxes-paid account by the amount of the credit, comparable to how "earnings and profits" accounts might be affected by an intercorporate dividend under present law.

If preference income is distributed to a corporate shareholder, there would be a further problem of whether to wash out the preference or not, since the income remains "in corporate solution." The A.L.I. study would treat a distribution of preference income as in principle implicating a DWT liability for the

scientific, testing for public safety, literary or educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. Section 170 also provides a tax deduction (within certain limits) for the amount of a gift made to a § 501(c)(3) organization, including publicly-supported churches, colleges and charities.

Otherwise "tax-exempt" institutions are subject to the tax of I.R.C. §§ 511-513 on their "unrelated business income," which does not include dividends on portfolio stock.

See generally John G. Simon, "The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies," Chapter 5 in Walter Powell (ed.), *THE NON-PROFIT SECTOR*, Yale Univ. Press (1987), pp. 67-98; Henry Hansmann, "Economic Theories of Nonprofit Organization" in *id.*, at pp. 27-42; Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54 (1981); Boris I. Bittker and George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 229-358 (1976).

158. I.R.C. §§ 871(a), 1441.

159. A.L.I. REPORTER, *supra* note 1, at 8.

160. *Id.* at 8-9.

161. See *id.* at 159-64 (exempt shareholders and creditors), 190-94 (foreign investors).

162. *Id.* at 192-93.

163. *Id.* at 151-58.

distributing corporation even though the distribution was made to a corporate shareholder. But, if the corporate identity of the shareholder were known, the A.L.I. proposal will permit treatment of the dividend as exempt income to the recipient. In that case, it would not give rise to DWT or be taxable or creditable to the recipient, and it would not produce any change in the TPA of either corporation.¹⁶⁴

The A.L.I. study also deals with the alternative means that corporate-source income can be realized by shareholders. It would distinguish between stock redemptions that are very similar to dividends, which would be taxable like dividends under the integration proposal,¹⁶⁵ and gains from the sale of corporate equity securities that would be taxable at the (ordinary income) rate of the seller. Also, stock losses would be deductible within certain ingenious limitations.¹⁶⁶

If a shareholder were to sell his shares before a distribution had been made by the corporation, but after tax had been paid by it, or if the shareholder received a non-dividend distribution under such circumstances, there could be a double tax on retained corporate income. This is possible because the shareholder's basis in his shares would not reflect the previously taxed but undistributed income of the corporation. To solve this problem, the A.L.I. Reporter's Study recommends an elective constructive dividend procedure resembling that in the proposal of the Carter Commission in Canada in 1966.¹⁶⁷ A corporation could declare any amount of its earnings as a constructive dividend, to be treated as followed by a constructive re-contribution of such amount back to the corporation. In such event, the constructive dividend would be taxable to the shareholders, but they would be able to offset the tax with available refundable tax credits just as they would if they had received an actual dividend. The shareholders would also be entitled to increase their tax bases in their shares by the amount of income taxable to them, even though the tax was offset by available credits. The corporation would then record these constructive amounts in a "previously taxed dividend account." Actual distributions made from this account would be tax-free to the shareholders to the extent each distributee had sufficient stock basis.

To produce proper (parallel) treatment of interest payments by a corporation on corporate debt, the A.L.I. Reporter also recommended retaining the interest deduction but adding a new "interest withholding tax" ("IWT") at the corporate level on interest on other than trade credit. The credit for such interest withholding tax would be usable against U.S. tax liability and would be refundable to the same extent as the shareholder withholding credit.¹⁶⁸

The A.L.I. Reporter's Study thus constructs and elaborates an excellent modern shareholder imputation credit model for integrating the U.S. individual

164. *Id.* at 154.

165. *See id.* at 143-44.

166. *See id.* at 129-32.

167. *See id.* at 126-29; *see also* McNulty, *Reform by Integration*, *supra* note 43.

168. *See id.* at 15, 90-92.

and corporate income taxes by using a design essentially following that in use for many years in the countries of the European Union, and more recently in Australia and New Zealand. Unless a practical partnership-type or allocation model can be shown to adequately address the problems of tax-exempt and foreign shareholders, the A.L.I. imputation credit model seems the optimal course for U.S. policy and legislation.

XI.

EVALUATION OF THE MERITS AND DEFICIENCIES OF THE A.L.I. AND TREASURY PROPOSALS

A. *The Integration Ideal*

The theoretically ideal model for corporate and individual income tax integration is the flow-through, partnership style, Subchapter S or "transparency" model. The Treasury Department study called this its "shareholder allocation prototype," although that model did not go nearly so far as does Subchapter S or true partnership-style integration.¹⁶⁹ Under such a system, the corporation is viewed merely as a conduit or vehicle for its owners. The corporate source income that is technically earned and retained or distributed by the corporation is treated as if earned by the owners of the enterprise, as it arises in the hands of the corporation. Such a transparency or conduit model provides the closest approximation between the taxation of income earned by a corporation and the taxation of the same income earned from the same business activity through an unincorporated form, such as a partnership or sole proprietorship.¹⁷⁰

In the partnership model, a tax is imposed on corporate source income as it arises. The tax is determined by taking into account the tax rates of the owners of the income. And finally, the income of a corporation is subjected to neither more nor less than one level of taxation.

These characteristics are satisfied by partnership or Subchapter S style integration because the earnings or losses are passed through and taken into account by the individual partners or S Corporation shareholders each year, whether or not distributed. The distribution of the burdens is sensitive to the individual tax-paying abilities of those benefitting from the income. The income of a tax-exempt shareholder is not subjected to any tax. The income of a low-bracket shareholder is taxed at low rates. The income of a high-bracket shareholder is taxed at high rates. The income of a foreign shareholder would be taxable or not by the source jurisdiction depending upon its international tax rules for dividends or other income sourced within its borders and taxable to foreign investors.

169. See TREASURY REPORT, *supra* note 1, at 27-38. For example, losses would not pass through in the Treasury model, in contrast to present law for partnerships, S Corporations, and limited liability companies.

170. See James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass-Through Paradigm*, 39 TAX L. REV. 345, 346 (1984).

B. *The A.L.I. and Treasury Proposals Compared*

Compared to the classical system presently in effect in the United States, both the A.L.I. and Treasury proposals have the effect of reducing or eliminating the "double" tax on distributed corporate source income. The Treasury proposal eliminates the shareholder tax entirely on fully-taxed corporate source income. The A.L.I. proposal ultimately eliminates the corporate-level tax by allowing payment of the corporate tax to provide a credit when shareholders receive distributions and are taxed on them.

It is important to emphasize this point: the Treasury dividend exclusion prototype (and CBIT) and the A.L.I. proposal are *not* models of *complete* integration, they are models of partial integration or "dividend relief." They provide relief or proper shareholder taxation only for *distributed* corporate earnings. They are theoretically inferior to partnership (or Subchapter S or pass-through or transparency) integration, which would allow a pass-through of losses as well as gains and would produce taxation of the shareholders at the time the income or losses were realized by the corporation, at the shareholder rates applicable, and without waiting until a distribution had been made to shareholders. Such a system would also allow a basis increase for the interest of the partners or Subchapter S shareholders so that a sale or exchange of their shares would not implicate a second, unintegrated tax.

Also, compared to a pure transparency system, the Treasury and A.L.I. proposals would not allow a complete pass-through of corporate preferences, including the foreign tax credit (if that is viewed as a preference), and would not allow foreign taxes to be treated as the equivalent of the payment of U.S. taxes. They also involve complicated withholding taxes and extra corporate level accounts in order to accomplish a variety of objectives.

As compared with each other, the A.L.I. shareholder imputation credit proposal seems quite superior to the Treasury dividend-exclusion prototype and the Treasury comprehensive income tax or "CBIT." The one advantage of the CBIT proposal over the dividend exclusion prototype is that it would treat interest just the same as dividends, by denying a corporate deduction for both and by excluding both from the income of shareholders. However, as Treasury recognized, the CBIT proposal would be difficult to phase in, would involve a schedular approach to the taxation of corporate sector income, and would not be sensitive to the individual rates and taxpaying status of various individual shareholders. The A.L.I. proposal would perpetuate and perfect the application of individualized rates. It would also partly equalize the tax treatment of debt with equity by its new interest-withholding tax and lender credit paralleling the dividend withholding tax and credit, although interest payments would remain deductible by the corporate borrower as under present law.¹⁷¹

As to equating the tax treatment of interest and dividends, the key item in the A.L.I. proposal is that because interest payments would remain deductible,

171. A.L.I. REPORTER, *supra* note 1, at 112-13.

the earnings used to pay them would not generate any increase in the "taxes paid account" ("TPA"). Any balance in the TPA account would not satisfy the corporation's liability for the new interest withholding tax (IWT) imposed when interest was paid by the corporation. So this IWT would constitute a *new* tax liability on payment of interest but would be creditable by recipients of corporate interest payments against their various tax liabilities on receipt of the interest income. What would be left then, if the IWT rate equalled the corporate tax rate, would be: corporate income (\$X) reduced to \$0 by interest deduction for interest paid; IWT tax on interest paid ($\$X \times \text{IWT rate}$); individual recipient's tax on \$X interest received, partly or wholly offset by the IWT credit; so interest paid would ultimately be taxed once and at each creditor's rate, much as dividends would be taxed after distribution.¹⁷²

The Treasury dividend exclusion prototype has the advantage of being relatively easy to phase in, merely by enacting a new exclusion for dividends in the Internal Revenue Code and then requiring the necessary corporate-level accounts and special rules for the treatment of special preference income and foreign source income. Depending upon one's point of view, it also may be an advantage of the dividend exclusion prototype that it would provide a more uniform rate of tax on corporate source income across shareholder lines. However, Professor Yin has shown that the dividend exclusion prototype actually permits a wide range of tax burdens on corporate source income, ranging from a low of negative 17% to a high of 58%.¹⁷³ In fact, there would be a substantial loss of neutrality.

Secondly, both the dividend exclusion and CBIT prototypes are objectionable on grounds of horizontal and vertical equity. Neither one is a very fair system, if fairness is determined by the rates of tax of individual shareholders, given their total income and filing status. To put it another way, the fairness of an integration system may be appropriately viewed as depending upon whether it removes a uniform percentage of the additional tax burden represented by the *corporate* tax for all income classes. The Treasury dividend exclusion prototype (or CBIT) fails both of these tests. Both the dividend exclusion prototype and CBIT would give increasing amounts of relief to higher-bracket shareholders compared to low-bracket shareholders. This would leave in effect a high rate of tax on low-income and tax-exempt shareholders. Thus, low-income shareholders would be overtaxed and, by some standards, high-income shareholders would be undertaxed.

The dividend exclusion prototype also has some complexities of its own, those dealing with preference income and other matters. By making dividend distributions much more favorable than non-dividend distributions or capital gains on sales, the perverse posture of present law (which favors non-dividend distributions of corporate profits) generally would be turned upside-down, rather than remedied. Nevertheless, in some instances, some individual shareholders

172. See *id.*

173. See Yin, *supra* note 122, 462.

would prefer non-dividends over dividends. Above all, taxing dividend income, unlike other income from a corporation, would raise serious problems with closely-held corporations, where it is difficult to distinguish between dividend income, salary income, rents, royalties and interest. A great deal of tax planning and tax avoidance by converting labor income to capital income, or vice-versa, would be invited by adoption of this proposal.

In contrast, the A.L.I. proposal deserves a relatively high score. Its adoption would leave corporate sector income taxed once, and—after distribution—at the rates and characteristics belonging to the individual shareholder recipients. Thus, it would provide considerably more neutrality as between investment and income in the corporate form and in non-corporate forms. It would allow the pass-through or wash-out of corporate tax preferences, as preferred by the legislature. It would be robust to possible tax rate relationship changes between the rates of corporate tax and the rates of individual income tax, something lacking in the Treasury's dividend exclusion prototype.

As to fairness, the A.L.I. proposal ranks very high. When it is compared with the theoretically preferable partnership or transparency complete integration model, the A.L.I. proposal would leave *distributed* corporate income taxed in the same way, that is at rates appropriate to the individual shareholders. Compared to the transparency model, the A.L.I. shareholder imputation credit would leave *undistributed* corporate earnings taxed at the corporate rates, inasmuch as the corporate income tax would remain in effect, and would serve to prevent undue deferral of income by incorporation, as well as serve as a tax tentatively collected from the business entity for the ultimate account of the individual shareholders. Compared to complete pass-through or Subchapter S integration, this means that the corporate income is taxed at the "wrong" rates (except by coincidence) for a period of time—until it is distributed to shareholders.

This could be cured by corporate elective constructive distribution of all retained earnings, and a deemed recontribution by the shareholders, envisioned by the A.L.I. Reporter. If the top individual income tax rate was the same as the applicable corporate rate, shareholders would be happy to receive such constructive dividends because the credit which would also be constructively distributed to them would at least offset their tax liability. In the case of lower-bracket shareholders, the excess credit would entitle them to a refund. However, this hope for a refund may be placing too much weight on the A.L.I. constructive dividend opportunity, just as the Treasury Department relies too much upon the D.R.I.P. proposal to solve some of its problems.

If the rate relationship between individual income tax and corporate income tax rates were to move toward a much higher individual rate schedule, shareholders might resist constructive distributions (if the credit would be insufficient and they would have to pay tax without having received any cash in hand). In contrast, if corporate rates rose above individual rates, shareholders would clamor for constructive or actual distributions because a higher corporate tax

rate and credit would provide even the highest individual tax bracket shareholders with substantial refunds.

In general, the A.L.I. proposal does the best job of providing partial integration or dividend relief because it accords with the fundamental philosophy of the U.S. income tax, which is to apply graduated rates to the global income of each shareholder, depending upon the filing status of that shareholder.

The A.L.I. proposal is legislatively more complex than Treasury's dividend exclusion prototype and perhaps more complex than the CBIT proposal, although that seems to be a problematic conclusion. As noted above, the Treasury proposals have their own complexity.¹⁷⁴ Furthermore, the shareholder imputation tax credit model can build upon the experience of a number of other industrialized countries. Hence U.S. legislators and administrators will be better able to anticipate administrative and compliance problems and the kinds of legislation and regulatory promulgation necessary to deal with them.

The A.L.I. proposal is relatively neutral as to the ways in which income can be taken from a closely-held corporation, that is to say, as deductible salary, interest, rents or royalties, or non-deductible distributions or profits. In effect, dividends (and interest) are deductible under the A.L.I. proposal, because the corporate tax on the corporate earnings is erased by the credit, and the final tax rate is the rate applicable to the individual recipient of the funds.

The A.L.I. proposal is better than Treasury's CBIT proposal in a number of respects. CBIT would require distinguishing interest or borrowings from investors from interest paid to trade creditors and others. It would rigidly impose its schedular system on all corporations and all unincorporated businesses. It would not leave any room for a Subchapter S or partnership complete integration system for the kinds of businesses that can now use those regimes in the United States.

The economic shock from the non-deductibility of interest under the CBIT proposal would be a major problem for the economy and would require a very gradual phase-in. Interest rates on CBIT interest, in the international economy, would be tax-prepaid and exempt to the recipient, at least insofar as the U.S. federal income tax goes.¹⁷⁵ And finally CBIT, like the dividend exclusion prototype which it incorporates, imposes a schedular tax system within the U.S. income tax system which is definitely not schedular in its make-up and underlying theory.

For these reasons and others, the shareholding imputation credit proposal of the American Law Institute seems distinctly preferable to both the dividend-exclusion and the CBIT prototypes proposed by the Treasury. The A.L.I. proposal resembles New Zealand's recent legislation and builds upon experience there and in Australia and Western European nations.¹⁷⁶ It is reasonably fair and

174. See *supra* parts VIII, IX.

175. See Gammie, *supra* note 58, at 258.

176. See A.L.I. REPORTER, *supra* note 1, at 72, 77, 84, 85; TREASURY REPORT, *supra* note 1, app. at 159-84.

secure, much more fair and more economically neutral than the dividend exclusion and CBIT proposals. It comes close to the merits of transparency or a partnership type integration, although only as to *distributed* corporate profits.

XII.

IMPORTANT THEMES: RATE RELATIONSHIPS AND STOCK BASIS

A. *Tax Rate Relationships*

One important theme that runs throughout an evaluation of proposals for corporate income tax integration is the importance of the relationship between certain tax rates. The most important relationship is that between the top or applicable *corporate* income tax rate and the top or applicable *individual* income tax rate. For example, if the corporate rate is much *lower* than the individual rate, the rate relationship establishes an incentive for taxpayers to incorporate their businesses, and even their passive investment assets, and to cause the corporation to retain earnings, sheltered from the higher individual tax rate until distribution or some other maneuver. It would seem, in other words, that such a rate relationship creates a disincentive for dividends. The retained earnings can be reinvested at the lower corporate income tax rate. Therefore, if the before-tax yield of investment by corporations is approximately equal to the before-tax yield of investment by individual shareholders, much more after-tax corporate income can be earned and retained over a period of years than would be true if the original earnings had been distributed to and reinvested by shareholders.

If corporate rates are much *higher* than individual income tax rates, this inverted rate relationship may not necessarily reverse the incentive to distribute, because the distribution under a classical system will incur a second tax. However, under these conditions the distributed earnings can be reinvested by shareholders at a lower rate of tax than if the earnings are reinvested by the corporation, so an incentive to distribute may well be created. This again assumes the before-tax rate of return of investments by shareholders will be approximately the same as the before-tax rate of return on investments by corporations.

If the corporate tax rate is much *lower* and a dividend exclusion or CBIT form of integration is adopted, corporate income will be taxed once and at a lower rate than the other income of individuals. This unequal schedular system seems unfair, is far from neutral, and very likely to induce tax avoidance planning. If the corporate rate is much *higher* than the applicable individual shareholder rates, there again will be an unfairness because corporate income will be taxed at higher rates than labor income and similar capital income of individuals who use entities other than corporations, entities such as partnerships, Subchapter S corporations, or proprietorships, to make their investments. If the

comprehensive business income tax approach is adopted, all businesses would be subjected to the same regime.¹⁷⁷

If the corporate rate is much *higher* than the individual shareholder rates, and the United States adopts a shareholder imputation credit system along the lines of the A.L.I. proposal, the tax on retained corporate profits will be higher than that imposed upon final distribution to shareholders. At least one result will be tremendous pressure to distribute, or constructively distribute, corporate earnings so that the high credit for corporate tax can be enjoyed by the shareholders as soon as possible and so that distributed earnings can be reinvested at lower tax rates. If the corporate rate is much *lower* than the individual income rate applicable to shareholders in question, there probably will be a tendency to retain corporate profits, rather than incur the higher shareholder tax soon, and make distributed earnings subject to higher tax rates upon investment outside the corporation. But the issue may be more complicated or doubtful than this.¹⁷⁸

The rate relationship between ordinary income and capital gains will also matter a great deal. If capital gains are taxed at a much lower rate, and if distributions by corporations can be made in nondividend form, then there will be an incentive for using such distributions and capital gain transactions (especially in the international economy) and for avoiding ordinary income. An extreme case is presented by the I.R.C. § 1014 fresh-start basis at death rule. If dividends can be postponed and corporate profits realized in the form of the sale of shares after the death of the shareholder, the fresh-start basis at death rule means that a sale of those shares can be made without any income (capital gains) tax. This is viewed as infinitely preferable to taxable dividends. It is not, however, preferable to dividends that are tax-free, if a dividend exclusion prototype or CBIT regime is in effect.

It also must be remembered that not all capital gains result from the retention of corporate profits. Appreciation in corporate assets that are not yet realized by the corporation, changes in interest rates, and market factors, including an expectation of future corporate profits or unrealized appreciation at the corporate level, can produce a big increase in the fair market value of shares in the corporation.

If capital losses are deductible, with lower tax benefit and subject to greater limitations than ordinary losses, there will be an incentive to convert capital losses into ordinary losses or into short-term capital losses if such losses are treated like ordinary losses.

177. Does that mean that individual, passive, and portfolio investments would also be subject to a CBIT tax? If not, the distinction between businesses (including proprietorships) and investments would become crucial.

178. See, however, the "new view" of dividend taxation, discussed, along with the "traditional view," in A.L.I. REPORTER, *supra* note 1, TREASURY REPORT, *supra* note 1, and in George R. Zodrow, *On The "Traditional" and "New" Views of Dividend Taxation*, 44 NAT'L TAX.J. 497 (1991). The ways corporate and individual rate relationships create a "retained earnings trap" are worked out in Arlen and Weiss, *The Political Economy of Double Corporate Taxation*, Working Paper, Law and Economics Program, Stanford Law School, No. 113 (August 1994).

Not only are rate relationships such as these important to be taken into account in considering the merits of a particular integration plan, it is important to prefer an integration plan that is robust and will be stable and sensible even if present rate relationships change a great deal. It is better to have a corporate tax system in which the legislature can from time to time increase the rates of corporate tax or individual income tax, and even change the relationship of these rates, without upsetting the entire system or the pattern of tax-planning incentives it creates. Also, any legislation of an integration plan must contemplate that some shareholders may be taxed at higher rates than others and some corporations at higher rates than others. Therefore, it is necessary to take into account a multiplicity of possible rate relationships between different corporations and shareholders, including tax-exempt shareholders, foreign shareholders, and between high- and low-bracket shareholders. Particularly in an international economy, a nation's corporate tax rates may be hostage to prevailing international levels and to international tax policy (capital exporting and capital importing) and tax avoidance considerations.¹⁷⁹

B. Basis Adjustments in Shares

A second very important theme has to do with rules regulating the owner's basis in corporate shares. If the basis in a shareholder's shares is not appropriately altered as a result of taxable or tax-free distributions or taxable allocations, the result may be that corporate income is taxed twice, or is not even taxed once rather than the one-tax goal of integration plans.¹⁸⁰ Incentives may be created for shareholders to deal with each other in order to shift losses or gains.

In the Subchapter S, limited liability company and partnership regimes in the United States, "outside basis" of a partner's interest, or adjusted basis in a shareholder's shares, is adjusted to take account of income that is taxable to the partner or the shareholder even though it has not yet been distributed.¹⁸¹ As a consequence, when an actual distribution is made, it is received tax-free up to the basis that has been created by the earlier taxation of those undistributed earnings to the investor. Or, if the investor sells his partnership interest or shares before actual distribution, the higher basis in the shares resulting from the earlier imputation means that there will be less capital gain or there will be a deductible loss upon the sale of the shares, which is appropriate in view of the earlier taxation to the investor.

It is not so clear that appropriate basis adjustments will be made under the Treasury proposals and other integration plans. For example, under Treasury's Dividend Exclusion model, there is an important question whether "stock basis would be reduced by what economically amount to return-of-capital distribu-

179. See Gammie, *supra* note 58, at 253.

180. Cf. I.R.C. § 1059 (providing for reduction in a corporate shareholder's basis by the non-taxed portion of an extraordinary dividend).

181. *Id.* § 1367.

tions."¹⁸² If not, the result could be that corporate income would not be taxed at all.¹⁸³

Suppose, for example, that a shareholder governed by the dividend exclusion prototype receives a dividend distribution from his corporation, one that is not taxable to him because there is sufficient balance in the EDA account. If his basis in his shares is not reduced by virtue of receiving this distribution, he could then sell the shares at a loss and take a loss deduction for the difference between the amount realized and his basis in the shares.

Suppose, on the other hand, that in year one a corporation had earned and retained profits. Those profits now could be distributed tax-free to a shareholder under the dividend-exclusion prototype. Suppose a second person buys the shares from the first shareholder for a price that reflects the value of the retained profits. In year two that new shareholder could receive the dividends apparently tax-free (up to his high cost basis), and could then sell the shares for a lower price (deductible loss), reflecting the fact that the retained earnings had now been distributed and the shares were worth less as a consequence.

A related problem has to do with the role that tax-exempt institutions might play as intermediaries for taxable shareholders. Under a shareholder imputation credit system, the credit would not do much good to a tax-exempt institution. However, if the institution sold the shares to a taxable shareholder, who could then receive a distribution and obtain a benefit from the shareholder imputation credit that flows out with the distribution, might there not be some tax avoidance? Or, under some integration proposals, as under the classical system, would not tax-exempt institutions bid up the price of shares because dividends are inherently not taxable to those tax-exempt shareholders, even though taxable (for example if out of corporate preference income) to other shareholders?

The ability to shift the refundable credit under a shareholder imputation credit model to a purchaser of stock might make it extremely difficult to insure in practice that all corporate income was in fact subject to a nonrefundable tax. Even if the credit were made nonrefundable, if it were still available for use against unrelated income of the shareholder, the effect would be much the same as that of a refundable credit. Practitioner Michael Schler has shown that clever tax practitioners would be very likely to find ways to avoid the one level of tax intended, or to shift taxability from high- to low-bracket taxpayers, under any integration proposal, particularly under the dividend exclusion models proposed by the Treasury Department.¹⁸⁴

A related danger is that an integration proposal might nevertheless result in the double-taxation of corporate profits. This might happen if, for example, a corporation earned income that was taxable to it and retained the earnings. If

182. Michael Schler, *Taxing Corporate Income Once (Or Hopefully Not at All): A Practitioner's Comparison of the Treasury and A.L.I. Integration Models*, 47 TAX L. REV. 509, 562 (1992).

183. *Id.*

184. *Id.*

the shares went up in value because of the retained earnings, under a system such as the dividend exclusion prototype, and if the shareholder sold the shares before an actual distribution was made, he or she would be taxable on the capital gain (a second tax, at the shareholder level), even though he or she could have received an excludable dividend distribution from the corporation. In other words, under such a system dividends would be much more attractive than non-dividend distributions or gains from the sale of securities. The purchaser in such an example would not reduce the price paid for the shares to capitalize any tax burden because the purchaser presumably would be entitled to receive the dividends tax-free and because of the basic function of the dividend exclusion prototype. In these cases, it is observed that there can be a failure of integration and a double-taxation of corporate profits, even under an integration system that is designed to remove the double-taxation (or "over-taxation") of corporate profits.

XIII.

CORPORATE TAX INTEGRATION WHILE RETAINING TWO TAXES

Another approach to the problem of over-taxation of corporate source income would be to retain both the corporate and shareholder income taxes and to relate the two taxes and tax rates so that the total burden on corporate source income would be the same as, or close to, that on non-corporate source income. This means using two relatively low-rate taxes.¹⁸⁵

The United States had a system of this type for some years following the enactment of the income tax in 1913. At that time dividend income was exempt from the flat-rate basic income tax, called the "normal tax," that applied to all individuals.¹⁸⁶ However, to preserve progressivity, dividend income was not excluded from the tax base of the "additional tax" or surtax on individuals, a graduated tax that applied only to high-income persons.¹⁸⁷ For such taxpayers, at that time, corporate source income was taxed once at the corporate level, at a relatively low rate, and then again as part of the shareholder surtax, if the dividends were received by a relatively high-income individual. Taxpayers in lower income ranges, subject only to the "normal tax," had their corporate source income taxed only once, at the corporate level.¹⁸⁸ This system endured in the United States until 1936, when the tax system became unintegrated.¹⁸⁹

To accomplish integration of the retained double taxes, the corporate tax rate could be reduced to the basic rate applicable to low-bracket investors. Thus, the corporate tax would serve as a surrogate for the tax otherwise owed by

185. See Yin, *supra* note 122, at 481.

186. ROY G. BLAKEY & GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX 96-97 (1940)*.

187. Yin, *supra* note 122, at 481.

188. *Id.*

189. See BLAKEY & BLAKEY, *supra* note 186.

The Treasury dividend-exclusion and CBIT prototypes could be modified so as to make dividends excludable from only a low or other fixed rate of shareholder taxation and leave them taxable to the extent of the difference between this and higher marginal shareholder rates. But this would invite tax-rate arbitrage between taxpayers and other income shifting and tax avoidance maneuvers.

those investors if they had earned the corporate source income directly, rather than through a corporation. As a result, dividends and other means by which such investors could realize the corporate source income, including gains realized upon the sale of equity securities, would be exempted from ordinary income tax. Because the corporate tax would be insufficient as a substitute for the total tax on higher bracket shareholders, they would be subject to a surtax, regardless of how they realized their corporate source income. Thus integration with the desired degree of progressivity could be accomplished roughly through a combination of the two taxes (or tax reliefs), each with relatively low marginal rates.¹⁹⁰

It must be admitted that zero-bracket or tax-exempt shareholders, including low-income individuals, would still suffer over-taxation of their income realized through the corporation because it would have been taxed at least at the relatively low corporate rate. To compensate, they could be given a refundable tax credit, one that would be used up if their overall incomes were higher. In general, the extremes of undertaxation and overtaxation that are entailed by the Treasury Department's dividend exclusion approach or CBIT approach would be minimized or eliminated. There would not be complete schedular taxation of corporate source income, but rather taxation largely geared to the individual income situations of the shareholders. While this approach does not match the accuracy and fairness of the Subchapter S pass-through model or the A.L.I. shareholder imputation credit model, it has some advantages and may deserve further exploration. However, its major and perhaps fatal weakness may lie in the ability of high-income shareholders to defer the application of higher tax rates and to shelter income by putting it into a corporation.

Professor Yin, who has developed and analyzed a sophisticated version of the two-tax model, called "Integration Through Double-Taxation: The Surtax Approach,"¹⁹¹ would let two low-rate taxes on the same income serve the function of a higher single rate of tax.¹⁹² He has analyzed the problems of preference income, political considerations, the simplicity of the tax system and the security of tax, the treatment of tax-exempt and low-bracket shareholders, the flexibility of the legal system, and the problem of deferred shareholder-level tax. He concludes that there are many merits to the idea and that the difficulties can be dealt with intelligently.¹⁹³ He also suggests that perhaps the surtax or double tax approach should be confined to widely-held, perhaps publicly-traded corporations.¹⁹⁴ This, of course, resembles the situation in the United States at the present time, inasmuch as closely-held corporations can elect Subchapter S inte-

190. See Yin, *supra* note 122, at 482. In a way the linking of reductions in two taxes resembles the pre-1988 Japanese system's combination of a reduced corporate rate on distributed corporate profits and a low shareholder tax credit for a fixed percentage of gross dividends received. See TAX BUREAU MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAXES 1992 50 (1992) (Japan).

191. Yin, *supra* note 122, at 480.

192. *Id.* at 481.

193. See *id.* at 505.

194. *Id.* at 500.

gration, or investors can use the partnership or limited liability company form. In fact, the limited liability company form may gradually be extended to more widely-held corporations as well. While Professor Yin acknowledges that the surtax approach is far from a perfect means of implementing integration, he intelligently argues for its merits, although he admits that the "tax shelter problem. . . may be its fatal flaw."¹⁹⁵

A related problem and solution has to do with the difference between the present U.S. tax system's treatment of corporate income that is financed by debt rather than by equity investments. It is this difference that seems to have driven the Treasury Department so far towards the dividend exclusion and CBIT approaches. If the classical system were retained, or if the rates were ameliorated somewhat to relieve the severity of the double-taxation of corporate income, the difference between debt and equity finance could be addressed to some extent by limiting or reducing the deductibility of corporate debt. Another possibility would be to favor somewhat the distribution of dividends and to lower the tax burden upon distributed corporate earnings by a split-rate or dividend deduction system, perhaps with a shareholder tax credit as well (as in Japan before 1988).¹⁹⁶ While such a system might make it difficult to prevent extending the benefits to foreign shareholders or to tax-exempt institutions, it has the advantage of tremendous simplicity. As a distinguished Japanese financial expert said in a conversation in 1979, "a deduction for dividends may be overall the best method of dividend relief and double-tax relief because it is the simplest." One might add that it is advantageous because it tends to reduce the difference between debt and equity finance. It could also be combined, as Japan for so many years combined its split-rate system, with a small credit given to shareholders for a percentage of the dividends they receive, a credit not based upon an imputation of the corporate income tax to the shareholders, but rather given merely as a blunt form of tax relief to taxable shareholders of corporations.

A study of the complexities and uncertainties entailed in the various integration proposals recently recommended in the United States, and proposed or studied over the years by tax scholars, may cause a tax theorist to say, as a Dutch tax adviser remarked in conversation a few years ago in Amsterdam, that "the classical system may not be such a bad system after all." In other words, one distinct policy alternative is to leave the classical system in place and to decide that integration or dividend relief is not worth the difficulties and costs involved, or to retain the double layer of tax but to minimize its economic and legal disadvantages.

195. *Id.* at 501.

196. *See supra* note 190. Another worthwhile idea would be to allow each corporation to deduct a standard percentage of its undistributed equity of shareholders, along the lines of the allowance for corporate equity (A.C.E.) proposed by the Institute for Fiscal Studies in the U.K.. *See supra* text accompanying notes 87-96.

Nevertheless, the benefits of complete, or partial, integration would be so great it seems mistaken not to continue the effort. The following sections of this article pursue that goal.

XIV.

THE SUPERIORITY OF COMPLETE INTEGRATION, PARTNERSHIP OR S CORPORATION STYLE, OVER OTHER METHODS

Complete integration, in the “pass-through,” “partnership,” or “S Corporation” style, or the nearest thing to it, such as the Carter Commission or A.L.I. proposals, seems far superior to CBIT and dividend exclusion (or even dividend deduction/split rate versions, in use in Germany, in Japan from 1961 to 1989 and elsewhere,¹⁹⁷ and recommended by the U.S. Treasury in 1984¹⁹⁸ and the President of the United States in 1985.¹⁹⁹) Business income ultimately should be taxed to the *owners* of the business, at *their* rates, when they earn or benefit from it. This view embraces, in other words, the fundamental theory of the U.S. individual income tax. That tax is a *personal* tax, one that takes a global (not a schedular) approach to its base and rates and, as a general principle, it is one that lumps all of a taxpayer’s financial gains together in one quantity and then taxes that amount according to Congress’ notions of “ability to pay”—the ability to pay of each individual taxpayer, as determined by his or her relevant financial, social and tax characteristics.²⁰⁰

As one author has put it, “. . . where under an income tax corporate tax rates diverge significantly from personal tax rates and the same *graduated* personal tax rates are intended to be applied to capital and labour income, the only satisfactory form of integration is a shareholder allocated method.”²⁰¹ Because only individuals can consume, or benefit from consumption, only individuals bear the incidence or burden of any tax, and it is this burden that should be geared to ability to pay (somehow rightly conceived) of the individual bearers. Ideally, all income would and should be taxed ultimately to individuals, and only to individuals.

Thus, if one takes the basic philosophy, structure and theory of the U.S. individual income tax seriously, one probably would prefer to tax undistributed corporate income to shareholders by taxing unrealized appreciation (and diminution) in the value of shares as an accretion to net worth, à la the von-Schanz/

197. See, e.g., TREASURY REPORT, *supra* note 1, app. at 172-76; TAX BUREAU MINISTRY OF FINANCE, *supra* note 190.

198. TREASURY I (1984), *supra* note 43, at 136-40. Recall that the U.S. Treasury Department at other times studied and advocated a pass-through integration model. See TREASURY BLUEPRINTS, *supra* note 43.

199. TREASURY II (1985), *supra* note 48, at 122-26.

200. See John K. McNulty, *Preserving the Virtues of Subchapter S in an Integrated World*, 47 TAX LAW REV. 681, 684, from which this section is derived [hereinafter McNulty, *Preserving Subchapter S*].

201. Gammie, *supra* note 58, at 252.

Haig-Simons²⁰² conceptions of income.²⁰³ However, the realization rule, part of the U.S. income tax's "genetic code" and the practicalities it represents, makes accretion taxation of unrealized share gains and losses apparently unworkable for most corporations.²⁰⁴ Yet, if the corporation's earnings are not taxed to shareholders until distribution, then the deferral or avoidance possibilities will be unacceptable. Consequently, a separate corporate income tax has evolved as a surrogate for (theoretically correct) current taxation of shareholders, lest undistributed corporate earnings go entirely untaxed for too long.²⁰⁵

This perspective emphasizes that the United States has an income tax on corporations in the classical mold largely because of the "rule of realization," without which there could be annual taxation of accretions or diminutions in value of shares, the theoretically correct way to tax shareholders. There is a separate tax on income received by corporations only as a kind of substitute tax because of the inability, or the unwillingness, to try to tax shareholders on an accretion basis. The corporate tax system serves as a "collection mechanism for the personal tax system."²⁰⁶

So, in this view, the corporate income tax is really just a tax designed to aid and perfect the *individual* income tax. It includes undistributed corporate sector earnings in the income tax base only in a crude and brute way and, without integration, it overtaxes distributed corporate earnings.²⁰⁷

Consequently, the Subchapter S (or pass-through) integration model, which taxes business income of Subchapter S corporations the way it would be taxed if the business were a proprietorship or a partnership, serves best as an *integration model*, and as a desirable real world system operating wherever it can be used.

202. Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX (Robert M. Haig ed., 1921), reprinted in AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959); HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938); Georg van Schanz, *Der Einkommenbegriff und die Einkommensteuergesetze*, 13 FINANZ-ARCHIV 1-87 (1896).

203. McNulty, *supra* note 43, at 1450; see Leon Gabinet & Ronald J. Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 912-18 (1977); see also Gammie, *supra* note 58, at 154-55; Noël B. Cunningham and Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary Approach" to Ownership*, 47 TAX L. REV. 725 (1992).

204. *But see* David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 644-51 (1967); David J. Shakow, *Taxation Without Realization: A proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons From the Past and a Proposal for the Future*, 10 VA. TAX REV. 237, 298-301 (1990).

205. Gammie, *supra* note 58, at 150. "The need to tax companies in some way or other can, therefore, be regarded as a measure of the extent to which the personal tax system falls short of achieving either the comprehensive income tax or the universal expenditure tax." *Id.*

206. *Id.* at 157.

207. To be sure, taxing a corporation's earnings to it at its rate does not do the same thing as taxing unrealized accretions or diminutions in share values, and dividends, to the shareholders at their rates. Nor is a pass-through approach to integration the same thing as taxing unrealized share gains and losses—because changes in share values do not exactly equal retained earnings, though the two values tend to move together. Among the tax substitutes for von Schanz-Haig-Simons accrual taxation, the Subchapter S approach seems far superior on theoretical grounds to either the unintegrated classical approach or to a schedular (Treasury) or other partial integration model.

It accords with U.S. values about individual income taxation. That is to say, it promotes progressivity, fairness, and horizontal and vertical equity and takes a global rather than a schedular definition of income.²⁰⁸ It is sensitive to rate, status and other individual characteristics of individual shareholders. These are some things the two main Treasury proposals do not do.²⁰⁹ Subchapter S integration also provides, for these reasons and others, the *fairest* method of integration, regardless of assumptions about the incidence of the income tax, an aspect that receives little attention in the Treasury Report.

Depending on their basis rules and capital gain taxes,²¹⁰ the A.L.I. and Treasury models still may differentiate between the effective taxation of retained and distributed earnings in important ways. Consequently, either of these models would constitute a sub-optimal improvement.

Subchapter S integration also should provide the most efficient *allocation of resources* between incorporated and unincorporated sections of the economy. It would enhance neutrality and economic *efficiency*. It is close to neutral with respect to the distribution or retention of earnings and as to debt versus equity capitalization of firms.²¹¹ It also is reasonably efficient *fiscally*. It is relatively neutral as between the choice of form: proprietorship, partnership, or corporation (or limited liability company, the coming phenomenon and a very important development on the choice-of-form scene²¹²). Moreover, if there is not retention and expansion of Subchapter S, limited liability companies will probably come to serve as substitutes for S Corporations. Treasury's CBIT plan would, presumably, override them, as it would override Subchapter S and the present

208. The models that Treasury recommended surreptitiously introduce a distinction between income from capital and income from labor. See, e.g., TREASURY REPORT, *supra* note 1, at 42. Doing so necessarily implicates the need systematically to distinguish one from the other. See Gammie, *supra* note 58, at 156, 253.

209. The Treasury recommendations do not so much propose to integrate the two taxes, as that term usually means both ensuring that only a single tax will be applied and that it will be levied at the shareholders' marginal rates, as they simply tend to lay a flat rate tax on capital income that takes the form of corporate profits. Gammie, *supra* note 58, at 250. The A.L.I. proposal, in contrast, does attempt to attain both aspects of integration.

210. For a comprehensive discussion of these issues, see Schler, *supra* note 182.

211. Treasury's CBIT would equalize debt and equity by denying a deduction for interest (just as dividends would be nondeductible), and excluding interest and dividends from recipients' income. TREASURY REPORT, *supra* note 1, at 39.

A recent study by two Treasury economists indicates that CBIT-type integration would have a strong effect on overall foreign asset holdings in the United States, resulting in a drop in the U.S. capital stock. Because CBIT denies an interest deduction, interest rates paid on U.S. debt would be expected to fall, and foreign capital, being mobile, would flow elsewhere. The study indicates that a full integration or dividend credit approach, in contrast, would not have this overall effect; although these plans would induce a decline in foreign holdings of U.S. equity, there would be an increase in foreign holdings of U.S. debt. *Corporate Integration Options May Alter Mix, Level of Foreign Investment in U.S.*, DAILY TAX REP. (BNA) No. 198, at G-4 to G-5 (Oct. 13, 1992).

212. Francis J. Wirtz & Kenneth L. Harris, *The Emerging Use of the Limited Liability Company*, 70 TAXES 377, 377-78 (1992); see Rev. Rul. 93-5, 1993-3 I.R.B. 6; Rev. Rul. 93-6, 1993-3 I.R.B. 8; Rev. Rul. 88-76, 1988-2 C.B. 360 (limited liability company taxable as a partnership); Edward J. Roche, Jr. et al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248 (1991).

proprietorship and partnership regimes,²¹³ but the dividend exclusion plan apparently would not do so.²¹⁴

The United States has a long and valuable experience with pass-through systems, including Subchapter K for partnerships and Subchapter S for electing closely-held corporations, not only at the federal level, but also among the states. Some states have adopted a Subchapter S analogue in their state income tax systems.²¹⁵ Other states have learned how to operate their own systems in a world where corporations are able to elect Subchapter S at the national level, or in other states. That experience ought not lightly be set aside.²¹⁶

In other words, Subchapter S-type pass-through correctly taxes all (realized) business income, including losses (negative income) on a comprehensive income tax approach; that is not true of the proposals of either the A.L.I. Reporter's Study or the Treasury Report. Subchapter S also provides a tremendously desirable form or model of integration because it is robust as to income tax rate changes and rate relationship changes. The other integration prototypes under consideration are immensely vulnerable, in varying degrees, if rate relationships (for example, between top individual and corporate rates or between ordinary income and capital gains rates) change a good deal—or even a little.²¹⁷ As a consequence, the Treasury's two main models, and even the A.L.I. approach, might tend to lock in the existing rate relationships, a considerable loss of national public policy flexibility. Subchapter S-type integration, however, would preserve flexibility.

Also, compared to Treasury's integration models at least, Subchapter S provides outside (shareholder) basis adjustments for the pass through of income and losses.²¹⁸ The system of basis and taxation of gains (or losses) is important when shareholders in an integrated system sell or dispose of their shares, in order to prevent "too much" or "too little" integration from resulting. In fact, it seems that some aspects of these problems have not been adequately worked out for other integration models,²¹⁹ but Subchapter S has a fine apparatus, and historical record, on this score. More particularly, under Subchapter S, when income (capital gains) tax is imposed upon the sale of shares, there is no double

213. TREASURY REPORT, *supra* note 1, at 39-43, 17-25.

214. See TREASURY RECOMMENDATION, *supra* note 1, at L-14.

215. See, e.g., CAL. REV. & TAX. CODE §§ 17087.5, 23800-23811 (West Supp. 1992); ILL. ANN. STAT. ch. 120, para. 2-205(c) (Smith-Hurd Supp. 1991).

216. The U.S. also has experience, at the federal level, with other pass-through or allocation systems, including Subpart F, applicable to foreign subsidiaries. See generally James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345 (1984). Moreover, proposed legislation would make the undistributed income of all subsidiaries of U.S. multinationals currently taxable by the United States. H.R. 5270, 102d Cong., 2d Sess. § 201 (1992).

217. Corporate tax rates, at least, are likely to change in response to rates in other countries, because of increasingly internationalized capital markets. Individual income tax rates can be set by each country more autonomously.

218. See Prop. Reg. §§ 1.1367-0,-1,-2,-3, 57 Fed. Reg. 24,426 (1992); cf. I.R.C. § 1059.

219. See generally, Schler, *supra* note 182.

taxation of retained profits,²²⁰ as would be the case under Treasury's dividend exclusion prototype or CBIT unless a dividend reinvestment plan, with basis consequences, were elected with respect to (exactly) all retained earnings. Consequently, pass-through type integration, as exemplified by Subchapter S or partnership taxation in the U.S., should continue to be the model for integration that applies to all corporations in the U.S.. If that model cannot be universalized, then the A.L.I. shareholder imputation credit model should be employed as the second best.²²¹

Compared to pass-through Subchapter S-type complete integration, the A.L.I. shareholder imputation credit is a good substitute, but the Treasury dividend-exclusion and CBIT prototypes, which also provide only dividend relief, not complete integration, are distinctly defective forms of relief from the classical system.²²² Even if complete integration were not possible, as some believe,²²³ an exclusion for dividends, as in the Treasury's models, cannot measure up as a reform model for the United States. As Professor Sunley says, the realistic choice lies between a dividends-paid deduction at the corporation level or an imputation credit at the shareholder level.²²⁴ As between these two approaches, the imputation credit model would be best. The A.L.I. Reporter's development of this model, building on extensive experience in many other countries, has shown how feasible and attractive, though admittedly complex, such an approach can be.²²⁵

XV.

WHY SUBCHAPTER S SHOULD BE RETAINED IN AN OTHERWISE INTEGRATED WORLD

Interestingly enough, the U.S. Treasury decided to recommend (in *December* 1992) legislation that would install a dividend exclusion method of integration for all corporations, *except S Corporations*. This plan would allow partnerships, electing S Corporations and other pass-through entities to remain governed by Subchapters K and S as at present.²²⁶ Treasury recommended retaining Subchapter S even though to do so is "somewhat inconsistent with our long-term policy preference for a schedular tax on enterprise activity and our

220. Income of an S Corporation passes through and is reported by the shareholders whether or not it is distributed (I.R.C. § 1366(a)) and increases the basis of the shares (I.R.C. § 1367(a)), thus preventing further tax on the same gain when they are sold.

221. See McNulty, *Preserving Subchapter S*, *supra* note 200, at 692-97; Martin Ginsburg, *Maintaining Subchapter S in an Integrated World*, 47 TAX L. REV. 665 (1992); Deborah H. Schenk, *Complete Integration in a Partial Integration World*, 47 TAX L. REV. 697 (1992).

222. See Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 626 (1992).

223. *Id.*; see TREASURY REPORT, *supra* note 1, at 27, *passim*.

224. Sunley, *supra* note 221, at 626.

225. In contrast, the Treasury's CBIT model both goes too far and not far enough. See Sunley, *supra* note 222, at 631-35.

226. TREASURY RECOMMENDATION, *supra* note 1, L-14 (Recommendation No. 10).

goal of tax simplification."²²⁷ It does so because the alternative regimes are so deeply embedded in the system that any other approach would prove exceedingly disruptive and would require elaborate transition rules.²²⁸ Treasury implied that conversion to a CBIT later would be desirable and would entail repealing Subchapter S.²²⁹

In opposition to this view, there are good reasons to retain Subchapter S even in a world that adopts some form of dividend relief for other corporations.²³⁰ One reason, implied by the foregoing, is that it is a superior system for the corporations and investors to whom it does apply. Therefore, it would be inadvisable to make them use something else—a dividend exclusion, or a dividend relief regime. They should be allowed to use Subchapter S, if they opt for it. In addition, this excellent pass-through system ought to be retained if there is to be dividend relief, in some form or another, with the hope of eventually expanding Subchapter S to cover more and more kinds of corporations.

To press further the question of why to retain Subchapter S in a world with dividend relief, it is illuminating to consider which entities and investors would want to elect Subchapter S treatment instead of the new partial integration system. For example, suppose the United States enacted Treasury's dividend exclusion model. Surely businesses that wanted to incorporate yet wanted to be able to pass through losses to shareholders, that is either start-up, high-risk or just ordinary businesses, would prefer Subchapter S. Any business that wanted, or would need, to retain much of its earnings and whose shareholders had marginal tax rates lower than the corporation's top rate would prefer to be able to elect Subchapter S.²³¹ If individual rates rose significantly above the top corporate rate, high-bracket shareholders would prefer the dividend exclusion system and liberal tax reformers would criticize the dividend exclusion model for enabling wealthy investors to shelter undistributed profits from high individual rates.²³² That situation would put pressure on several of the following: the capital-gains rate differential, nondividend distributions, § 1014 (fresh start basis at death) and any other escape from tax on unrealized appreciation, the debt/equity distinction, the corporate resemblance test, the accumulated earnings surtax, the personal holding company tax and the foreign personal holding company tax, not to speak of foreign tax haven planning.

Suppose, instead, that the admirable 1993 A.L.I. proposal were enacted. It would give total relief from the "double tax" on distributed or allocated (con-

227. *Id.*

228. *Id.*

229. *See, e.g., id.* at L-9, L-14.

230. *See* McNulty, *Preserving Subchapter S*, *supra* note 200, at 688, from which this section is taken.

231. Admittedly, perhaps a corporation unlikely to suffer losses but often wanting to retain earnings would be indifferent between Subchapter S integration and dividend exclusion with the dividend re-investment plan. The corporation might even prefer the latter if it could be turned on and off more easily than a Subchapter S election could be made, revoked and made again.

232. In 1993, the top individual rates (36% and 39.6%) were once again set above the top corporate rate (35%), which reversed the 1986-1993 relationship between top nominal rates.

structively distributed) profits. Even so, loss businesses would prefer to be able to elect Subchapter S, would be forced into the partnership mold or would leap into "limited-liability company" form. And businesses that wanted to retain profits would be pleased that lower corporate rates (present—1994—usual maximum 35%) would apply during the period of retention, rather than the higher individual rate (present maximum 39.6%). If the corporate rate went higher than the top (if applicable) individual rate, as it did from 1986-1993, this effect would be reversed. One solution would be to "allocate" (Carter Commission language) or "constructively distribute" (DRIP) the retained earnings, but an S election would still be attractive.²³³

In contrast, if the top (or applicable) individual rates were to go much higher than the top (or applicable) corporate rate, retained earnings would not be allocated or distributed voluntarily. The tax law would create a disincentive to distribution, as at present (in the "traditional view"²³⁴). It also would allow taxpayers a choice of paying whichever rate was lower, if profits could be retained but either "allocated" or not. Mandatory or elected, Subchapter S would allow less game-playing and would be neutral with respect to actual distributions, more so even than the A.L.I./Carter Commission system.

Now, suppose that Treasury's CBIT were enacted. Also assume that present U.S. tax rate relationships survived. Loss corporations would prefer Subchapter S, as would businesses with unused losses from pre-incorporation, pre-CBIT years, in order to use those losses against the businesses' future profits (if that were allowed). Again, in a profitable corporation, since 1994, high-income shareholders would no longer prefer to have their own individual rates apply rather than the entity's slightly lower top corporate rate; and they could accomplish that because a Subchapter S election would not be available. Some shareholders, however, would prefer their applicable individual rates to the top or high corporate rates, but would be barred from making an S election.

Then, imagine that individual rates parted company with corporate rates by a significant margin. Movement in either direction would mean that business income of an individual would be taxed at very different rates from other income, including salary, rents and royalties. Great pressure would be put on the line between dividends and interest (both nondeductible and excludable and therefore taxed at schedular corporate rates under CBIT) and wages, rents or royalties (deductible, but not excludable and therefore taxed at individual rates). If these rate relationships were reversed, taxpayers and tax planners either would thrive on the need for reversing their planning or would cry for stability and a return to Subchapter S. If the rate relationship were far from parity, but remained stable, the fairness, efficiency and neutrality of Subchapter S or even the

233. To be sure, if a Carter Commission voluntary allocation or an A.L.I. constructive dividend could easily be chosen or not, corporations that did not distribute earnings and predicted no losses might even prefer the A.L.I. model to Subchapter S integration, since the Subchapter S election cannot so readily be made, unmade and made again.

234. See Zodrow, *supra* note 178, at 501-03. This effect is often called the "retained earnings trap." See Arlen & Weiss, *supra* note 178, for an economic analysis of this effect.

A.L.I. imputation credit system would be lost, except to the extent the DRIP allocation technique salvaged something. The result would be the inequities, non-neutralities and inefficiencies of a more schedular income tax system.

XVI.

HOW TO RETAIN SUBCHAPTER S IN AN OTHERWISE INTEGRATED WORLD

If CBIT, or any similar integration system that disallowed interest on corporate debt as a deduction, were to be enacted, how could Subchapter S be preserved?²³⁵ If the only interest payments that were made nondeductible were interest paid to shareholders or other business owners such as partners, and if that interest were excludable to them on receipt and if that rule were *not* applicable to S Corporations, decisions whether to make Subchapter S elections might be influenced by efforts to maximize the benefit of the interest deduction to higher-bracket shareholder-lenders on the pass-through of corporate profit determined *after* deducting interest at the corporate level or to maximize the benefit of a CBIT exclusion of interest received by high-bracket shareholder-lenders after taxation at the corporate level. If the new rule did apply even to S Corporations, it would shift income the other way, perhaps toward the lenders, as other shareholders would no longer share in the interest expense tax benefit.

Some strategic maneuvers would ensue either way. But that does not add up to a recommendation against retaining Subchapter S in a CBIT world. Even in the nonelecting or CBIT corporations, or all corporations if Subchapter S were revoked, some planning or schemes would be concocted to stream excludable dividends and interest to high-bracket owners and other income to low-bracket owners, especially in closely-held businesses susceptible to such efforts. Again, unfavorable rate relationships and changes would direct and redirect these efforts in a CBIT world.

Probably for reasons such as this, Treasury, even in its January study, proposed to exclude the smallest businesses, defined in terms of gross receipts, from the new CBIT regime.²³⁶ Since Subchapter S evidently was not to be retained, perhaps Treasury contemplated that former S Corporations would remain taxable under the classical system, the better advised among them managing to "zero out" and pay no corporate income tax. If so, preservation of an S election would seem to be better public policy. More likely, Treasury would have imposed the CBIT regime on such former S Corporations if they were not eligible for the "smallest business exception." In December 1992, as noted earlier, Treasury actually advised retaining Subchapter S, at least temporarily, under its A.T.I. dividend exclusion recommendation.²³⁷

235. See McNulty, *Preserving Subchapter S*, *supra* note 200, at 690-91, from which this section is derived.

236. TREASURY REPORT, *supra* note 1, at 42.

237. See *supra* note 139.

Subchapter S and its basis rules are designed to operate in a tax environment that includes an income tax on the capital gain if shares are sold or redeemed at a gain to the selling shareholder. If Subchapter S were retained in a CBIT world where the capital gains tax on the sale of shares was abolished, the treatment of gain or loss on Subchapter S shares would have to be differentiated (or reevaluated). How to deal with a corporation that had elected in and out of Subchapter S and CBIT seems a formidable problem. It resembles the problem presented by a small corporation excluded from CBIT that then grew and became subject to CBIT, or the reverse, a former CBIT corporation that began to fail or shrink and became eligible for the gross receipts CBIT exemption.

XVII.

"DO IT YOURSELF" INTEGRATION

Recently, especially since about 1988, lawyers in the United States have created a new form of business entity in an attempt informally to accomplish corporate individual tax integration for companies unable to elect Subchapter S treatment and yet seeking the non-tax advantages of incorporation, without requiring new federal tax legislation to integrate the taxes. Many of the 50 states of the United States have enacted legislation that permits the formation of "limited liability companies." This form of business organization has most of the civil-law, non-tax advantages of incorporation, including limited liability, and enjoys the income tax advantages of pass-through, partnership or Subchapter S style complete integration, with single taxation of undistributed and distributed company profits to "members." The IRS has ruled that such companies can qualify for taxation as partnerships, rather than as "associations taxable as corporations."²³⁸ As such, they are free of the corporate income tax. Moreover, they are free from many confinements of Subchapter S, such as the 35-shareholder limit, preclusion of corporate and foreign shareholders, single-class stock rule, special entity-level taxes on built-in gains or excess passive investment income, prohibition of subsidiaries and consoling, etc.²³⁹ Yet they have no size or ownership restrictions.²⁴⁰

The limited liability company ("LLC"), under state enabling legislation, has rapidly gained in popularity throughout the United States. As of early Spring 1994, at least 36 states had enacted LLC legislation.²⁴¹ Reportedly, at least 12-14 of the remaining 16 states were considering it, some delaying the

238. See Francis J. Wirtz & Kenneth L. Harris, *The Emerging Use of the Limited Liability Company*, 70 TAXES 377, 378 (1992); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992); McNULTY, *TAXATION OF S CORPORATIONS*, *supra* note 25, ¶ 11.04, at 203-04; see also Culpepper, *Tax Aspects of Limited Liability Companies*, 73 OR. L. REV. 5 (1994).

239. See Wirtz & Harris, *supra* note 238, at 389-93.

240. In the extreme, the huge growth in use of this form of business organization paralleling the GmbH of Germany and the u-gen geishaw of Japan could soon overshadow the general partnership, limited partnership, (electing) S Corporation and closely-held C Corporation form of entity.

241. See Bernard Wolfman, *Self-Help Integration (LLCs) or Otherwise*, 62 TAX NOTES 769 (1994).

process in order to be able to adopt, or take account of, a uniform LLC statute to be proposed in 1994. Barring unforeseen developments, national coverage, if not uniformity, is to be expected in 1994 or soon thereafter.

The I.R.S. has been issuing rulings on LLCs in increasing numbers. Initially, it attempted to *deny* partnership classification to limited liability companies.²⁴² This position was withdrawn and a new study begun. In 1988, the I.R.S. issued a favorable ruling on a Wyoming LLC,²⁴³ which has been subsequently followed.

Some rulings contemplate "bulletproof" statutes, ones containing mandatory rules on the four secondary corporate characteristics, so that an LLC properly formed under the statute certainly will be classified as a partnership for federal income tax purposes. Other state statutes are more flexible, as in New York and Delaware, and permit LLC members to choose which two of the four characteristics will be built in, with default provisions to govern in the absence of explicit agreement to the contrary.²⁴⁴

LLC legislation is designed to enable organizers to get around some of the restrictive rules of Subchapter S and to provide back-door integration for corporate-like business entities. They are attractive for use by professionals, joint ventures, foreign operations, passive investments, "subsidiaries" of S Corporations and businesses held by more than 35 owners or by foreign or corporate owners. Unless Congress acts soon to liberalize Subchapter S, or to integrate the corporate and individual income taxes for most or all corporations, the LLC will become the entity of choice for what are now Subchapter S and relatively closely-held Subchapter C forms of business.²⁴⁵ This is true even after the 1993 setting of top individual rates above the top corporate rate. If, at least for a while, secure tax classification as a partnership and *not* an association taxable as a corporation requires that a limited liability company have more than one member, Subchapter S corporations may remain indispensable in many one-owner situations.²⁴⁶

242. See 45 Fed. Reg. 75,709 (1980); I.R.A. News Release IR-82-145 (Dec. 16, 1982).

243. Rev. Rul. 88-76, 1988-2 CB 360.

244. See Rev. Rul. 93-38, 1993-1 C.B. 223 (on the Delaware Act); Rev. Rul. 93-30, 1993-1 C.B. 231 (on the Nevada Act).

245. See Wolfman, *supra* note 241; William P. Streng, *Choice of Entity*, 700 T. M. PORTFOLIO (BNA) (1993). The limited-liability company form is not suitable for widely-held or publicly-traded corporations because of the need to impose restrictions on transferability of shares, duration of existence and/or centralization of management in order to escape the corporate resemblance test, while retaining limited liability.

246. See Susan Kalinka, *supra* note 238, at 1126; see generally Louis A. Mezzullo, *Limited Liability Companies: A New Business Form?*, 21 TAX'N FOR LAW. 296 (1993); Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of The One-Member Limited Liability Company*, 59 TAX NOTES 1829 (1993); Kenneth L. Harris & Francis J. Wirtz, *Corporate Governance, Limited Liability Companies and the IRS's View of Centralized Management*, 71 TAXES 225 (1993); Wirtz & Harris, *supra* note 238; Barbara C. Spudis, *Counseling the Client on Limited Liability Companies*, 17 A.L.I.-A.B.A. COURSE MATERIALS J. 89 (1992); Lee A. Sheppard, *New York Contemplates The Cost of Limited Liability Companies*, 57 TAX NOTES 1481 (1992); see also Golding, *Tax Aspects of Converting a Partnership or Corporation Into an Oregon Limited Liability Company*, 73 OR. L. REV. 25 (1994).

XVIII.

IMPLICATIONS FOR CHOOSING AMONG INTEGRATION PROPOSALS

The theoretical advantages and merits of the "pass-through" or "Subchapter S" method of "integrating" the corporate and individual income taxes, or of "taxing corporate income once," suggest the desirability of choosing the A.L.I. shareholder imputation credit method, rather than either of Treasury's dividend exclusion (or CBIT) proposals, as the general method of integration for corporations ineligible to make a Subchapter S election. A combination of Subchapter S for eligible, electing corporations and the A.L.I. system for all other corporations is more sensible, coherent and feasible than a combination of Subchapter S and either of Treasury's preferred prototypes.²⁴⁷

Subchapter S and the A.L.I. proposal are more compatible than the other combinations. Like Subchapter S, the A.L.I. proposal ultimately would tax *distributed* corporate earnings at individual shareholder rates and, like Subchapter S, the A.L.I. proposal also would do that for *undistributed* earnings if the corporation voluntarily allocated them to shareholders, as the Carter Commission proposal would have done. Unlike Subchapter S, the A.L.I. proposal would not "correctly" tax undistributed and unallocated earnings and would not integrate losses. Nevertheless, when the undistributed earnings finally were distributed (or allocated) or were realized by sale of shares, or when losses became terminal and were taken into account by shareholders as share losses (either capital or ordinary by virtue of § 1244), the end result would be ultimately to treat these gains and losses according to individual shareholder rates and tax return characteristics, as in Subchapter S. Treasury's dividend-exclusion and CBIT models would not do that, and hence distributed corporate earnings would be taxed very differently depending on whether a corporation were governed by Subchapter S or by a dividend-exclusion/CBIT system. The preferable policy choice, in other words, is to combine a retained Subchapter S, optional or mandatory for closely-held corporations, with a shareholder imputation credit integration system exactly as the A.L.I. Reporter's Study has proposed it, until ways can be found to apply Subchapter S-type integration to *all* corporations.

Another reason to retain Subchapter S in an integrated world is that the income of closely-held businesses is often a combination of income from capital and income from entrepreneurial efforts or services. Under Subchapter S integration, the income preserves its character and is taxed to the individual shareholder in whatever way and at whatever rate the tax law deems appropriate. In contrast, in some integration prototypes, particularly Treasury's dividend exclusion and CBIT proposals, corporate (or all enterprise) income is taxed at a rate that may differ from that applying to other income of an individual.²⁴⁸ Whatever one may think of moving more toward a schedular income tax system and differentiating tax rates between capital income and labor income, the char-

247. See McNulty, *Preserving Subchapter S*, *supra* note 200, at 691-94, from which this section is derived.

248. See Gammie, *supra* note 58, at 156, 251, 256.

acterization of all corporate income as income from capital is much more palatable when applied to portfolio income of a shareholder in a widely-held corporation than to the profits of a closely-held corporation. In the latter case, preserving the Subchapter S election would allow such shareholders, who often are involved in the creation and management of the enterprise, to have not only their salaries, but also their entrepreneurial profits, taxed at the rates appropriate to them, not at a (possibly very different) rate set for all capital income.

Preserving Subchapter S as an elective regime may, of course, allow a closely-held corporation to elect out of pass-through treatment if doing so would be advantageous. Consequently, if a very much lower single rate were to be set for the taxation of the corporation under CBIT or the dividend-exclusion prototype, thought might be given to making Subchapter S the *mandatory* form of integration for closely-held corporations. If that were done and if the CBIT or the dividend exclusion corporate rate subsequently were to rise much higher than the applicable, graduated rates for other income of individuals, the need would grow to separate the part of a closely-held corporation's income that truly was income attributable to capital from the part that was entrepreneurial or from services and that should be eligible for normal, individual income tax rules.

The A.L.I., Carter Commission or Treasury shareholder imputation credit method of integration would not present such serious problems deriving from different rates for capital and for labor income because corporate income ultimately would be taxed at individual shareholder rates. However, until such rates become applicable, upon (an actual or constructive) distribution, similar considerations apply and suggest the value of retaining Subchapter S, as an elective or mandatory integration technique, for closely-held corporations.²⁴⁹ All in all, in a world of graduated rates for individual taxpayers, a different, single, flat-rate final tax for small businesses seems very unattractive and unwise.

Could retention of Subchapter S as an election in a tax system which applies the A.L.I. model or Treasury proposal to widely-held corporations do any other harm? Not more than it does in today's world of classical nonintegration,²⁵⁰ it would seem.²⁵¹

If these are the only costs and disadvantages, and if they seem as small as they do now, they would be more than offset by the gains achieved through the superiority of the Subchapter S system over the new integrated C regimes.²⁵²

249. The Subchapter S system preserves the character of income or loss when it is passed through to shareholders more than would the ALI or Treasury system. See McNulty, *S Corporations*, *supra* note 54.

250. Problems include revenue loss, elections in and out, compliance, planning and administrative costs, and some influences upon behavior to conform and qualify for the election.

251. It may not be possible, however, to foresee all the problems, especially as various possible rate relationships may produce them. For example, if top individual rates rise above corporate rates in a CBIT or dividend exclusion world, the capital income of a corporation electing (or forced into) Subchapter S would be taxed at rates higher than those applying to capital income in a larger business, even when those profits actually are retained by the small business. This could lead to elections out of Subchapter S or cries for relief from a mandatory Subchapter S integration regime.

252. *But see* Schenk, *supra* note 221 (questioning whether Subchapter S should be retained).

And retaining Subchapter S would preserve the possibility of enlarging or improving it, finding solutions for its limitations and expanding it.

XIX.

THE PROSPECTS FOR SUBCHAPTER S AND FOR EXPANDING SUCH TRANSPARENCY INTEGRATION

For years, the thought has been that problems created by allowing foreign shareholders, corporate shareholders, tax-exempt shareholders and varieties of preferred shareholders in an S Corporation, and ownership by an S Corporation of stock in other corporations, made Subchapter S-type integration impossible for all but corporations without these attributes. The difficulties created by tax-exempt and foreign shareholders are very serious.²⁵³ *Maybe* they are conclusive, but it may be too early to accept that conclusion. Subchapter S should be retained as something that might be expanded to include larger and more varied corporate structures.²⁵⁴

As to corporate shareholders and ownership of subsidiaries, and the chain ownership or circular problems of simultaneously determining income or loss to be passed through that were thought to be so serious, there are methods of accounting and mathematical methods of solving simultaneous equations that probably can handle those problems. At the least, Subchapter S should be broadened to allow an S corporation to have a C corporation subsidiary, even if they were barred from filing a single consolidated income tax return.²⁵⁵ In addition, a C corporation should probably be allowed as a "permitted shareholder" in an S corporation. To do so may amount to relaxing the limit on the number of shareholders, but not in any way that would seem to lead to serious problems or costs.²⁵⁶ In fact, the number limit perhaps should be abolished outright, which would produce excellent elective integration in many more corporations. Allowing a C corporation to own stock in an S corporation, either in small, portfolio amounts or in larger or controlling investments, also could undermine the one class-of-stock requirement, but again might be a desirable and "innocent" broadening.²⁵⁷ Subchapter S has employed a workable system for allocating income to shareholders even when shares change hands during the year, and even when audit adjustments sometimes must be made for prior years.

253. See Gammie, *supra* note, 58, at 253.

254. This section is taken from McNulty, *Preserving Subchapter S*, *supra* note 200 at 694; See also John K. McNulty, *Why Subchapter S (Partnership Tax Treatment for Closely-held Electing Corporations) Should Be Retained Even if Integration by Some Other Method is Enacted in the United States*, 2 TILBURG FOREIGN L. REV. 377 (1993) (Neth.) [hereinafter McNulty, *Retain Subchapter S*].

255. Interview with James S. Eustice, 11 A.B.A. SEC. TAX'N NEWSL. 38, 40 (1992) (interviewed by Christopher H. Hanna). See also S. 1690, 103d Cong., 1st Sess. (1993) (the "S Corporation Reform Act of 1993," introduced as proposed legislation by Senator Danforth and Representative Pryor on November 19, 1993, proposing expansions of S Corporation eligibility).

256. Interview with James S. Eustice, *supra* note 255, at 40.

257. *Id.*

As to the varieties of forms of equity ownership, which are solved in the Subchapter S world by the single class-of-stock rule, these things, too, possibly can be solved by some accounting techniques, such as the "equity method" of accounting; at least that possibility deserves a closer look. Treasury has contemplated a system in which private agreements would have to be made as to the allocation of retained earnings.²⁵⁸

It seems astonishing that Treasury really would mean to obliterate Subchapter S,²⁵⁹ but the January 1992 Treasury Report *had* to mean obliteration for Subchapter S.²⁶⁰ Subchapter S is incompatible with CBIT (except if Subchapter S occupied the small business exemption from CBIT). Therefore, in my view, CBIT should not be adopted.

Subchapter S should be retained even in a dividend relief world. Treasury probably would oppose that result in principle because then all business income would not be taxed equally. Given Treasury's goal and its tolerance of, or enthusiasm for, a flat schedular tax on this one kind of income, the response seems natural.²⁶¹ But in any other world, or without that as a dominating criterion, there would seem to be no reason to discard Subchapter S as an elective regime for corporations eligible to choose it and perhaps gradually to expand the number of shareholders and the kinds of shareholders allowed in eligible, electing S corporations.

In summary, the Treasury proposals do not so much seek to integrate the personal and corporate taxes as they do to impose a flat rate of final tax, once, and only once, on capital income that takes the form of corporate profits.²⁶² They de-emphasize horizontal and vertical equity among individual taxpayers, and tax-rate flexibility, and they emphasize simplicity and ease of administration, and neutrality as to sources or forms of finance. Genuine integration strives for more than just this, but, as a consequence, it may be harder to achieve.

The ultimate policy goal should be complete integration, not just dividend relief. I think the question should be turned around: what is the role that best can be played by the A.L.I. or Treasury models of integration in a world *with* Subchapter S? Presumably the best answer is to provide some limited form of integration or dividend relief for larger or more complicated corporations, but only for them, unless and until ways to extend Subchapter S to them too can be found. For that purpose, the A.L.I. shareholder imputation credit proposal is considerably superior to the two prototypes favored by Treasury.

258. See TREASURY REPORT, *supra* note 1, at 32-33.

259. See Ginsburg, *supra* note 221, at 679.

260. See TREASURY REPORT, *supra* note 1, at 32-33. The December Treasury legislative proposal and its dividend exclusion recommendation explicitly *would* retain Subchapter S as a concession to practicality. TREASURY RECOMMENDATION, *supra* note 1, at L-14 (Recommendation 10).

261. *But see* TREASURY RECOMMENDATION, *supra* note 1, at L-14 (advising retention of Subchapter S under a dividend-exclusion regime).

262. See Gammie, *supra* note 58, at 250.

Subchapter S should be retained in its present scope even in a world with A.L.I. or Treasury integration, and the S election should be expanded to the extent possible. Tax theorists should try to solve its problems and continue to hope to make *it* the long-term ultimate goal, perhaps a model for *mandatory* integration. The United States ought to work toward this goal even if dividend relief, in some form, ought to be adopted as an interim experiment—if the U.S. Congress is reluctant or unable now to expand Subchapter S to the entire range of corporations.

XX.

AN OVERVIEW AND FURTHER POSSIBILITIES

The fairness and neutrality of integrating the corporate and individual income taxes either by a partnership (or S Corporation) method or some imputation-credit method reveals the real problem presented by the separate corporate income tax. It is not so much a matter of proposing revisions to improve the corporate income tax; there is not much *theoretical* justification for a separate corporate income tax. The real goal of integration is to improve the income taxation of individuals.²⁶³

The United States has employed a separate corporate tax at least partly to compensate for a fundamental theoretical defect in its individual income tax: its failure to tax shareholders either on their imputed portions of undistributed corporate earnings or (on an accrual basis) for the increase in their share values each year as they hold the shares. This failure comes from the “rule of realization,” which means that gains in share values will not be taxed unless and until the shareholder “realizes” them. He or she “realizes” them only by selling or exchanging the shares. Not even a gift or bequest of the shares is treated as a realization (although it probably should be).²⁶⁴ This is a major preference, a tax expenditure, a “loophole” in the individual income tax law. It allows an investor to defer individual income tax for an indefinite period, by causing his corporation to retain its profits and by not selling his shares that have gone up in value as a consequence of retained profits.²⁶⁵

When individual income tax rates were much higher than corporate rates, this advantage was very large. Now it is small or nonexistent, as to retention gains, under the new post-1986 and post-1993 United States rate relationships. But those rates and rate relationships are likely to change again; the top individual rate has again risen (in 1993) above the top corporate rate. (Moreover, in the United States deferral can lead to forgiveness, due to the fresh-start basis-at-death rule.) And in any event, the corporate rate will only accidentally equal the

263. See McNulty, *Reform by Integration*, *supra* note 43, at 1449-53; McNulty, *Future Reform*, *supra* note 67, at 72-76, from which this section is taken.

264. See KRAGEN & McNULTY, *supra* note 22, at 49-60.

265. See Gabinet & Coffey, *supra* note 203, at 915-18; Andrews, *supra* note 11.

appropriate shareholder rate, and the two taxes combined will rarely, if ever, impose the "correct" tax burden.²⁶⁶

So enactment and retention of a separate, unintegrated corporate income tax has been partly justified as an effort to compensate and correct for the failure of the individual income tax to reach unrealized gains in share values resulting from undistributed corporate profits.²⁶⁷ If that failure cannot be fixed, a partnership (or S Corporation) transparency system, or an elective or mandatory shareholder imputation credit method, would prove the right "second-best" solution. The result would be right because it would tax shareholders once, at their individual rates, as determined by their individual circumstances, on their shares of undistributed as well as distributed corporate earnings. It would eliminate the double tax or "overtaxation" problem of the unintegrated United States corporate tax. It would be only "second-best" because share value increases may not correspond exactly to corporate earnings such as those taxable at once to a partner or proprietor, or to shareholders under a Carter Commission or transparency integration system. Also, the partnership method would be problematic because of the liquidity problem.

Discussed in the next section is another possible variation on the mandatory shareholder imputation credit approach which would also—like the Carter proposal—include an element of voluntariness.²⁶⁸

XXI.

ALTERNATIVE SOLUTIONS

A. *Methods to Tax Unrealized Gains, Or The Indirect Equivalent*

Once it is perceived that the trouble with the United States' classical, unintegrated tax system of taxing corporate sector earnings lies in the failure of the individual income tax to include unrealized appreciation in corporate shares when the gains accrue, other promising approaches can be imagined or dis-

266. "Correct amount of tax," of course, presupposes the point asserted here—that the income earned by the corporation really amounts to the income of the shareholders and should ultimately be taxed to them at their applicable marginal rates, perhaps adjusted for deferral. See THE INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* 143 (1978) (Report of a Committee Chaired by J. E. Meade) [hereinafter MEADE COMMITTEE REPORT]; cf. JOSEPH A. PECHMAN, *TAX REFORM, THE RICH AND THE POOR* 51-52 (1989). Deferral of goodwill gains in shares remains possible and advantageous due to the rule of realization, the time value of money, and the fresh-start basis rule of I.R.C. § 1014. However, taxation of such gains at rates close to ordinary income rates and the absence of indexing for inflation somewhat counteract these influences. Section 1014 now allows "back-door integration" by escape from shareholder taxation. Enactment of the Carter Commission (Canada) Model would support repeal of § 1014 and introduction of a carryover or zero basis rule.

267. See Gammie, *supra* note 58, at 149-50.

268. See McNulty, *Future Reform*, *supra* note 67, at 73-78, from which the following text partly is derived. See also John K. McNulty, *Corporate and Individual Income Tax Integration in the United States During The 1990s*, 2 TILBURG FOREIGN L. REV. 205, 219-227 (1993) (Neth.) [hereinafter McNulty, *1990s Integration*].

cerned.²⁶⁹ Of course, one direct approach would be to try to estimate or determine the annual increase or decrease in share values and to require inclusion of gains (or deduction of loss) in the shareholder's income each year. The troubles with this approach include the difficulty of determining the changed values without a market transaction in each share, and the supposed liquidity problems for shareholders taxable each year on paper gains when they may not have cash or liquid assets with which to pay the tax. Perhaps both kinds of problems could be overcome by various techniques applying an annual accrual method income tax as to some assets, particularly publicly-traded stocks.²⁷⁰

Another approach, drawn from feasible proposals for the correct taxation of gains on sales of capital assets, and resembling a specialized technique in the U.S. international tax area, may be promising. It would permit repeal of the corporate income tax and its accoutrements, even without an imputation credit, or if a credit could not currently be given at a rate high enough to remove shareholder resistance to taxable distributions or allocations.

This approach involves the proposition that a reasonable approximation of taxing accrued but unrealized gains in corporate shares could be made by taxing the gains (including extraordinary dividends) only at the time of realization (sale, exchange, or distribution of an extraordinary dividend) and also imputing the gains evenly to the years of the holding period and charging interest for the deferral of tax (until the year of realization). The bunching phenomenon could be cured by an averaging approach that treats the gains as having accrued ratably over the period the asset was held, and under the actual rates of tax of each of those years, or a single assigned rate could be applied to each year's gain. (While rates remain relatively low and flat, as in the United States since the 1986 Tax Reform Act and even after 1993, the need for such averaging is minimized). Losses could be allowed upon realization (but probably without a *negative* interest charge). Distributed earnings would, of course, be taxable to shareholders on receipt, as now.

Taxation of share gains at the time of realization on the theory that the gains occurred ratably over the years the asset was held, with an interest charge for deferral, would disadvantage shareholders whose gains in fact happened late during the investment period and would undertax those whose gains actually happened earlier. The system would not always correspond to what an accurate annual accrual system would do—either as to gains or deductible losses. Particularly in the case of untraded, closely-held corporations it might never be ascertainable whether and how much the realization/proration/interest charge tax differed from an annual accrual without realization system.

269. See McNulty, *Future Reform*, *supra* note 67, at 73-78, from which the following text is partly derived; see also McNulty, *1990s Integration*, *supra* note 268, at 219-27.

270. See Shakow, *supra* note 204, at 1132-37; Victor Thuronyi, *The Taxation of Corporate Income: A Proposal for Reform*, 2 AM. J. TAX POL. 109 (1983); David Slawson, *supra* note 204; Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982); Victor Thuronyi, *Tax Reform For 1989 and Beyond*, 42 TAX NOTES 981, 984-85, 992 (1989).

A method of ameliorating the possible injustice to shareholders, or the economic inefficiency of such a realization/interest charge system would be to let shareholders choose instead to be subject to a transparency regime, if they preferred it as an alternative. This regime would be one that would tax shareholders each year on their proportions of undistributed corporate earnings in lieu of taxation on share gains upon realization and with interest. In other words, shareholders could elect the partnership (or S Corporation) style of integration (full taxation of undistributed as well as distributed corporate earnings) as an alternative to throw-back tax and interest charge on realization. Share basis increases upon taxation annually would mechanically adjust the computation of gain or loss on later realization.

If gain on realization occurred over and above the adjusted basis (and undistributed earnings taxed to shareholders), it could either be ignored or (better) it could be taxed then as an investment gain that occurred in addition to share market value increases resulting from retained earnings. (If current taxation forgave all shareholder tax on share gains, those including goodwill gains as well as retention gains, goodwill gain income would escape tax and shareholder choices between regimes would be heavily influenced by the likelihood of one form of gain rather than another). If taxed, this added gain could be treated either as arising pro-rata over the years (even though the taxpayer had opted out of this system as to gain-equaling retained earnings) or as occurring upon realization, as it is now. If a loss resulted, and was deductible, that would correct for over-taxation in earlier years when retained earnings evidently exceeded the overall increase in share values (or there was an actual decrease). Or, the loss could be ignored and non-deductible (as could gains) as a price or reward for having opted the annual transparency tax alternative.

The election of annual (transparency) taxation on retained corporate earnings would be particularly necessary and feasible for shareholders of small, closely-held companies where annual changes in market value of shares prove difficult to determine. One question is whether such an election would have to be made by the entity itself or by all of its shareholders uniformly, as when the partnership or S Corporation form is selected, or whether each shareholder could make his/her/its own choice, a new and relatively untried possibility. In effect, all the undistributed corporate earnings could be allocated to shareholders, or each shareholder could choose individually whether to accept such an allocation and pay tax on it. Another question would be whether shareholders individually, or acting in concert or through the entity, could change their elections from year to year, and whether a new shareholder could make a fresh choice for newly acquired shares.

B. An Example from U.S. International Tax

The United States Congress in 1986 constructed a small regime that consists of just such a choice between realization with interest or annual transparency treatment in the international field, when it enacted the PFIC (Passive

Foreign Investment Company) legislation.²⁷¹ The PFIC legislation²⁷² was conceived as a method to close a loophole, or undesired advantage, enjoyed by U.S. persons who put passive investments in foreign corporations or made portfolio or similar investments through them, such as in foreign mutual funds. The goal of the taxpayer was to have the income from the investments retained in the foreign corporation subject to (lower) foreign rates of income tax and free from (higher) U.S. rates for a period of time. (As Gilbert and Sullivan said, in voices referring to Poohbah, in the Mikado, "His object all sublime, he would achieve in time.") The technique, in other words, *deferred* application of the higher tax until distribution, sale or other repatriation, at which time the higher United States tax would be borne.²⁷³

Even though U.S. tax were collected later (and not avoided by holding the property until death, when a fresh-start basis under § 1014 could allow tax-free realization of the profit from the retained investment income), deferring that tax meant larger after-tax profits in the end. The larger profits come from reinvesting each year's full investment profits reduced only by lower foreign tax, and not subtracting an additional amount for the higher U.S. tax. And no interest was charged later when this "deferred" tax was paid. Paying the higher tax later rather than earlier amounted to an "interest-free loan" of the tax from the United States government to the taxpayer. The funds "loaned" without interest could be reinvested by the taxpayer and he could keep the added profits (less eventual tax on the added profits). The time value of money means that the present value (or cost) of a later payment of the higher United States tax is less than the present value of paying it earlier, given the fact that only the lower rate of foreign tax would apply to annual profits in the interim.

So the PFIC anti-deferral system, like the FPHC (Foreign Personal Holding Company), CFC (Controlled Foreign Corporation) and FIC (Foreign Investment Company) systems that preceded it, was designed to counteract the undue deferral of U.S. tax on retained passive investment profits of a foreign corporation. To do so, this PFIC system takes a dual approach, with a taxpayer election that mirrors the domestic "integration" system pictured above.

The first alternative, under PFIC rules, consists of taxing shareholders of non-electing PFIC's when they realize gains on receipt of certain sales of shares, or on receipt of certain dividend or liquidating distributions (called excess distributions), by allocating the income ratably to the shareholders' holding period.²⁷⁴ Tax and interest would be charged to cover the fact that tax on the earlier years'

271. See Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988). The predecessor of the PFIC system, §§ 1246-47 for Foreign Investment Companies, allowed an election of *actual* distribution of 90% of taxable income as an alternative to ordinary income (vs. capital gains) treatment on sale of shares of an FIC up to taxable dividend potential. The PFIC election thus is different and much more interesting as a model for corporate tax integration.

272. I.R.C. §§ 1291-1298.

273. Preferably, there would be a foreign tax credit for the (lower) foreign taxes paid earlier.

274. *Id.* § 1293.

income has not been collected until later.²⁷⁵ As a consequence of this arm of the PFIC system, tax is not imposed until sale or distribution, when the amount of gain is fixed by a market transaction and liquid funds presumably are available to the taxpayer for use in paying this tax.²⁷⁶

Probably because ratable attribution of realized gains may over-tax or under-tax the shareholder, the PFIC system allows for another option. If a PFIC shareholder elects to have the corporation treated as a Qualified Electing Fund ("QEF") as to him, the U.S. shareholder is taxed currently (each year) on his pro-rata share of the PFIC income, including undistributed earnings.²⁷⁷ This is in lieu of taxing realized gains at the end of the line. It requires that shareholders pay tax on undistributed as well as distributed PFIC earnings. So they must find liquid assets to pay the tax (or demand an annual distribution sufficient to pay the tax on the undistributed and distributed earnings.) This amounts to an election to submit to "partnership," S Corporation or transparency-type integration. It is voluntary, shareholder by shareholder; either the realization-with-interest rule applies or, if an election is made by a shareholder (and if the company complies with specified requirements), it becomes a QEF with respect to that shareholder who then is taxed currently on the ordinary earnings and net capital gain of the fund, even though not distributed.²⁷⁸

The two arms of the PFIC legislation offer the U.S. shareholders of a PFIC their choice of burden to bear to counteract the improper benefit of deferring U.S. tax on their passive investment income. They may elect to be taxed on accrued gains later at the time of realization, with interest, or earlier, currently (upon undistributed earnings), as they wish.

The deferral of proper U.S. tax on the shareholders, which PFIC attempts to correct, is analogous to the deferral of proper tax a U.S. shareholder in a domestic U.S. corporation obtains, albeit at the price of paying both a corporate income tax on undistributed corporate earnings plus a later individual income tax on the shareholder if he receives dividends or gain on the sale of his shares. The PFIC legislation thus suggests an analogous solution to this parallel problem.

The corporate income tax could be repealed and all U.S. shareholders could be given a choice of current taxation on undistributed profits, or the alternative of taxation later upon realized gains, with interest.²⁷⁹ No escape by the fresh-start basis-at-death rule would be tolerable under this proposed solution. The PFIC system itself contains a rule requiring carryover basis at death, or fair market value if lower.²⁸⁰ And indexing for inflation would be a separate and desirable change to make.

275. *Id.*

276. "Earnings and profits" of the PFIC are not relevant in this regime.

277. *Id.* § 1295.

278. *Id.* § 1293.

279. Or, the corporation income tax could be preserved, as a withholding tax that would yield an imputation credit if and when retained earnings were actually distributed.

280. I.R.C. § 1291(e) (incorporating the basis rule of § 1246(e) regarding basis in stock in a "foreign investment company" for PFIC purposes).

Two admissions must be made. First, while corporate and individual tax rates are as similar as they recently have been in the United States, the deferral of individual tax at the expense of unrelieved corporate tax is not so big a loophole. But there remains the problem of inappropriate taxation of retained earnings and the problem of double taxation, or overtaxation, of distributed corporate profits, problems that a *complete* integration system would solve.

Second, even if some complete integration system were adopted, there would remain the problem of deferral of individual income tax on unrealized gains in assets other than corporate shares, unless the United States converts from a realization-style to an accretion-style income tax in general. The present separate corporate income tax in effect tries to compensate for the deferral of tax on undistributed corporate profits and unrealized increases in share values, even though no such correction is made as to most other assets. Shareholder imputation and credit would remove this unusual, uncharacteristic and crude "correction" for corporate earnings and possibly would better harmonize their taxation with the taxation of unrealized gains in other investments. So would some of the other proposals made here.

The realization plus interest approach could be applied to *all* assets, not just shares of stock. If it were not, the question would arise why to treat corporate share gains differently and more disadvantageously than other investments. One answer to the latter question might be that the taxation of each year's accrued but unrealized gain in shares is an approximation of taxing the annual earnings of the corporation that were retained and not distributed. It would be an alternative to the partnership or transparency (or S Corporation) method of taxing corporate sector earnings. The transparency method is usually viewed as a preferable reform of the corporate income tax. The former (accretion taxation) would be a second-best corporate tax reform and a good individual income tax reform. It would truly be "first-best," however, only if extended to all assets.

XXII.

NEW OPPORTUNITY

The post-1986 years present a new opportunity for the United States: to take advantage of the still roughly equal rate relationship between individual and corporate rates enacting at least an optional shareholder imputation credit method of integrating the corporate and individual income tax, with a voluntary "allocation" aspect along the lines of the Canadian Carter Commission Report or the A.L.I. 1993 and Treasury 1992 proposals. Whether or not earnings were distributed, they could be "allocated" and taxed to shareholders, most of whom would not object because of sufficient credit they would be entitled to claim against their individual income tax liability or have refunded. Many shareholders would prefer taxable allocation or distributions because of the refund. In other words, the corporate income tax could and should become a tentative withholding tax to be applied (credited) against individual income tax liability. It would provide revenue and would repair the present failures of the individual

income tax as to corporate earnings and unrealized shareholder gains. Thus the corporate tax would become even more the "handmaiden" or assistant of the individual income tax.

A broader reform, to tax gain on all assets upon realization with a throw-back principle and an interest charge for deferral, could resolve the question of corporate tax integration and provide a first-best reform of the U.S. individual income tax. An election of Subchapter S-type transparency treatment, as for PFIC's, would allow corporations to step out of the realization (throwback) interest charge if they preferred.

XXIII.

INTERNATIONAL TAX PROBLEMS RAISED BY DOMESTIC (U.S.) INTEGRATION

One way of stating the underlying international fiscal problem arising from integration of the corporate tax is to say that corporate tax integration, by relieving the double taxation or overtaxation of U.S. corporate sector income, would create a situation in which the residents of the United States would experience a powerful incentive to invest in domestic United States companies that earn United States source income, rather than in foreign corporations (or in domestic corporations earning foreign source income). This would be the case unless special international provisions were made to give U.S. shareholders the benefit of foreign integration systems. Similarly, unless such provisions were made, the integration system might tend to discourage investment in the United States by foreign investors. This would be particularly true for investors residing in countries having domestic integration systems of their own, assuming that the benefits of integration in those foreign nations were not extended to investment by their residents in the United States. It is even possible that an integration system would be enacted in part for the purpose of encouraging such domestic (U.S.) investment and to discourage not only foreign investment by Americans but also investment in the United States by foreign persons.²⁸¹

The purpose of integrating the corporate and shareholder income taxes, or at least providing partial integration or "dividend relief," is to remove or reduce the extra taxation of distributed corporate earnings. Whether this is done by a shareholder credit mechanism or dividend exclusion, this system works automatically only when the tax at the corporate level and the tax (or exemption) at the shareholder level are both imposed by the country with an integrated system. If either the corporate level tax or shareholder level tax is imposed by another country, the integration system does not automatically integrate those taxes.

281. See Stephen C. Wrappe, *The Protectionist Potential of the Imputation Form of Corporate Integration*, 46 TAX NOTES 727 (1990); see also David R. Tillinghast, *Corporate-Shareholder Integration as an Obstacle to the International Flow of Equity Capital: A Proposal*, 56 TAX NOTES 1215 (1992). My presentation of the international aspects of integration is also available in John K. McNulty, *International Aspects of Proposals for Corporate Income Tax Reform in the United States: Integration of the Corporate and Individual Income Taxes*, 3 TILBURG FOREIGN L. REV. 307 (1994).

A. *The Two Problems: Foreign Shareholders And Foreign Corporate Income Taxes*

The international aspects of integration contain two major problems. The first problem is whether the integration country, the United States in the present context, will somehow grant or deny the benefits of integration to *foreign shareholders*. This can be phrased as asking whether the United States as the *source* country (of income flowing to foreign investors) would grant the benefits to foreign persons in the *residence* country.

The second problem is whether the United States and its integration system would treat *foreign* corporate income taxes the same as income taxes paid to the United States are treated.²⁸² More specifically, the question becomes whether it would allow a foreign tax credit for foreign corporate income taxes paid for purposes of the integration system as well as for the pure international double taxation relief system.

The goal of the integration system is to relieve *domestic* double taxation of corporate income. The goal of the international tax system is to relieve *international* double taxation of income.²⁸³ These two double tax relief systems need themselves to be integrated or put together in some way when a country such as the United States chooses to adopt a domestic integration system.

One of the purposes of the international tax system of the United States is to remove obstacles to the international flow of capital, whether outward from the United States to foreign countries, or inbound from foreign countries into the United States. Doing so, either by the foreign tax credit of the Internal Revenue Code,²⁸⁴ by other exclusions and allowances in the Internal Revenue Code, or by the foreign tax credit, exemption and tax rate reduction agreements of international tax treaties, the relief of international double taxation entails a revenue loss for the United States. (It also entails a revenue loss for the treaty partners, or other countries across whose borders investment is flowing either to or from the United States.) A certain amount of reciprocity and nondiscrimination or equal treatment is involved in the tax treaties and in the philosophy of the U.S. Internal Revenue Code provisions.²⁸⁵ Now the question becomes how those systems will operate or should be changed if the United States adopts some form of corporate tax integration for its domestic shareholders and domestic corporations.

282. Another way of stating this problem is to say the question is whether the United States as the residence country of its investors would treat foreign income tax as paid to the source country, in which U.S. corporations are earning income, the same as U.S. income taxes.

283. For an introduction to the policy problems and law of international taxation, see MICHAEL J. MCINTYRE, *THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES* (1992) and PAUL R. MCDANIEL & HUGH J. AULT, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* (3rd rev. ed. 1989).

284. I.R.C. §§ 901, 902.

285. See Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 *LAW & POL'Y INT'L BUS.* 461, 486 (1978).

As stated above, the basic model of the integration system works automatically only when the tax at both the shareholder level and at the corporate level are paid to the same country. If either tax is paid to another country, either the double taxation will not be relieved, or special rules and allowances will have to be enacted to achieve that result. In particular, it becomes necessary for the integrating country, such as the United States, to consider whether to extend the benefits of integration to foreign *taxes* and foreign *shareholders*.

For example, as to foreign shareholders if the United States were to adopt partial integration or "dividend relief" (perhaps by a shareholder imputation credit system like that designed by the A.L.I. Reporter), suppose a U.S. corporation paid a dividend to a shareholder who was a resident of country X. Unless there were a treaty provision to that effect, after integration the United States would not refund or credit any part of the corporate income tax paid in the United States. Likewise, the residence country (X) probably would not give any kind of imputation credit against its shareholder's tax for the corporate tax paid in the United States. Nor, if it used the exemption system, would it be likely to exempt the dividend in the hands of the shareholder. Therefore, a shareholder residing in foreign country X who received a dividend from the U.S. corporation would not obtain any integration relief. As a consequence, he might be disinclined to make the investment in, or inclined to withdraw the investment from, the United States.

To examine the second aspect of the problem, the treatment of foreign taxes, imagine that a U.S. corporation had a foreign-incorporated subsidiary that resided in foreign country Y and had only Y source income. Suppose that the foreign subsidiary earned \$100 and paid a corporate income tax to country Y of \$35. No U.S. tax would be owing to the United States by the foreign subsidiary.²⁸⁶ Suppose as well that the U.S. corporate parent also earned \$100 in the United States and paid a U.S. corporate income tax of \$35. If the foreign *subsidiary* paid a dividend of \$65 to the U.S. *parent*, the United States would allow an indirect foreign tax credit for the foreign corporation tax (country Y tax) paid by the subsidiary. Therefore, the U.S. parent would not have to pay any additional U.S. tax upon receiving the dividend.²⁸⁷

If the U.S. *parent* paid a dividend of \$65 (attributable only to its own U.S. source earnings) to its shareholders, all of whom reside in the United States, corporate tax integration would work automatically. The dividend would be treated as deriving from the \$100 earned by the U.S. parent, and the shareholders either would gross up the dividend and get a credit for the \$35 of tax paid by the U.S. parent under a shareholder credit imputation system, or would pay no tax on the dividend if a dividend exclusion method were in effect.

286. I.R.C. §§ 11(d), 882. The United States does not generally seek to tax a foreign corporation (even if U.S. owned) on foreign source income not yet repatriated to the United States. See Treas. Reg. § 1.11-1(a) (as amended in 1976); I.R.C. § 882(a)(1).

287. See I.R.C. § 902.

However, if the U.S. *parent* paid not only that dividend but also an additional dividend of \$65 out of funds received from its foreign subsidiary, the system would not work. Because the \$35 tax imposed on the additional \$100 of earnings, consisting of the dividend received from the U.S. corporation's foreign subsidiary, was a tax paid to the *foreign* country in which the subsidiary was operating, the United States could (or would) refuse to take it into account. A U.S. income tax would be imposed on the U.S. shareholders, with the result that although international double taxation would have been relieved, domestic double taxation would remain. This is because the United States would not (automatically) treat the corporate income tax paid by the subsidiary to the foreign country the same as it would treat a corporate income tax paid by a U.S. subsidiary to the U.S., or by the U.S. parent in this example, and would not *automatically* allow it to be treated as a prepayment of the shareholder's tax in a shareholder imputation credit system, or as a basis for excluding a dividend paid out of earnings subjected to that tax under a dividend exclusion approach.²⁸⁸

B. *Theoretically Correct Policy*

Unless the integration system in the United States did extend its benefits to foreign *shareholders* and foreign *taxes*, the result would be undesirable economic and legal effects. Assuming equal opportunities for before-tax returns on investments worldwide, U.S. shareholders, residing in a country with an integration system, would obtain larger after-tax returns from investments made in the U.S. than from investments made in companies that resided in other countries, or in U.S. corporations that obtained income abroad. Presumably the governments of trading partners of the United States would object to this differential treatment of foreign taxes and foreign shareholders. Doing away with these effects would tend to promote "the efficient international allocation of capital" and hence "would maximize economic welfare."²⁸⁹

C. *U.S. Taxation of Multinational Corporate Sector Income Without Integration: The Case of a Foreign Investor's Corporate and Dividend Income From U.S. Sources*

Let us consider how an investor who is foreign to the United States is taxable at the present time on income sourced in the U.S.. First, if an investor such as an individual, who resides in and is a citizen of a country with which the U.S. does not have an income tax treaty, makes a portfolio investment by buying shares of stock in a U.S. corporation, how will his income be taxed? If the corporation has \$100 of net taxable income attributable to the foreign shareholder's investment, that \$100 will be taxed to the U.S. corporation at rates up to 35%, in which case \$65 will remain for distribution. If \$65 is distributed as a dividend, the income tax statute also imposes a 30% withholding tax, a *final* tax

288. This example is adapted from Tillinghast, *supra* note 281, at 1216, 1218-20.

289. *Id.* at 1216.

on the gross amount of the dividend (\$65) paid to the nonresident alien (non-citizen) individual, so long as that person is not engaged in a trade or business in the U.S. (\$19.50).²⁹⁰ A typical international tax treaty would reduce the rate of this tax to 15% or \$9.75.²⁹¹

If interest were paid by the U.S. corporation to a foreign individual lender (as distinguished from dividends paid to a foreign shareholder), the interest paid would be deductible by it (under I.R.C. § 163), so long as the interest-stripping rules of § 163(j) did not apply. Hence there would be no U.S. tax at the corporate level and the § 871 withholding tax would be imposed on the interest income. (The typical treaty would reduce the rate to 12% (\$7.80).)²⁹² If the foreign investor were a foreign corporation, the same result would follow, with the withholding tax imposed by I.R.C. § 881 (a foreign corporation having U.S. source income not connected with a U.S. business).²⁹³

What if a direct investment were made by a U.S. subsidiary of the foreign corporation, a U.S. corporation, engaged solely in a trade or business in the United States? If so, the subsidiary would be taxable as a U.S. corporation, at rates up to 35% on its taxable income.²⁹⁴ A dividend of \$65 paid by the U.S. subsidiary corporation to its shareholder(s) would be subject to the 30% withholding tax on dividends,²⁹⁵ possibly reduced by the typical treaty to 15% (\$9.75) (or 10% (\$6.50) if at least 10% of the stock were held by a corporate investor in the dividend-paying corporation.)²⁹⁶

If a foreign corporation were to use a branch or permanent establishment (of itself) in the United States, rather than a U.S. subsidiary, it would face the U.S. corporate income tax at rates up to 35%. It would also face the 30% U.S. "branch profits and interest tax" of I.R.C. § 884, to the extent it did not reinvest its after-tax "effectively connected earnings and profits" in "U.S. net equity."²⁹⁷ This tax applies instead of the § 871 and § 881 dividend withholding tax and the § 861(a)(2) second-level withholding tax, unless and to the extent any applicable tax treaty relieved the branch tax. So, if the U.S. investment yielded \$100 before U.S. corporate income tax (of \$35), and all after-tax profits were distributed as dividends, the U.S. would impose a dividend withholding tax of 30% (\$19.50) by statute, reduced to 15% (\$9.75) by the treaty, on the \$65 dividend (or "dividend equivalent amount" in the branch profits tax or "BPT").

290. I.R.C. § 871.

291. See, e.g., Convention for the Avoidance of Double Taxation, June 4, 1976, U.S.-Korea, art. 12, 30 U.S.T. 5253, 5281 [hereinafter U.S.-Korea Income Tax Treaty].

292. See, e.g., U.S.-Korea Income Tax Treaty, *supra* note 291, art. 13, 30 U.S.T. at 5282; but see I.R.C. §§ 881(c), 871(i)(2) (the exemption for portfolio or bank deposit interest by a U.S. borrower to a foreign lender).

293. The typical Treaty would reduce the withholding tax to 15%, or possibly to 10%. See, e.g., U.S.-Korea Income Tax Treaty, *supra* note 291, art. 12, 30 U.S.T. at 5281.

294. See, e.g., I.R.C. § 11.

295. I.R.C. §§ 871(a), 881(a), 1441-1442.

296. See, e.g., U.S.-Korea Income Tax Treaty, *supra* note 291, art. 13, 30 U.S.T. at 5281.

297. I.R.C. §§ 11, 882, 884.

If the United States were to adopt some form of integration of the U.S. corporate income tax and the U.S. income tax on corporate earnings distributed as dividends, would the taxation of foreign shareholders be affected? Would a shareholder imputation credit be extended to a foreign shareholder, such as an individual portfolio investor, to serve as a credit against the I.R.C. § 871 dividend withholding tax? Or, if a dividend exclusion method of integration were chosen, would the § 871 tax be repealed, so that the dividends would be received by a foreign individual shareholder excluded from U.S. income tax?

The answer is that these integration devices would only extend the benefit of integration to foreign shareholders *if* Congress chose to legislate that result. Unlike *corporate*-level integration mechanisms, such as a deduction for dividends or a reduction in rate of corporate income tax, the shareholder imputation credit and shareholder dividend exclusion methods do not *automatically* extend the benefits of integration to all shareholders; only those whom the legislation directly specifies would benefit from the integration. Hence, the question becomes whether the U.S. Treasury dividend exclusion method (or its CBIT variation) or the A.L.I. shareholder imputation credit model specifies that foreign shareholders would receive the dividend exclusion or imputation credit.²⁹⁸

Likewise, if a U.S. corporation, its U.S. or foreign subsidiary, or a U.S. individual shareholder received foreign source income and paid or was deemed to have paid creditable foreign income taxes, would payment of such taxes entitle the U.S. shareholder to receive excludable dividends (Treasury Proposal) or to receive imputation credits usable to offset U.S. income taxes on the shareholders (A.L.I. model)? Again, explicit legislation on each question would be required to determine the result, and the Treasury and A.L.I. models make mention of what each recommends.

In general, both the Treasury and A.L.I. models contemplate extending the benefits of integration to foreign shareholders and giving credit to foreign taxes paid only through individual negotiated tax treaty agreements, but not by statute, to all foreign shareholders and foreign taxes. More specific description of these features of the Treasury and A.L.I. models is given below.

XXIV.

INTERNATIONAL ASPECTS OF PROPOSALS

A. *U.S. Treasury Dividend Exclusion Prototype: International Aspects*

The drafters of the U.S. Treasury Report, and the Dividend Exclusion Prototype in particular, contemplated retaining the U.S. foreign tax credit system, including the indirect foreign tax credit for income taxes paid by foreign subsidiaries of U.S. companies to foreign governments.²⁹⁹ However, under the January 1992 Treasury dividend exclusion approach, foreign taxes would *not* be treated

298. The Treasury and A.L.I. dividend relief proposals for partial integration of the corporate and individual taxes were described early in this article; *see supra* parts VIII, IX, X.

299. TREASURY REPORT, *supra* note 1, at 17, 21-22, 73-80.

similarly to U.S. taxes for purposes of determining the Excludable Distributions Account (EDA).³⁰⁰ Therefore, as is true presently in the United States without integration, a distribution by a U.S. company of foreign earnings that have been shielded by the foreign tax credit at the corporate level would become taxable to U.S. shareholders upon distribution.³⁰¹ So, for "outbound investment," an investment by U.S. persons outside the United States, the benefits of integration would not be extended. Foreign taxes would not "frank the dividend," that is, they would not entitle the corporation to pay a dividend exempt or excludable by the U.S. shareholders. The technical reason is that the corporate tax paid was not paid to the United States government.

As for "inbound investment," which is to say investment by foreign persons in the United States, the pre-existing U.S. inbound investment rules would be retained. The United States would keep the 30% statutory withholding rate on dividends and the branch profits tax on earnings from U.S. branches of foreign subsidiaries.³⁰² The withholding tax could be reduced through the negotiation of tax treaties.³⁰³

In other words, this January 1992 U.S. Treasury model would not automatically extend the dividend relief to either (a) foreign taxes or (b) foreign shareholders. The reason for this result lies in the sweeping constraint that Treasury adopted at the outset of its study, which stated that "integration should be extended to foreign shareholders only through treaty negotiations, not by statute" and "[f]oreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. Government."³⁰⁴

As to *outbound* investment by U.S. investors, The Treasury Report concluded that although a U.S. corporation might face higher taxes on foreign source income than domestic source income, the foreign source income would not face double-taxation greater than under pre-existing law. Therefore, U.S. firms operating in foreign countries would not be confronted with any competitive disadvantage *greater than that faced before integration*.³⁰⁵ This seems an entirely unsatisfactory explanation.

As to *inbound* investment in the U.S. by foreign investors, the Treasury Report gave two reasons for not extending integration to foreign shareholders by statute. First, if the U.S. statutorily granted integration benefits to foreign shareholders, it would in effect be abstaining from the source-based taxation of dividends, with no assurance that the foreign investors would not confront a second level of tax in their residence country.³⁰⁶ In other words, substantial revenue might be lost by the U.S. without any necessary increase in the efficiency of

300. *Id.*

301. I.R.C. § 61(a). The foreign tax credits of §§ 901-904 thus would not apply.

302. TREASURY REPORT, *supra* note 1, at 79-80.

303. John Turro, *U.S. Treasury Department's Corporate Integration Study Addresses Inbound/Outbound Issues*, 4 TAX NOTES INT'L 307, 309-10 (1992).

304. TREASURY REPORT, *supra* note 1, at 16.

305. *Id.* at 77.

306. *Id.* at 79.

capital allocation. The second reason for not extending the benefits to foreign shareholders was a matter of giving revenue away for nothing in return. Extending an imputation credit or other integration benefit to foreign shareholders, combined with low dividend withholding rates in a treaty, would reduce the U.S. tax on distributions to foreign shareholders without a corresponding benefit for new investment in the treaty country.³⁰⁷ The report emphasizes that integration is supposed to benefit the corporate form of organization, but not the treasuries of foreign governments.³⁰⁸ Therefore, the U.S. report stresses that a source country should not "sacrifice its claim to this tax revenue for the sake of consistency."³⁰⁹

In the December 1992 U.S. Treasury Department legislative recommendations, no significant change was made in the treatment of foreign *shareholders*.³¹⁰ In recommendation 21(a), the Treasury persisted in saying that integration benefits would not be extended to foreign shareholders by statute.³¹¹ Therefore, non-resident aliens and foreign corporations would continue to be subject to withholding tax on dividends, and foreign corporations would be subject to the branch profits tax, except as integration benefits might be granted to foreign shareholders by treaty. Furthermore, constructive (or D.R.I.P. for "Dividend Re-Investment Plan") dividends would *not* increase the bases of *foreign* shareholders' stock, but would decrease the corporation's adjusted taxable income (A.T.I).³¹²

In contrast, as to foreign *taxes*, Recommendation No. 2 *would* extend integration to foreign source income by "flowing through" creditable foreign taxes *without* the need for treaty agreement, *so long as* the major trading partners of the U.S. granted reciprocal treatment.³¹³ This reverses the position taken in the January 1992 Treasury Report regarding foreign taxes.

To summarize, under the U.S. Treasury *January* 1992 Report dividend-exclusion prototype, foreign income that has not borne United States tax because such tax was offset by the foreign tax credit would remain taxable at the shareholder level, although a taxpayer-favorable stacking rule would treat domestic fully-taxed income as distributed first.³¹⁴ Also, dividend distributions to foreign shareholders of U.S. corporations would continue to be subject to the statutory withholding rate of 30% (or a lower treaty rate). The *December* 1992 Treasury Recommendation would (conditionally) treat foreign corporate income taxes as entitling shareholders to excludable dividends even without treaty agreement, so long as this treatment was generally reciprocated.

307. *See id.*

308. *Id.*

309. *Id.*; see Turro, *supra* note 303, at 309.

310. *See* TREASURY RECOMMENDATION, *supra* note 1, at L-15 (Recommendation No. 21).

311. *Id.*

312. *Id.* (Recommendation No. 21(b)).

313. *Id.* at L-7; *see id.* at L-9.

314. TREASURY REPORT, *supra* note 1, at 17; *see* Richard Doernberg, *International Aspects of Individual and Corporate Tax Integration*, 4 TAX NOTES INT'L 535 (1992); *but see* TREASURY RECOMMENDATION, *supra* note 1 at L-7.

B. U.S. Treasury C.B.I.T. Prototype: International Aspects

Under the "comprehensive business income tax" prototype (CBIT), foreign income that has not borne *U.S.* tax at the corporate level would remain taxable at the shareholder level, either directly or by virtue of a new corporate-level compensatory tax.³¹⁵ However, the taxation of foreign shareholders would be altered and dividend distributions to them by U.S. corporations would *not* be subject to withholding taxes.³¹⁶ That "adjustment was made to ensure that dividends and interest would be subject to the same single level of U.S. tax."³¹⁷

C. U.S. Treasury Imputation Credit Prototype: International Aspects

In the shareholder imputation credit method of integration that the Treasury Department analyzed but did not recommend, the system described would deny the imputation credit to foreign shareholders and they would remain subject to the withholding tax on dividend distributions.³¹⁸ Also, foreign taxes would not be integrated into the U.S. imputation system for direct investment and dividends on portfolio investment in foreign corporations would not carry the credit.³¹⁹

D. American Law Institute Reporter's Study: International Aspects

In its international aspects, the A.L.I. Reporter's Study somewhat paralleled the Treasury's imputation credit prototype. As a first principle, foreign shareholders would be entitled to the equivalent of the imputation credit on the same basis as domestic shareholders. However, the dividend and the credit that went with it would be subject to a new "foreign investor's tax," as would corporate *interest* payments to foreign lenders, with the accompanying *interest* credit.³²⁰ This "foreign investor's tax" would be set at a rate equivalent to the domestic shareholder-level tax, which in turn would be set to equal the corporate tax rate. The new "foreign investor's tax" would be offset by the foreign investor's equivalent of the domestic shareholder's imputation credit for corporate tax paid; the "new foreign investor's tax" would absorb the imputation credit for foreign shareholders. The credit would offset the *U.S.* shareholder level tax on dividends paid to *foreign* shareholders. No additional withholding tax would be applied to dividends or interest paid to foreign shareholders or lenders.

315. Hugh Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 *TAX LAW REV.* 565, 580 (1992); see *TREASURY REPORT, supra* note 1, at 45-48.

316. See Turro, *supra* note 303, at 309; Ault, *supra* note 315, at 580-81.

317. Ault, *supra*, note 315, at 580.

318. *TREASURY REPORT, supra* note 1, at 96; Ault, *supra* note 315, at 581.

319. Ault, *supra* note 315, at 581; *TREASURY REPORT, supra* note 1, at 95-106.

320. A.L.I. REPORTER, *supra* note 1, at 169-203 (Proposal No. 10); Ault, *supra* note 315, at 581.

Under the A.L.I. Reporter's Study, foreign corporation income taxes would be accepted in the domestic imputation system only by treaty.³²¹ The study details the method of acceptance. In effect, the foreign corporation taxes would be integrated in the U.S. imputation system, subject to the usual foreign tax credit limitation rules that prevent the foreign taxes from reducing the U.S. tax on U.S. source income. The A.L.I. proposal, in order to avoid making individual shareholders apply those foreign tax credit limitation rules in their own tax returns, converts the income that was subject to foreign tax to a corresponding amount of income that is tax-exempt in the hands of the American shareholder when it is distributed.³²² Further, the domestic imputation system would not apply to dividends received from foreign corporations.³²³ The result would be, if a treaty applied, that foreign income taxes would be treated much the same as U.S. taxes for domestic integration purposes as well as for foreign tax credit (international double-tax relief) purposes.

XXV.

WHAT THE UNITED STATES SHOULD DO INTERNATIONALLY

A. *Extend Integration*

Ideally, from a theoretical and an economic point of view, the United States (and all other countries) should extend full integration benefits to foreign shareholders and for foreign taxes, subject only to the foreign tax credit limitations. Doing so would accomplish capital-export neutrality, the philosophy upon which the U.S. international tax system is based. Capital-export neutrality is achieved if income taxes do not influence an investor's decision about where to make his or her marginal investment.³²⁴

If there are no tax barriers to, or disadvantages of, foreign investment, an American investor presumably will invest at home or in the foreign country according to the place where the greatest pre-tax rate of return, adjusted for risk, can be obtained. If all countries in the world operate in the same way, capital-export neutrality will achieve worldwide efficiency in the allocation of resources, because investments would be made where the greatest *pre-tax* rate of return could be obtained, regardless of tax, and thus where world income would be most maximized.

The United States assumes that there will be taxation of international income in both the source (primary jurisdiction) and residence (secondary jurisdiction) countries and attempts to achieve "capital-export neutrality" by allowing a foreign tax credit to U.S. persons for (source country) foreign taxes on income

321. A.L.I. REPORTER, *supra* note 1, at 198 (Proposal No. 11), 108 (Proposal No. 3); see Ault, *supra* note 315, at 581-82; A.I.C.P.A. REPORT, *supra* note 1, at 21-23, 63-67.

322. A.L.I. REPORTER, *supra* note 1, at 198-203.

323. Ault, *supra* note 315, at 581-82.

324. TREASURY REPORT, *supra* note 1, at 74-77; see also PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS 109-38, 139-62 (1969) (explaining capital-export neutrality.)

that is also taxable by the United States.³²⁵ While the United States does not refund the excess of foreign tax over domestic tax liability, and therefore does not exactly set the conditions for complete capital-export neutrality, its system goes very far in that direction.³²⁶ The U.S. believes in its foreign tax credit approach, although it does use an exemption or exclusion method in some instances, for certain kinds of income.³²⁷

In contrast, "capital-import neutrality," or "competitive neutrality," is concerned with the tax burden that an investor faces in any country in which its capital is used. The goal of capital-import neutrality is achieved when the source country taxes the income and all the residence countries involved exempt the income. Capital-import neutrality is achieved if all capital invested in the source country bears the same rate of tax as is borne by domestic entities in the source country and no additional tax, by virtue of the fact that foreign capital flows in from abroad, is imposed.³²⁸

Like many tax systems, the U.S. tax system and its international tax treaties contain some rules and mechanisms that tend toward capital-import neutrality as well as capital-export neutrality. With respect to *portfolio* income (dividends and interest), the principle of capital-export neutrality is predominant. In its tax treaties, the United States usually arranges that the source country will either reduce its source country taxation considerably or give it up entirely.³²⁹ In turn, the residence country reserves the right to tax its investors' foreign portfolio income at the normal rates but is obliged to give a foreign tax credit for any tax that the source country is allowed to impose.³³⁰ After taxation by the residence country, with an allowance for a low rate of tax in the source country, the portfolio income ends up taxed at the effective rate of the residence country, which is a condition that is compatible with, and enhances, capital-export neutrality.

As to *business* income from direct investment, the United States accepts the idea that the source country will be entitled to tax business income within its borders at its normal rates, assuming a permanent establishment has been located there, and that the residence country will be the one obliged to relieve double-taxation. This relief may be provided either by an exemption for income attributed to the source country, or, more frequently in the United States' experience, the residence country is allowed to tax the income but is obliged to give a

325. See McINTYRE, *supra* note 283, at 1-1 to 1-12, 4-5 to 4-12; MUSGRAVE, *supra* note 324, at 140-62; see also I.R.C. §§ 27, 901-908, 960.

326. See I.R.C. § 904. "Capital-export neutrality" can also be accomplished by a system that contemplates taxation in the residence country and exemption in the source country, or taxation in the source country and exemption in the residence country but only so long as the tax rates in all the countries involved are the same.

327. See, e.g., I.R.C. §§ 911 (exclusion for qualified, electing U.S. citizens living abroad for foreign earned income and housing costs), 931 (exemption for bona fide residents of a U.S. possession), 921-927 (foreign trade increase of a F.I.S.C.).

328. See MUSGRAVE, *supra* note 324, at 109, 119-21.

329. See BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION* ¶ 66.2.3 (1991); JOSEPH ISENBERGH, 2 *INTERNATIONAL TAXATION* ¶¶ 36.1-.8, 40.1-.10 (1990).

330. ISENBERGH, *supra* note 329, ¶¶ 36.2-.3.

credit for the source country tax.³³¹ The source country tax must be consistent with allocation rules of the treaty or statutory law.

The problem of integration arises when it blurs or obliterates the distinction between the corporation, which traditionally was the earner of the business income, and the investor, which was traditionally the earner of the portfolio income.³³²

In order to produce or enhance capital-export neutrality and the worldwide efficient allocation of resources, the United States *should* extend the benefits of any domestic corporate tax integration to foreign shareholders and foreign taxes, subject to the foreign tax credit limitation. Doing so, however, may produce a substantial revenue loss and will not necessarily accomplish what Professor Peggy Musgrave has called "inter-nation equity."³³³ That is to say, unless all of the countries of the world were to adopt mirror images of the U.S. system, at the same rates and with the same acceptance of integration and international taxation, the United States might lose revenue and also find itself doing so in a world in which capital-export neutrality is not genuinely achieved because of the actions of other nations. To put it more abstractly, the territorial division of jurisdiction to tax, worldwide, would not be equitable as among the various nations or from the point of view of the self-interest of the United States. The United States might sacrifice a great deal of revenue without succeeding in maximizing world economic welfare or promoting the efficient international allocation of capital.

Other countries have faced these problems and have taken some helpful steps. Some countries have adopted treaties that extend integration benefits to *portfolio* or indirect investors who receive foreign dividends but not to direct investors, who are residents of the treaty partners.³³⁴ If there is an imbalance in the flow of capital in this situation (one country is a capital-exporting country and the other one a capital-importing country), and if the capital-importing country is the integration country, it presumably is willing to extend the integration benefits in order to attract the level of inbound portfolio investment it needs. A few treaties entered into by the United Kingdom also relieve the disincentives to *direct* investment, whether inbound or *outbound*, and to outbound portfolio investment.³³⁵

If both interacting countries have integration systems, a situation that arises with some frequency in Europe, some countries have reciprocally extended the benefits of integration between them. The United Kingdom and Finland have recently entered into a protocol extending benefits to each others' portfolio investors and partial benefits to direct investors.³³⁶ Under the U.K./Finland proto-

331. See BITTKER & LOKKEN, *supra* note 329, ¶ 65.5, at 65-31; RICHARD DOERNBERG, *INTERNATIONAL TAXATION* 12-14, 127-29, 134-40 (2d ed. 1993).

332. See generally, Ault, *supra* note 315, at 566.

333. MUSGRAVE, *supra* note 324, at 130-33.

334. Tillinghast, *supra* note 281, at 1217.

335. *Id.* at 1217 n.16.

336. *Id.* at 1217.

col, it is the country of source that bears the cost.³³⁷ In other words, when earnings arise in one country, it is that country that relieves the double-taxation by refunding its corporate tax to an investor from the second country.

In contrast, the Report of the Ruding Committee goes further and recommends "the reciprocal extension of benefits for *both* portfolio and direct investment situations."³³⁸ Under this proposal, the residence country bears the revenue cost.³³⁹ This means that corporate earnings arising in one country are taxed there (source country), and when they are distributed to an investor in the other country, the investor's (residence) country is expected to give a credit for the first country's tax.

As Professor Tillinghast has observed, this kind of system will work best if the costs and benefits are reciprocal, for example, if each country will share in the aggregate revenue loss, the sharing will be nearly equal because capital flows more or less equally in both directions. Moreover, as he points out, this kind of system will work only between countries that integrate corporate and shareholder taxation at reasonably comparable levels. If the levels of relief are different, the system in effect extends integration benefits only to the extent those benefits are provided by the country offering the *lesser* integration benefits. This means that there will be no integration at all if the arrangement exists between an integration country and a country without an integration system. Within the European Community, revenue costs can be allocated or shared between the source and residence countries, and the use of binding directives can permit a clearinghouse system that would enable all the member countries to share in the revenue losses. Such a congenial situation does not exist in many other places in the world and, in particular, does not seem generally accessible to the United States.³⁴⁰

Therefore, it is recommended that the United States go as far as possible in extending integration benefits to foreign shareholders and foreign taxes. That both the Treasury Department Report and the American Law Institute Reporter's Study were reluctant to recommend that these benefits be extended unilaterally is understandable. However, reliance on the treaty process may be somewhat optimistic. The United States has international income tax treaties with only about forty or so of the many nations of the world. Negotiation and renegotiation of even these treaties would take quite some time. If integration of the corporate and individual shareholder taxes is to become a worldwide movement, this movement would develop more rapidly and easily if the benefits of integration were extended by each country, as it developed an integration system, to other countries of the world unilaterally and without a requirement of the negotiation or renegotiation of tax treaties with each and every other country in the world. Let us hope this is not too idealistic a goal for which to strive.

337. *Id.*

338. *Id.*

339. *Id.*

340. See McNulty, *Integrating?*, *supra* note 43.

This means that it would be desirable if, under the Treasury's dividend-exclusion prototype (or CBIT), income that had been taxed abroad would be treated as fully taxed income and would increase the "excludable distributions account," even without agreement to that effect by an international tax treaty. Similarly, it would be desirable if foreign taxes paid would be treated as the equivalent of U.S. corporate income tax paid, subject to the usual foreign tax credit limitations, for purposes of the integration scheme. The Treasury Department did bring itself to make such a recommendation in its later, December 1992 Legislative Recommendation, though evidently only for purposes of the ATI proposal.³⁴¹

Similarly, under the A.L.I. Reporter's Study, foreign source income that has been taxed abroad should be treated as exempt income that could be distributed tax-free to the investors in the corporation, thus passing-through the benefit of the foreign tax credit, even in the absence of a tax treaty with the foreign country involved. Also, foreign taxes should be treated as the equivalent of U.S. income taxes, subject to the foreign tax credit limitation, for purposes of allowing a shareholder imputation credit to U.S. investors, at least if the nature of the foreign tax and the preferences and other characteristics of the earnings history of the foreign corporation will permit application of rules like those applicable to U.S. corporations in the domestic context. Otherwise, this A.L.I. approach would leave a strong tax bias in favor of investment "at home" rather than abroad and would seriously impair capital-export neutrality.

B. Legitimacy of Denying Integration To Foreign Shareholders And Foreign Taxes

The amount of transnational investment across United States borders is tremendous. Professor Doernberg reports that at the end of 1990 U.S. investors owned \$714 billion in foreign direct investment and \$910 billion in foreign portfolio investment.³⁴² Foreign investors owned \$530 billion in direct investment in the United States and \$1.34 trillion in U.S. portfolio investment.³⁴³ U.S. investors received a total of \$54.4 billion of income from their foreign direct investments and \$65.7 billion of income from their portfolio investments.³⁴⁴ Foreign investors received \$1.8 billion from direct investments in the United States and \$78.5 billion from their U.S. portfolio investments.³⁴⁵ The international aspects of the proposals for integration in the United States have a great many dollars of potential revenue at stake.

There does not appear to be any constitutional or statutory restraint in U.S. law that would prohibit the U.S. Congress from denying the benefits of integra-

341. TREASURY RECOMMENDATION, *supra* note 1, at L-10.

342. Richard Doernberg, *International Aspects of Individual and Corporate Tax Integration*, 4 TAX NOTES INT'L 535, 537 (1992).

343. *Id.*

344. *Id.*

345. *Id.* (citing TREASURY REPORT, *supra* note 1, at 73.)

tion to non-resident shareholders, Professor Doernberg concludes.³⁴⁶ Likewise, he concludes there is no constitutional or statutory problem with treating foreign income taxes and U.S. income taxes differently under the integration system.³⁴⁷ He also states that the U.S. treaty commitments do not prevent differential treatment.³⁴⁸ The nondiscrimination article does not apply because it is concerned with the treatment of a foreign national who resides in the United States compared to a U.S. national in similar circumstances.³⁴⁹ The foreign tax credit article in the treaties does not oblige the United States to pass through the benefits of the foreign tax credit to a corporation's shareholders. Doernberg also concludes that international law does not compel the United States to extend the benefits of integration to foreign shareholders and foreign taxpayers. He thinks that it would be wise strategic behavior and good international relations for the U.S. to extend integration benefits in this way, as Australia does by statute.³⁵⁰

Professor Doernberg notes that the arguments made by the Treasury Department against extending integration benefits to foreign source income could also be made against the foreign tax credit in general.³⁵¹ As he observes, corporate income earned in the United States is subject to two levels of U.S. tax, while foreign source income is subject to only one level of U.S. tax, the shareholder level.³⁵² This is because the corporate tax is paid in the country of source and the foreign tax credit often offsets any U.S. corporate-level tax. There is a large cost in foregone revenue involved in not collecting two levels of tax in this situation, but presumably if the United States did not relieve the international double-taxation, there would be a marked decrease in foreign investment by U.S. investors. Also, the administrative burden of implementing the foreign tax credit is substantial.³⁵³ Nevertheless, the Treasury does not conclude that the basic international foreign tax credit should be repealed.³⁵⁴ As Doernberg concludes, if domestic integration reduces by one level of tax the overall tax on U.S. source corporate sector income, it may very well make good sense to reduce the tax on foreign source corporate sector income by one level of tax as well.³⁵⁵ I join him in this recommendation.

XXVI.

CONCLUSION

Integration in the United States would be desirable. Research and studies have shown that the theoretically optimal method of taxing corporate-sector

346. *Id.* at 541.

347. *Id.*

348. *Id.* at 542.

349. *Id.*

350. *Id.* at 541-43.

351. *Id.* at 541.

352. *Id.*

353. *Id.*

354. *See id.*

355. *Id.*

earnings would be to tax them on a pass-through, partnership or Subchapter S approach.³⁵⁶ Under these approaches, the earnings would be taxed once to the shareholders of the corporation at their rates and according to their individual tax positions. The tax would be imposed at the time the earnings were received or accrued by the corporation. However, there are important practical and administrative problems with this approach when applied to widely-held corporations, and those problems have not yet been fully solved.³⁵⁷

Until and unless the pass-through or Subchapter S approach to integration can be made available to widely-held corporations, the method of integration that would most nearly approximate this optimal form would be the shareholder imputation credit method, as exemplified by the American Law Institute Reporter's Study in the United States in 1992.³⁵⁸ It has many advantages over the dividend exclusion prototype or the comprehensive business income tax prototype recommended by the U.S. Treasury Department in 1992. The advantages of the shareholder imputation credit method over a dividend exclusion approach include its fairness and consistency with the fundamental values of the individual income tax system in the United States, its ability to function even if significant changes in rates or rate relationships are made in the future, its flexibility for purposes of denying or granting the benefits of integration to foreign shareholders, its logic and political acceptability, its relative similarity to the integration systems in effect in many other industrialized countries, and with respect to foreign income taxes paid by American corporations, its retention of a tax at the corporate level and the shareholder level for purposes of regulatory, countercyclical and revenue purposes. The United States should not adopt the prototypes recommended by the U.S. Treasury Department, but should prefer the shareholder imputation credit model.

If complete integration along the lines of Subchapter S or partial integration by means of the shareholder imputation credit approach, or any other means, should prove impossible or unacceptable, the United States should retain the classical, unintegrated system but should make some efforts to relieve the amount of overtaxation of corporate sector income and possibly the differential in taxation of corporate earnings distributed as dividends and as interest. Possible rate reductions, at the corporate or shareholder level, possible partial credits for a portion of dividends received, a reduction in the level of tax (perhaps by a partial deduction for dividends), while keeping the tax rate relationships in focus, or some limitation on the deductibility of interest, might offer some possible methods of obtaining some of the benefits of double tax relief, without going as far as partial or complete integration of the corporate and individual income taxes.

356. See McLURE, *supra* note 42, at 20; TREASURY BLUEPRINTS, *supra* note 43, at 68-75; McNulty, *Integrating?*, *supra* note 43, at 667-69.

357. See TREASURY REPORT, *supra* note 1, at 27-37.

358. In 1993, the Tax Division of the American Institute of Certified Public Accountants also recommended corporate income tax integration by a shareholder imputation credit method, in part for reasons related to financial reporting. A.I.C.P.A. REPORT, *supra* note 1, at 66.

If and when the United States adopts some form of integration or dividend relief, it will be doing so in an international context in which it should extend its domestic integration benefits to foreign income taxes and to foreign shareholders, preferably unilaterally (by statute), as it has done with the foreign tax credit, for reasons of international comity and leadership, economic neutrality, and to induce and encourage other countries to follow this modern, selfless approach.

APPENDIX A

The Federal Income Tax, codified in the Internal Revenue code,³⁵⁹ is a creature of statute enacted under the power granted to Congress in Article I, Section 8, Clause 1 of the U.S. Constitution “[t]o lay and collect Taxes, Duties, Imposts and Excises” with the qualification that “all Duties, Imposts and Excises shall be uniform throughout the United States.” Uniformity, simply stated, means charging the same rates everywhere within the territorial limits of the United States. It does not require that each person bear the same tax burden, only that the citizens of one part of the country not be subjected to higher rates than those in another part. For this reason it is often characterized as a requirement of “geographic” rather than “intrinsic” uniformity.³⁶⁰ The uniformity requirement was inserted by the framers of the constitution to allay any fears that a majority of the states would conspire to inflict harsh taxes on the minority.³⁶¹

Another limitation upon the congressional power to tax is set out in Article I, Section 2, Clause 3: “Representation and direct taxes shall be apportioned among the several states according to their respective numbers,” counting a slave as 3/5 of a free man. This section was amended by Section 2 of the 14th amendment to “count the whole number of persons.” It could be argued that this amendment removed the apportionment requirement. However, Article I, Section 9, Clause 4 was left standing. The apportionment requirement is recapitulated in Article I, Section 9, Clause 4, which says that “[n]o capitation or other direct, Tax shall be laid, unless in Proportion to the census or Enumeration hereinbefore directed to be taken.” Like many provisions of the U.S. Constitution, this restriction had its genesis in a compromise between the Northern and Southern states. The constitutional convention was deadlocked over the issue of representation in the lower house of Congress: should slaves be counted in determining representation? Gouverneur Morris offered a solution to the problem. If slaves were counted as 3/5 in determining both representation and taxation, then the southern states would bear a lesser tax burden while gaining in representation.³⁶² The solution was accepted. Publius (James Madison) alluded to this rationale in Federalist No. 54 when he rhetorically asked “Could it be reasonably expected that the southern states would concur in a system which considered their slaves in some degree as men, when burdens were to be imposed, but refused to consider them in the same light when advantages were to be conferred?”³⁶³

Modern students of taxation are justifiably puzzled over the meaning of “direct tax” and “apportionment” and the restrictions such concepts imposed on the institution of an income tax. The distinction between direct and indirect

359. 26 U.S.C.A. §§ 1-8023.

360. See Knowlton v. Moore, 178 U.S. 41, 104 (1900).

361. See E.R.A. SELIGMAN, THE INCOME TAX 547 (1911).

362. See MAX FARRAND, 1 THE RECORDS OF THE FEDERAL CONVENTION OF 1787 591-97 (1911).

363. See J.E. COOKE, THE FEDERALIST 368 (1961).

taxes originated in the writings of 18th century political economists such as Adam Smith and Turgot. However, these writers were not in agreement on the meaning of the terms, probably due to the different systems of taxation employed in England and the European continent. Their confusion seems to have afflicted the delegates to the constitutional convention. James Madison's Notes on the convention show the following entry: "Mr. King asked what was the precise meaning of direct taxation. No one answered." Professor Seligman, in a survey of the ratification proceedings of the state legislatures, found no less than five different meanings in use.

In the first place . . . it is used to signify a tax on the states. Secondly, it is employed to mean only a land tax. Thirdly, it is used to signify a land and poll tax. Fourthly, it is employed to mean a poll tax, together with a general assessment on property. In the fifth place it is used in the sense of a tax on land, together with the specific articles of personal property.³⁶⁴

When attempting to ascertain whether an income tax was considered within the scope of these various definitions it is helpful to remember that a tax on income was not in use in either England or the United States at this time. Furthermore, it is interesting to note that by the end of the 19th century the definition of direct taxation used by political economists had diverged from that adhered to by the courts. The esteemed Henry Campbell Black, author of Black's Law Dictionary as well as treatises on taxation, noted that political economists referred to direct taxes as those levied on the person who would pay, while indirect taxes were levied on persons who would indemnify themselves from others (by passing along the burden, or "shifting" the tax).³⁶⁵

Faced with this definitional ambiguity, the Supreme Court was left to decide upon a legal meaning for direct taxation. *Hylton v. United States*,³⁶⁶ the first case to test the constitutionality of a Federal tax, concerned a tax on carriages. The Court unanimously held that the tax was not a direct tax, but only Justice Patterson would conclusively rule that direct taxes were confined to capitation taxes (a tax on persons regardless of income, wealth, etc.) and taxes laid on land. In *Springer v. United States*,³⁶⁷ the Court tested a general tax on incomes against the constitutional limitations and upheld the tax. "Our conclusions are, that direct taxes . . . are only capitation taxes . . . and taxes on real estate."³⁶⁸ Nevertheless, in the landmark case of *Pollock v. Farmers' Loan and Trust Co.*,³⁶⁹ the court expanded its definition and struck down the Income Tax of 1894 on the grounds that direct taxes included taxes on income from real estate and certain personal property. Since Congress had failed to apportion the tax, it was held unconstitutional.

364. SELIGMAN, *supra* note 361, at 566.

365. H.C. BLACK, *HANDBOOK OF AMERICAN CONSTITUTIONAL LAW* 209 (1910).

366. 3 U.S. (3 Dall.) 171 (1796).

367. 102 U.S. 586 (1880).

368. *Id.* at 602.

369. 158 U.S. 501, 557 (1895).

Precisely how were direct taxes to be apportioned? Early drafts of the clause indicate that direct taxes and population would be separate components in a formula to determine representation in an effort to link wealth to political power.³⁷⁰ The final version, however, rejected this formula and clearly based representation and taxation directly upon population, a method conceded by Publius to be in no case a precise measure of wealth.³⁷¹ Mr. Justice Story offered an explanation of the accepted formula for apportionment that seems most plausible. Assume that state X and state Y each has 10% of the membership of the House of Representatives. Congress decides to raise \$100,000 by a tax on carriages, as in the *Hylton* case. The tax must be apportioned so as to raise \$10,000 from both state X and state Y since each has 10% of the representation, a figure that should correspond to its percentage of the total population. Since population bears no necessary relationship to wealth there is a probability of inequity in the application of the tax. If there are 1,000 carriages in state X and 5,000 in state Y, the carriage owners in state X will pay five times the per unit tax as the carriage owners in state Y.³⁷² Moreover, it could not be argued that the uniformity requirement imposed on duties, imposts and excises superseded the apportionment requirement, since the court in *Pollock*³⁷³ categorized them as indirect taxes. In fact, after *Pollock* the Court characterized the estate tax³⁷⁴ and a corporate income tax³⁷⁵ as excise taxes to save them from the apportionment requirement.

It is obvious that the apportionment requirement destroys both the utility and equity of an income tax. A tax on incomes is, in a way, a tax on wealth. If it is apportioned by population the citizens in a state with lower average incomes will pay a greater percentage of that income in tax than the citizens of a state with higher average incomes, in much the same way the citizens in the state with fewer carriages paid a greater per unit tax. This is contrary to the desired result of a modern income tax. In addition, the notion of predetermining the amount of revenue to be raised runs counter to contemporary notions of income taxation as a policy tool as well as a source of revenue.

After *Pollock*, proponents of an income tax felt the necessity of clearing constitutional barriers by amendment. The result was the Sixteenth Amendment, which states that "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to census or enumeration." It should be noted that this amendment leaves intact the requirement that Federal capitation and

370. See FARRAND, *supra* note 362, at 593-94.

371. See COOKE, *supra* note 363, at 366.

372. JOSEPH STORY, 1 COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 682 (Thomas M. Cooley, ed., 1973); see also the opinion of Mr. Justice Chase in *Hylton v. United States*, 3 U.S. (3 Dall.) 171, 174 (1796); see generally EDWARD S. CORWIN, NORMAN J. SMALL AND LESTER S. JAYSON, CONSTITUTION OF THE UNITED STATES: ANALYSIS AND INTERPRETATION (1964).

373. See *supra* note 369.

374. *Knowlton v. Moore*, 178 U.S. 41 (1900).

375. *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

property taxes must be apportioned by population. The amendment was ratified in February, 1913, and was followed shortly thereafter by the enactment of the precursor to the present income tax law, in October, 1913.

APPENDIX B

The following examples (using the 1994 top individual rate of 39.6%) illustrate the variety of income tax burdens and rates that apply to U.S. shareholders and *other investors* and demonstrate the possibilities for over-taxation of earnings distributed as dividends, as compared to earnings retained or distributed as deductible interest or in redemption of shares.

Examples of Tax Burdens

Example #1: *Partnership or proprietorship.* After the Omnibus Budget Reconciliation Act of 1993, the federal income tax on U.S. source income earned by a top tax-rate partner (owner) in a partnership, a proprietor of an unincorporated business enterprise, or a shareholder (owner) of an electing S Corporation:

—\$100 income, if taxed at top rate for a married or unmarried individual of 39.6%,³⁷⁶ tax = \$39.60;

#1 Total Tax: \$39.60

Example #2: *Distribution of Dividends.* A "C Corporation" distributes dividends to its shareholders. Assuming the top corporate tax rate on income earned by a regular (non-electing) C Corporation, the total corporate and individual federal income tax burden:

—\$100 income, if taxed at top corporate rate of 35%,³⁷⁷ tax = \$35.00;

—if after-tax income (\$65) is distributed by the corporation as an ordinary dividend to shareholder(s), taxed at top individual rate of 39.6%, tax = \$65 X 39.6% = \$25.74;

—total of corporate and individual taxes on distributed corporate profits originating as \$100 of corporate revenue = \$60.74;

—total tax rate (tax as a percentage of corporate taxable income) = 60.74%

#2 Total Tax: \$60.74

Example #3: "*C Corporation*" pays interest to investors. What is the federal income tax burden on corporate earnings distributed as *interest* to corporate shareholders?

—\$100 corporate taxable earnings produces gross income of \$100; payment of \$100 interest to a creditor (who may also be a shareholder) produces a \$100 deduction; consequently there is no taxable income, and the tax burden on the corporation is zero;

—tax burden on shareholder (total tax burden) at top rate of 39.6% = \$39.60

#3 Total Tax: \$39.60

376. I.R.C. § 1(a), (c).

377. I.R.C. § 11(b).

Example #4: Long-term capital gains on sale or redemption of shares. The total federal income tax burden and the income tax rate if the corporation retains its profits and the shareholder sells his shares for their fair market value ("FMV"):

- \$100 corporate income if taxed at top corporate rate of 35%, tax = \$35.00;
- shareholder's cost basis in his shares is \$100 (e.g. if purchased for \$100 before earnings by corporation);
- there is no basis adjustment for the income earned or retained, or tax paid, by the corporation;
- sale for FMV after earnings of \$100 by corporation and payment of corporate income tax of \$35; \$165 (FMV) - \$100 (basis) = \$65 taxable gain;
- shareholder's capital gain of \$65, if it qualifies as long term-capital gain, taxed at a rate of 28%,³⁷⁸ tax = \$18.20;
- total of corporate tax on income and shareholder tax on gain = \$53.20;
- total tax rate (as a percentage of corporate taxable income) = 53.2%

#4 Total Tax: \$53.20

Example #5: Fresh-start basis at death. The income tax rate and burden if the corporation retains its profits, the shareholder holds his shares until death, and the person who inherits the shares immediately sells them at FMV:

- \$100 corporate taxable income if taxed at top rate of 35%, tax = \$35.00;
- shareholder's heir sells shares for \$165 immediately after shareholder's death; seller has a new basis of \$165 (if that is the FMV) by virtue of I.R.C. § 1014;
- no gain on sale by heir of deceased shareholder because heir receives a new (fresh-start) basis in the shares equal to their fair market value at death, tax = \$0;

#5 Total Tax: \$35.00

Example #6: Intercorporate dividends. The corporate and individual tax burdens on income (1) earned by a subsidiary corporation and distributed to its parent corporation, and (2) earned by the parent corporation and distributed to its individual shareholders:

- \$100 income earned by subsidiary taxed at the top rate of 35%, tax = \$35.00;
- \$65 available for distribution;
- \$65 distributed by subsidiary to parent; tax to parent corporation on \$65 dividend from subsidiary:
 - a) if parent owns 80% to 100% of stock of subsidiary corporation, the dividends are not taxable,³⁷⁹ tax = \$0;

#6(a) Total Tax: \$35.00

378. I.R.C. § 1(h).

379. I.R.C. §§ 243(a), (b), 1504.

b) if the parent owns 20% to 79% of the subsidiary, taxed on 20% of the \$65 dividend ($\$65 \times 20\% = \13); \$13 if taxed at the top corporate rate of 35%, tax = \$4.55

#6(b) Total Tax: \$39.55

c) if the parent owns less than 20% of the subsidiary, taxed on 30% of the \$65 dividend ($\$65 \times 30\% = \19.50); \$19.50 if taxed at the top corporate rate of 35%, tax = \$6.83

#6(c) Total Tax: \$41.83

#6 Total Tax (range): \$35.00 to \$41.83

Example #7: *Tax-exempt shareholders.* The total federal income tax burden if the shares are held by a tax-exempt shareholder, such as a qualified charitable organization, university or art museum:

—\$100 corporate taxable income taxed at top corporate rate of 35%, tax = \$35.00;

—shareholder tax on dividend = \$0

#7 Total Tax: \$35.00

Example #8: *Foreign shareholders.* The income tax burden if the shares are held by a foreign shareholder (a non-resident alien individual or a foreign corporation) engaged in a trade or business in the United States:

—corporate income tax on \$100 taxable income at 35% (top) rate, tax = \$35.00;

—corporation pays \$65 dividend;

—withholding tax on gross amount of dividend (\$65) at 30% under I.R.C. § 871 or § 881, tax = $\$65 \times 30\% = \19.50 ;

#8 Total (U.S.) Tax: \$54.50

In addition, there may be a foreign tax imposed by the shareholder's country of residence, against which a *direct* foreign tax credit may be given by the residence country for the U.S. withholding tax paid (on the dividend) and an *indirect* foreign tax credit for the U.S. corporate income tax paid on the taxable income of the corporation.

These examples, using top rate-bracket taxpayers, show several important tax consequences of the classical, unintegrated taxation of corporate source income. Example Number 2 reveals how much higher are the combined federal income tax burdens of a corporation and its shareholders (\$60.74) on distributed corporate earnings than the burden on a Subchapter S shareholder (\$39.60) as in Example Number 1. Example Number 3 shows how much lower is the tax on corporate earnings that are distributed as (deductible) interest to an investor (lender) in the corporation (\$39.60). Retained corporate earnings, meanwhile, are subjected to a tax at only 35%.

Example Number 4 reveals how the tax on distributed corporate earnings can be reduced from \$60.74 to \$53.20 if the distribution is made in such a way as to qualify the recipient for the special (28%) capital gain rate of taxation. Example Number 5 shows how the total burden is much lower (\$35) if the

shares are held until death and then redeemed by the corporation; the second (shareholder) level of tax is completely eliminated. Much the same result and burden follow if the shareholder is a tax-exempt institution (or individual) as in Example Number 7. Example Number 6 shows how relief from a *triple* tax is provided if corporate earnings are distributed to a corporate-parent shareholder. To this example could be added the tax that would apply to an individual shareholder upon receipt of the after-tax earnings of \$58.18 by an individual shareholder of the parent corporation. If the applicable tax rate were 39.6%, the shareholder tax would amount to \$23.04 which, when added to the supposed two corporate-level taxes of \$41.83, would equal \$64.87, or a combined tax rate of nearly 65% compared to the partner's 39.6%.

As the examples show, the U.S. has a top individual tax rate of 39.6% and that rate applies, as the total tax burden, to business earnings distributed to a proprietor, partner or Subchapter S shareholder (Ex. 1) or to an individual lender to a corporation (Ex. 3). In contrast, the rate of tax rises to 60.7% if the business or enterprise is incorporated (Ex. 2). That total can be reduced to a rate of 53.2% if earnings are retained and a capital gains distribution can be managed. If shares are held until death (Ex. 5), or if the shareholders are tax-exempt (Ex. 7), the corporate tax (35%) is the only one that applies.

If multiple corporate layers are involved, the combined rate on distributed earnings can go still higher, to 68.3%. Foreign shareholders bear an intermediate combined rate of 54.5%.

APPENDIX C

The issue of the incidence of the corporate income tax is pervasive. The question of who bears the tax, or who suffers what economic consequences of imposing, raising or lowering the rates of the tax, seems important for general policy-making decisions about tax rates and whether to retain the separate tax. In imposing the tax, are the legislators trying to tax corporations, shareholders, managers, employees, consumers, or holders of capital throughout the nation or the world? They probably think they are taxing corporations, but whether that is true and just what it means is a difficult matter.

More specifically, the argument for integration and against a separate corporate income tax rests often, and at least in part, on an argument of "double taxation," or an argument that there is an *overtaxation* of the income of corporations and sectors of the economy in which corporations predominate because there is no relief from the combination of tax at the corporate level and upon dividend distributions (or perhaps upon sales of shares whose values have increased because of retained corporate earnings). If the corporate income tax in fact is borne by labor, because it is shifted backward by corporations, or by customers, because it is shifted forward by corporations, or in some part by these other constituents in addition to shareholders or owners of capital, policy-makers may think the corporate income tax not to be such a good idea (or some of them may like it even more).

If the tax is entirely shifted forward, backward or sideways, it might seem that the argument for integration would disappear entirely. That is not necessarily so, for reasons that become apparent.

Whether true double taxation of (distributed) corporate income exists at all depends on whether the corporation or some other person actually pays or bears the burden of the corporation income tax. Many answers have been suggested in response to the question "Who pays the corporate income tax?" The potential payers are obvious. Either the corporation pays the tax itself, and its owners/shareholders lose money, or the burden of the tax is shifted. It may be shifted to the employees of the corporation or to its customers or in other ways to all holders of capital in the economy.

Traditional economic analysis concludes that no shifting occurs in the short run. Presumably, a rationally managed corporation will operate to maximize profits in an economy with no corporate income tax. At such a production level, the cost of producing an additional item (marginal cost) will just equal the additional revenue gained from selling that item (marginal revenue). The enactment of the tax should have no effect on the output of the already profit-maximizing firm. At each level of output, the amount of profit will be reduced by the same percentage, the corporate tax rate. Therefore the output point of maximum profit will remain the same after the tax is imposed. To increase production would mean increasing marginal costs past marginal revenue, regardless of the tax. To decrease production would mean reducing profits, again regardless of the tax's effects. Furthermore, any pricing change (movement along the demand curve) would also presumably decrease profits. Therefore, the introduction of a corporate income tax will produce no change in production or pricing. In the short run, the corporation itself, and thus its shareholders, will bear the burden of any corporate income tax — according to the traditional analysis.

One school of thought, personified by Harberger, essentially agrees with this approach.³⁸⁰ He asserts that there will be an absorption of the tax by the capital investors in the now-taxed corporate sector or, at least, in its equity-financed portion.

In the longer run, Harberger's analysis continues, the necessary result of the imposition of a corporate income tax will be to shift capital away from the corporate sector, at least from the equity-intense corporate area. His view focuses on the rate of return to capital as the parameter by which to measure the effect of the incidence of a new corporate tax. Accordingly, Harberger contends that the elasticity of supply factors, that is, the substitutability of labor for capital, will heavily influence the future production in a newly-taxed field. Harberger's analysis implies an inefficient and artificial reallocation of resource capital from highly productive (efficient) investment to less productive (inefficient) investment. The result is an underallocation of investment in corporate equities and a loss in efficient production.

380. See Arnold Harberger, *The Incidence of the Corporate Income Tax*, 70 J. POL. ECON. 215 (1962).

Another school, represented by Krzyzaniak and Musgrave, disagrees.³⁸¹ Beginning with the same traditional economic analytical framework, Krzyzaniak and Musgrave take a different path at the fork. They conclude that there is a short-run shifting of the burden of a corporate tax—to consumers. First, Krzyzaniak and Musgrave feel that many corporate enterprises do not presently maximize profits, whether to deter competition by not appearing overly prosperous or out of satisfaction with an already healthy rate of return. Those firms desiring to maintain their previous profits will, after the imposition of a tax, more actively engage in profit maximization than before. Once satisfied with their pricing because their rate of return was sufficient, such firms may find themselves needing more income for the same rate of return. Thus prices will rise. Furthermore, those firms that had not been exercising all the market muscle they had, those with monopolistic or oligopolistic control, will exercise more of their market power to raise prices. Additional firms may be able to raise prices due to imperfect competition. Pricing, formerly regarded as optimal, may be reexamined; Krzyzaniak and Musgrave put stress on practical exceptions to the general rules of neo-classic economic *analysis*.

Goode sides with Harberger and adds to his analysis the contention that all prices will rise as a result of the corporate tax. The prices in taxed areas will rise, if a rate of return is to be maintained, and prices in non-taxed areas will rise as a result of the inflationary tendencies brought about by the price increases in the taxed areas.³⁸²

That corporations and capital investors bear some of the brunt of the tax burden seems likely; that consumers bear part of it also seems probable. Labor also may not escape unscratched. Frequently, labor union contracts are tied to, or at least affected by, after-tax profits. If these are decreased by a corporate income tax, labor may carry some of the tax burden as well.

This incidence question has troubled many economists, even after the meaning of the term "burden" in the question has been determined (no easy task).³⁸³

381. See, e.g., MARIAN KRZYZANIAK & RICHARD A. MUSGRAVE, *SHIFTING OF THE CORPORATION INCOME TAX, AN EMPIRICAL STUDY OF ITS SHORT RUN EFFECT UPON THE RATE OF RETURN* (1963).

382. Richard Goode, *Who Bears the Corporation Income Tax?*, 1964-65 U. CHI. L. REV. 410.

383. On this issue of burden or incidence, see Klein, *supra* note 63, or for a major analysis and synthesis of some of the literature, see BALLENTINE, *supra* note 44; see also Pechman, *supra* note 2, at 141-46, 409-10.