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INTERNATIONAL ASPECTS OF PROPOSALS FOR
CORPORATE INCOME TAX REFORM IN THE UNITED STATES :
INTEGRATION OF THE CORPORATE AND INDIVIDUAL INCOME TAXES

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International Aspects of Corporate Tax Reform in the United States

Background: domestic integration.

At present, the United States uses the “classical” method of taxing corporate sector income and investors in the corporate sector, in the domestic context. A corporation is subject to corporate income tax on its earnings (at rates up to 35%).¹ When those earnings are distributed as dividends, or in dividend-like distributions, to the shareholders of the corporation, the dividend income is taxable again to the shareholders (at statutory rates up to 39.6%),² without any relief arising from the fact that the earnings out of which the dividend has been paid were earlier taxed to the corporation, and the fact that a tax has been paid by the corporation. This produces what is often called the “double taxation” or, perhaps a better term, the “overtaxation” of distributed corporate sector income.

In contrast to this system for publicly-held corporations, the United States has a pass-through or allocation system for proprietorships, partnerships and for those closely-held corporations that elect to be taxed under Subchapter S of the Internal Revenue Code.³ For these businesses, the ordinary income of the business is not taxable to the business as a separate entity, but the income is taxable to the owners (partners or shareholders) when earned by the business, whether or not distributed to them at that time. The immediate taxability of the investors on the earnings of the business entitles the investors to increase their income tax bases (“cost”) in their shares or partnership interests. As a consequence, later actual distributions of cash or property are not taxable to the investors, up to the amount of income tax basis that each has in his, hers or its shares. Thus there is a single tax imposed on the business earnings of these organizations, at the time the earnings are received or accrued by the business, to the shareholders or partners, at their rates and according to the individual tax filing status of each.

¹See U.S. Internal Revenue Code of 1986 (hereafter I.R.C.) §11.

²See I.R.C. §1, §61(a).

³See I.R.C. §§701-761 (Subchapter K, for partnerships); §§1361-1379 (Subchapter S for electing closely-held corporations).

In the case of both the ordinary, publicly-held or "C" Corporation, and the partnership or electing S Corporation, or the sole proprietorship, earnings of the business that are paid out as interest to creditors, who have lent funds to the business, are generally deductible at the business level.⁴ As a consequence, in the case of the C Corporation, the earnings that are paid out as interest, being deductible, are not taxed at the corporate level and are taxed once, according to the tax rates and filing status of the creditor (individual investor), who may be a person who is also a shareholder in the enterprise, or who may be an independent creditor. Thus the rate of tax on business earnings distributed as interest will usually be lower than the rate of tax on business earnings distributed as dividends, which creates a tax bias in favor of capitalization by debt rather than by equity in the usual corporation.

The double taxation or overtaxation of corporation earnings also leads to a frequent preference for the partnership or S Corporation form of business organization, a preference created by the tax law. It may also lead to a tendency on the part of corporations to refrain from distributing their after-tax earnings, in order to delay or avoid the second income tax, the tax imposed on the shareholders who receive dividends. Overall the higher taxation of corporate earnings distributed to shareholders probably produces a diminished investment in the corporate sector of the economy, and a welfare loss for the economy as a whole.⁵

It is the purpose of corporate tax integration proposals to reduce the double taxation or overtaxation of distributed corporate earnings, and sometimes to go so far (with complete integration proposals) as to tax corporate sector earnings to individuals at their individual income tax rates, just once, and without delay. With truly complete integration, this result

⁴See I.R.C. §163. But see the "interest stripping restrictions" in §163(j).

⁵See generally Arnold Harberger, The State of the Corporate Income Tax: Who Pays It? Should it be Repealed? in Walker and Bloomfield, New Directions in Federal Tax Policy for the 1980s, Ballinger Publishing Co, Chapter 8, p. 161 (1983); Emil Sunley, Corporate Integration: An Economic Perspective, 47 Tax L. Rev. 621 (1992).

would apply to retained as well as to distributed earnings, and would pass through losses as well as gains.

The United States has contemplated partial or complete integration proposals over the years, including proposals to provide a deduction (or split corporate tax rate) for dividends, or to exclude dividends from the individual shareholders' tax base, or to repeal the corporate income tax while leaving dividends taxable to shareholders, or to tax corporations on a partnership or Subchapter S passthrough model, or to use a shareholder imputation credit technique to treat the corporate income tax as merely a prepayment of the individual income tax, with a reconciliation to be achieved at the time actual distributions are actually made by the corporation. In 1992 and 1993, three important studies were published in the United States. They contain different and competing proposed models for integration of the corporate and individual income tax in the United States.

The U.S. Treasury Department January 1992 Report and December 1992 Legislative Recommendations.

The first study was the Report of the United States Treasury Department, issued in January of 1992.⁶ (This was followed by somewhat revised and more specific legislative recommendations published in December 1992.)⁷ The Treasury Department recommended a dividend exclusion approach for corporate tax integration, for adoption in the near term. In the longer term, it recommended adoption of a "comprehensive business income tax" (CBIT) which would apply a dividend exclusion approach to all businesses, including partnerships and closely-held corporations, and would also deny a corporate deduction for interest, but would exclude interest income from the gross income of recipients of such interest income.

⁶U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, issued January 6, 1992 ("Treasury Report").

⁷U.S. Treasury Department, *A Recommendation For Integration Of The Individual and Corporate Tax Systems*, December 1992, published in Bureau of National Affairs, *Daily Tax Report*, December 14, 1992, pp. G-11, L-7 through L-17.

The Treasury Department did not recommend a pure pass-through or allocation model or a dividend deduction or a split-rate system. More surprisingly, it also did not recommend a shareholder imputation tax credit approach.

The 1992 American Law Institute Reporter's Study.

In 1992, with final publication in 1993, the American Law Institute undertook and completed a "Reporter's Study", conducted by Prof. Alvin C. Warren of the Harvard Law School, in which a shareholder imputation tax credit method was recommended for the United States.⁸ This shareholder imputation tax credit model was developed extensively and brilliantly by the Reporter. It resembles in many respects the systems recently placed into effect in New Zealand and Australia. Under this system, the income tax on corporations would remain in effect in the United States, but corporate taxes paid would be credited to the account of shareholders when they received distributions out of previously-taxed corporate income. Consequently, the corporate income tax would act as a kind of withholding tax or advance payment of the ultimate tax liability owing on the corporate earnings. That liability could finally be determined only when the earnings were distributed to shareholders and when their individual tax rates and filing status could be employed in determining the ultimate tax obligation. The A.L.I. Reporter also recommended an interest withholding tax and lender credit, to parallel the dividend withholding tax and shareholder credit.

The question then becomes what international tax implications would follow from the adoption of either the Treasury or American Law Institute models of integration in the United States, or some other version of integration, and what did these studies have to say about the international tax implications of the particular model recommended by each.

⁸American Law Institute, *Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, by Alvin L. Warren, Jr., Reporter, March 31, 1993.

See also AICPA, *Integration of the Corporate and Shareholder Tax Systems (1993)*, by the Tax Division of the American Institute of Certified Public Accountants.

What are the international tax problems raised by domestic (U.S.) integration.

First, what is the underlying international fiscal problem arising from integration of the corporate tax. One way of stating the problem 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), unless special international provisions were made. Similarly, unless such provisions were made, the integration system might tend to discourage investment in the United States by foreign investors, particularly 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 foreign investment by Americans, and investment in the United States by foreign persons.⁹

The purpose of integrating the corporate and shareholder income taxes 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 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.

⁹See Wrappe, Stephen C., 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).

The two problems: foreign shareholders and foreign corporate income taxes.

This means that 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. 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. 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. 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 of some kind.

One of the purposes of the international tax system of the United States is to remove obstacles to the international flow of capital, whether from the United States to foreign countries, or from foreign countries to the United States. Doing so, either by the foreign tax credit of the Internal Revenue Code,¹⁰ or 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

¹⁰I.R.C. §§901, 902.

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.¹¹ 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.

As stated above, the basic model of the integration system works automatically only when both the tax at the shareholder level and at the corporate level are paid to the same country, the United States in the present context. 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, suppose a U.S. corporation pays a dividend to a shareholder who is a resident of Country X. Unless there is a treaty provision to that effect, after integration the United States will not refund or credit any part of the corporate income tax paid in the United States. Likewise, the residence Country (X) will probably not give any kind of credit against its shareholder's tax for the corporate tax paid in the United States. Nor, if it uses the exemption system, is it likely to exempt the dividend in the hands of the shareholder. Therefore, a shareholder residing in foreign country (X) who receives a dividend from the U.S. corporation will not obtain any integration relief. As a consequence, he may be disinclined to make the investment, or inclined to withdraw the investment, in the United States.

¹¹See Hugh Ault, International Issues in Corporate Tax Integration, 10 Law & Policy In International Business 461 (1978).

To take the second aspect of the problem, the treatment of foreign taxes, imagine that a United States corporation has a subsidiary that resides in foreign Country Y. Suppose that the foreign subsidiary earns \$100 and pays a corporate income tax to Country Y of \$35. Suppose also that the U.S. corporate parent also earns \$100 in the United States and pays a U.S. corporate income tax of \$35. If the foreign subsidiary pays a dividend of \$65 to the U.S. parent, the United States will allow an indirect foreign tax credit for the foreign corporation tax (Country Y tax) paid by the subsidiary and therefore the U.S. parent will not have to pay any additional U.S. tax, upon receiving the dividend.

If the U.S. parent pays a dividend of \$65 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, or pay no tax on the dividend if a dividend exclusion method were in effect.

However, if the U.S. corporate parent pays not only that dividend but also an additional dividend of \$65, the system will 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, and a U.S. income tax would be imposed on the U.S. shareholders, with the result that international double taxation would have been relieved, but domestic double taxation would exist. 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 a basis for excluding a dividend paid out of earnings subjected to that tax, under a dividend exclusion approach. [This example is borrowed from Tillinghast, op. cit. n. 9, supra.]

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 that then had 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.¹²

U.S. Taxation of Multinational Corporate Sector Income Without Integration: The Case of a Korean 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, for example, the Republic of Korea 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 Korean shareholder's investment, that \$100 will be taxed to the U.S. corporation at rates up to 35%, in which case \$65 remains for distribution. If \$65 is distributed as a dividend, the income tax statute (I.R.C. §871) imposes a 30% withholding tax, a final tax on the gross amount of the dividend (\$65) paid to the nonresident alien (noncitizen) individual, so long as that person is not engaged in a trade or business in the U.S. (\$19.50). The R.O.K./U.S. international tax treaty reduces the rate of this tax to 15% or \$9.75 (See Article 12).

¹²See David Tillinghast, Corporate-Shareholder Integration As An Obstacle To The International Flow Of Equity Capital: A Proposal, *op. cit.* n.9 *supra* p. 1216 at notes 11 and 12.

If interest were paid by the U.S. corporation, 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, so there would be no tax at the corporate level and the §871 withholding tax would be imposed on the interest income and Article 13 of the treaty would reduce the rate to 12% (\$7.80).

[If the Korean investor were a Korean corporation, the same result would follow, with the withholding tax imposed by I.R.C. §881 (on a foreign corporation having U.S. source income not connected with a U.S. business. The Treaty (Article 12) would reduce the withholding tax to 15%, or possibly to 10%.]

What if a direct investment were made by a U.S. subsidiary of the Korean corporation, a U.S. corporation engaged in a trade or business in the U.S.? If so, the subsidiary would be taxable much as would any other U.S. corporation, at rates up to 35% on its taxable income. A dividend of \$65 paid by the U.S. subsidiary corporation to its shareholder(s) would be subject to the I.R.C. §871(a), §881(a), and §§1441-1442, 30% withholding tax, on dividends, reduced by Article 12 of the R.O.K./U.S. 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).

If a Korean corporation were to use a branch or permanent establishment in the U.S., rather than a U.S. subsidiary, it would face the U.S. corporate income tax, as above, at rates up to 35% and 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," unless and to the extent the treaty relieves the branch tax. This tax acts in place of the §871 and §881 dividend withholding tax and the §861(a)(2) second-level withholding tax.

So, if the U.S. investment yields \$100 before U.S. corporate income tax, and all after-tax profits were distributed as dividends, the U.S. would impose a dividend withholding

of 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").

If the United States were to adopt some form of integration of the U.S. corporate income tax and the U.S. income tax in 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 a Korean 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 could be received by a Korean 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 in 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, but only to those when the legislation directly specifies. Hence the question becomes whether the U.S. Treasury dividend exclusion method (or its C.B.I.T. variation) or the A.L.I. shareholder imputation credit model specifies that foreign shareholders would receive the dividend exclusion or imputation credit.

Likewise, if a U.S. corporation, or its U.S. or foreign subsidiary, or a U.S. individual shareholder receives foreign source income, for example in the Republic of Korea, and pays or is deemed to have paid creditable foreign income taxes, will 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 foreign taxes only by individual negotiated tax treaty agreements, and 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.

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. However, under the January 1992 dividend exclusion approach, foreign taxes would not be treated similarly to U.S. taxes for purposes of determining the Excludable Distributions Account (EDA).¹³ 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. So, for “outbound investment”, that is to say investment by U.S. persons outside the United States, the benefits of integration would not be extended and foreign taxes would not “frank the dividend” or entitle the corporation to pay a dividend excludable by the U.S. shareholders. The technical reason simply lies in the fact 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. That is to say the U.S. would keep the 30% statutory withholding rate on dividends and the branch profits tax on earnings from U.S. branches of foreign subsidiaries. The withholding tax could be reduced through the negotiation of tax treaties.¹⁴

¹³See Treasury Report, pp. 21-22, Jan. 1992.

¹⁴See John Turro, U.S. Treasury Department's Corporate Integration Study Addresses Inbound/Outbound Issues, Feb. 17, 1992 Tax Notes International 307.

In other words, this January 1992 U.S. Treasury model would not automatically extend the benefits either (a) to foreign taxes or (b) foreign shareholders. The reason for this result probably lies in the constraint that Treasury stated it 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 "foreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. government."

As to outbound investment by U.S. investors, The Treasury Report concluded that although a United States corporation might face higher tax on foreign source income than domestic source income, the foreign source income would not face double-taxation greater than under pre-existing law, and therefore that U.S. firms operating in foreign countries would not be confronted with any competitive disadvantage greater than that faced before integration. This seems an 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. In other words, substantial revenue might be lost by the U.S. without any necessary increase in the efficiency of 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. The report emphasizes that integration is supposed to benefit the corporate form of organization, but not the treasuries of foreign governments. Therefore, the U.S. report stresses that a

source country should not sacrifice its claim to this tax revenue for the sake of consistency.¹⁵

In the December 1992 U.S. Treasury Department legislative recommendations, no significant change was made in the treatment of foreign shareholders. See recommendation 21. In recommendation 21(a), the Treasury persisted in saying that integration benefits would not be extended to foreign shareholders by statute, and 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.) dividends would not increase the basis of foreign shareholders' stock, but would decrease the corporation's A.T.I. See Recommendation 21(b).

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. This reverses the position taken in the January 1992 Treasury Report as to foreign taxes.

To summarize, under the U.S. Treasury January 1992 Report dividend-exclusion prototype, foreign income that has not born 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.¹⁶ 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

¹⁵ See Turro, *op. cit. supra*, at 308-309.

¹⁶See Treasury Report, pp. 51-52, Jan. 1992. See Treasury Report at 107. See also Richard Doernberg, International Aspects of Individual and Corporate Tax Integration, for Tax Notes International 535 (March 16, 1992). But see the December, 1992 Treasury Legislative Recommendation.

1992 Treasury Report would (conditionally) treat foreign corporate income taxes as entitling shareholders to excludable dividends even without treaty agreement, so long as this treatment were reciprocated.

Under the comprehensive business tax prototype (CBIT), foreign income that has not born 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. 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.¹⁷ That adjustment was made to ensure that dividends and interest would be subject to the same, single level of U.S. tax.¹⁸

In the shareholder imputation credit method of integration that the Treasury Department analyzed but did not recommend, the system studied would deny the imputation credit to foreign shareholders and they would remain subject to the withholding tax on dividend distributions. 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.¹⁹

American Law Institute Reporter's Study.

The ALI Reporter's Study was somewhat parallel in its international aspects. In principle, foreign shareholders would be entitled to the equivalent of the imputation credit on the same basis as domestic shareholders. The dividend and the credit that went with it would, however, be subject to a new "foreign investors tax", as would corporate interest payments to foreign lenders, with the accompanying interest credit. This new foreign investors tax would also apply to corporate interest payments paid to foreign lenders. That

¹⁷See Turro, loc cit supra, p. 309.

¹⁸See Ault, Hugh, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax Law Review 565 at 580.

¹⁹ See Treasury Report at 95-106. See also Ault, op. cit. supra n. 18, at 581.

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. No additional withholding tax would be applied to dividends or interest paid to foreign shareholders or lenders.²⁰

Under the American Law Institute Reporter's Study, foreign corporation income taxes would be accepted in the domestic imputation system only by treaty. The study works out 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 ALI proposal, in order to avoid making individual shareholders apply those foreign tax credit limitations 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. And, the domestic imputation system would not apply to dividends received from foreign corporations.²¹

What should the United States do?

Ideally, from a theoretical and economic point of view, the United States (and all other countries) should extend full integration benefits to foreign shareholders and with respect to 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. 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

²⁰ See A.L.I. Report, supra note 8, at 169-203; Ault at 581.

²¹ See Ault, op. cit. supra at 581-582; Hugh Ault, International Issues in Corporate Tax Integration, 10 Law and Policy and International Business 461, 469 (1978). See also A.I.C.P.A. Report, supra note 8, at 21-23, 63-67.

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 attempts to achieve “capital-export neutrality” by contemplating that there will be taxation of international income in both the source (primary jurisdiction) and residence (secondary jurisdiction) countries, but by allowing a foreign tax credit for foreign taxes on income that is also taxable by the United States. 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.²² The U.S. believes in its foreign tax credit approach, although it uses an exemption or exclusion method in some instances, for certain kinds of income. The capital-export neutrality goal is designed to permit the optimal allocation of resources worldwide.

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. If all capital invested in the source country bears the same rate of tax as is born by domestic entities in the source country and no additional tax by virtue of the fact that foreign capital flows in from abroad, capital-import neutrality or competitive neutrality is reached.

Like many tax systems, the U.S. national and international 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

²² “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 residence country (so long as the tax rates in all the countries involved are the same).

United States usually arranges that the source country will either reduce its source country taxation considerably or give it up entirely. In turn, the residence country reserves the right to tax 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. 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, 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 credit for the source country tax. 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.²³

In order to produce or enhance capital-export neutrality and the worldwide efficient allocation of resources, the United States should extend the benefits of 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 is sometimes called “inter-nation equity” (by Professor Peggy

²³ See generally, Hugh Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax Law Review 565 (1992), at 574 and 566.

Musgrave).²⁴ 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 U.S. 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 others nations. To put it more abstractly, it might not only be that national self-interest would be impaired, but also that 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 U.S. 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 investors, but not direct investors, who are residents of the treaty partners.²⁵ If there is an imbalance in the flow of capital in this situation, that is to say if 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.²⁶

If both countries have integration systems, a situation that arises with some frequency in Europe, some countries have reciprocally extended the benefits of integration between the two countries. The United Kingdom and Finland have recently entered into a Protocol

²⁴ See Peggy B. Musgrave, *United States Taxation of Foreign Investment Income* (1969) at 130ff.

²⁵ See Tillinghast, *op. cit. supra* n.6 at 1217, note 15.

²⁶ See Tillinghast, *op. cit. supra* n.6 at 1217, note 16.

extending benefits to each others' portfolio investors and partial benefits to direct investors.²⁷ The Report of the Ruding Committee goes further and recommends the reciprocal extension of benefits for both portfolio and direct investment situations.²⁸ Under this proposal, the residence country bears the revenue cost. 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. In contrast, under the U.K./Finland protocol, it is the country of source that bears the cost. 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.

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 and 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 by the United States.²⁹

²⁷ See Tillinghast, op. cit. supra 1217 at note 17.

²⁸ See the Ruding Committee Report at 33-34.

²⁹ See John McNulty, Integrating the Corporate Income Tax?, 31 American Journal of Comparative Law 661 (1983).

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. That the Treasury Department Report was especially cautious about extending the benefits, except by international income tax treaties, is also understandable considering the source of the Report. 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 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, that 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 on a unilateral and statutory basis, without a requirement of the negotiation or renegotiation of tax treaties with every other country in the world. Let us hope this is not too idealistic a goal for which to strive.

This means that it would be desirable if, under the Treasury's dividend-exclusion prototype, 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.

Similarly, under the ALI 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. And, 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.

The international aspects of the proposals for integration in the United States have a great many dollars of potential revenue at stake, because the amount of transnational investment across United States borders is so great. 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. Foreign investors owned \$530 billion in direct investment in the United States and \$1.34 trillion in U.S. portfolio investment. 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. Foreign investors received \$1.8 billion from direct investments in the United States and \$78.5 billion from their U.S. portfolio investments.³⁰

Legitimacy of Denying Integration To Foreign Shareholders And Foreign Taxes

Professor Doernberg also concludes that 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 integration to non-resident shareholders. 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. He also concludes that the U.S. treaty commitments do not prevent differential treatment of this kind. 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. 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. He also concludes that international law does not compel the United States to extend the benefits of integration to foreign shareholders and foreign taxpayers. He does think that it would be wise strategic behavior

³⁰See Richard Doernberg, International Aspects of Individual and Corporate Tax Integration, March 16, 1992 Tax Notes International 537-538, citing Treasury Report at 73.

and good international relations for the U.S. to extend integration benefits in this way, as Australia does by statute.³¹

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. As he observes, corporate income earned in the United States is subject to two levels of tax in the U.S., while foreign source income is subject to only one level of tax, the shareholder level. 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 U.S. 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. It's also true that the administrative burden of implementing the foreign tax credit is substantial. Nevertheless, the Treasury does not conclude that the basic international foreign tax credit should be repealed. 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.³² I join him in this recommendation.

³¹See Doernberg, op.cit.supra at pp. 541-543.

³²See Doernberg, March 16, 1992 Tax Notes International 535 at 541.

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