# PART III: PRINCIPAL ISSUES

## INTRODUCTION

Each of the systems of corporate integration considered in this Report would move the U.S. tax system in the direction of more neutral taxation of capital income and, in so doing, reduce current tax-induced distortions in the allocation of capital. All the systems of corporate integration would substitute a single level of tax for the existing two level classical corporate tax system. The CBIT prototype also would eliminate tax distortions in the choice between corporate and noncorporate forms of business organizations by taxing all business income uniformly, at entity level tax rates.

Each of the systems of corporate tax integration is economically equivalent if income earned by corporations and individuals were taxed at the same tax rate, all income earned by corporations were treated the same, and all investors were taxed at the same tax rates.[1] But they are not.[2] The existence of differing tax rates among individuals and between corporations and individuals, tax preferences for a variety of kinds of income and deductions, domestic tax-exempt and foreign suppliers of capital, and foreign source income earned by U.S. corporations create significant differences among basic systems of integration. These circumstances also raise fundamental structural issues that must be addressed within the context of each of the integration systems. How these issues are resolved in an integrated corporate tax system significantly affects the choices among the basic integration alternatives and, ultimately, the efficacy of the method chosen in reducing or eliminating the distortions associated with the classical corporate tax system.

Transition rules also must be addressed in any integration proposal. The speed and administrative ease with which integration can be implemented, the degree of distortion experienced during the transition period, and the revenue impact of different rules may affect the feasibility and the desirability of different integration prototypes.

These issues raise important and controversial issues of tax policy apart from their effects in structuring an integrated corporate tax system. Current law reflects compromises among goals of economic efficiency, equity in taxation, and other political, social, or economic policy goals (including furthering, for example, specific categories of investment) as well as the coordination of taxation across international borders.

The appropriate connection between such policy considerations and the construction of an integrated corporate tax system is further complicated because the Internal Revenue Code to date has addressed questions concerning tax preferences, tax-exempt suppliers of corporate capital, international considerations, and tax rates only in the context of a classical corporate tax system, not within the structure of an integrated system. Indeed, in some cases, provisions of current law have been enacted, at least in part, to redress the burdens of the classical corporate tax. Therefore, the treatment of these specific issues under current law may or may not be the appropriate benchmark for resolving the issue under an integrated system. On the one hand, current law tax rules have had a major impact on economic decisions and have shaped a wide variety of existing financial arrangements; care must be exercised so unwarranted disruptions do not occur in moving to an integrated corporate tax system. On the other hand, the resolution of these issues may have considerable influence on the degree of success of an integrated corporate tax system in removing the distortions of the existing system. Our task, therefore, has been to approach these issues in a manner that advances this Report's fundamental objective—more neutral taxation of capital income—where practical, without demanding that a move from a classical to an integrated corporate tax system be accompanied by a comprehensive reevaluation of such fundamental issues as the treatment of tax preferences or international business transactions.

Although this part discusses these issues as discrete topics, they are often interrelated. For example, decisions regarding the use of tax preferences may affect decisions concerning the treatment of tax-exempt shareholders, and decisions concerning tax-exempt shareholders may influence policies regarding foreign investors.

# CHAPTER 5: TREATMENT OF TAX PREFERENCES

Under current law, the Code provides favorable treatment that is generally recognized as deviating from standard accounting rules for particular items of income or expense.[1] These tax preferences may take the form of exclusions of income or preferential rates for items of income, accelerated deductions or deferred income recognition rules or credits. Some preferences (like the exclusion for interest on certain state and local bonds) create a permanent reduction of tax liability. However, most corporate preferences (like accelerated depreciation) offer deferral of tax, rather than outright exemption.

Under current law, there are two mechanisms for restricting the use of business tax preferences: the earnings and profits rules and the corporate and individual minimum tax provisions. The earnings and profits rules define the pool of corporate earnings that is taxable as dividends (rather than as a return of basis or as capital gain) when distributed to shareholders. Earnings and profits are calculated to include most corporate tax preferences. Thus, income that is tax-preferred at the corporate level is generally subject to tax when it is distributed to noncorporate shareholders.[2] Thus, under current law, tax preferences may provide corporations with retainable, but not necessarily distributable, tax-preferred funds.

A strengthened minimum tax for both individuals and corporations was a central feature of the Tax Reform Act of 1986. Under current law, the alternative minimum tax (AMT) is payable only if the computation of the minimum tax produces a tax greater than the tax due under the regular computation. For individuals, the AMT is imposed at a 24 percent rate on an expanded tax base that includes most tax preference items. In the case of corporations, the AMT is imposed at a 20 percent rate on a tax base that includes a broad list of tax preference items. The corporate minimum tax serves to limit the capacity of tax preferences to reduce tax on retained, as well as distributed, earnings.

The expanded tax bases for the AMT and the relatively narrow rate differentials between the regular and minimum taxes make the minimum tax provisions of current law a powerful revenue source with widespread impact on the tax planning of both high-income individuals and corporations. If the corporate AMT were repealed, a significant increase in the corporate tax rate would be required to offset the revenue loss. The minimum tax provisions not only raise revenue directly but also serve to increase the regular income tax paid by individual and corporate taxpayers who limit their use of preferences to avoid being subject to the AMT.

In integrating the corporate and shareholder income tax systems, the fundamental question about tax preferences is the continuing role of limitations on corporate tax preferences. Some commentators have suggested that integration implies giving to shareholders tax reductions due to corporate level tax preferences.[3] They argue that if integration is to achieve tax neutrality between corporate and noncorporate investments, extending preferences to shareholders is appropriate. The cost of not extending to shareholders preferences that are available to noncorporate businesses is retaining a bias against the corporate form for any activities that are granted tax preferences. Such activities will tend to be performed by noncorporate firms. As discussed in Chapter 1, an economic loss results to the extent that such activities could be carried on by corporations at lower costs.[4]

With respect to deferral preferences, such as those permitting rapid depreciation or amortization of capital expenditures, some analysts regard distribution of the related income to shareholders as the appropriate occasion for ending tax deferral and view the earnings and profits provisions of current law as appropriately serving that function. Retaining the approach of current law and taxing preferences when distributed to shareholders would continue some disadvantages for distributed, as opposed to retained, earnings, but this could be mitigated by treating distributions as coming first from fully-taxed income. Where corporate tax preferences are intended to alleviate the classical system's double taxation of equity income, they serve no function in an integrated system and, at a minimum, should not be passed through to shareholders. Some analysts, for example, consider the reduced rate on the first $100,000 of corporate income as a tax preference intended to reduce the degree of double taxation for small corporations that decline to elect (or are ineligible for) S corporation status.

In addition, there are substantial revenue costs to extending corporate level preferences to shareholders just as there are in cutting back on the AMT.[5] The revenue cost of extending preferences to shareholders or limiting the impact of the AMT would increase the cost of corporate integration, require higher tax rates to produce equivalent revenues, and, in effect, increase the value of tax preferences relative to taxable income. Maintaining current law restrictions on tax preferences would reduce the need to raise tax rates and thus reduce the efficiency costs associated with such rate increases.[6] Hence, the issue of the proper treatment of preferences involves a comparison of these possible costs with the benefits provided by the preferences in an integrated world.

Finally, if a goal of integration is to tax corporate income once, corporate tax preferences should not be extended to shareholders. In an integrated system, extending preferences to shareholders may eliminate both the individual level and the corporate level tax. Foreign systems generally do not allow corporate preference income to be distributed tax-free to shareholders. Belgium, Canada, Denmark, and Japan are exceptions.[7]

Integration of the corporate and individual tax systems provides an opportunity to review both corporate and noncorporate tax preferences to determine whether they are justifiable in an integrated system, but such a comprehensive review of tax preferences is beyond the scope of this Report. This Report concludes, however, that, where practical, integration of the corporate tax should not become an occasion for expanding the scope of tax preferences. Neither equity nor economic efficiency would be enhanced by such an expansion.

In practice, this conclusion implies that in a distribution-related integration prototype, specific mechanisms must be devised to play a role similar to the earnings and profits provisions of current law to ensure that preferences are not extended to shareholders. Similarly, the role and function of both the corporate and individual AMT must be reexamined to prevent the extension of the scope of current tax preferences.

A simple dividend exclusion or shareholder imputation credit method of distribution-related integration will not produce the desired result with respect to preference income.[8] Integrated tax systems outside the United States that do not extend corporate tax preferences to shareholders have principally relied on either or a combination of two mechanisms.[9] The first is an imposition of corporate level tax on the distribution of preferences through a compensatory tax system.[10] The second is a tracing mechanism or overall limitation that restricts the amount of relief from tax at the shareholder level to actual corporate level taxes paid.[11] The limitation mechanism eliminates the benefit of preferences on distributed income by imposing tax at the shareholder rate on distributed preference income. The two methods can vary significantly when the shareholder tax rate differs from the corporate tax rate, and would, for example, impose very different tax burdens on distributions of corporate preference income to tax-exempt shareholders.[12]

The choice between the two mechanisms is a close one and a different alternative may be more appropriate depending on the method of integration adopted. In the distribution-related integration prototypes described in this Report, we have recommended limiting tax relief at the shareholder level to the amount of corporate taxes paid and imposing shareholder level tax on distributed preferences. Under the dividend exclusion prototype, this is accomplished by requiring corporations to keep an account limiting excludable dividends.[13] In CBIT, this mechanism also is possible; on the other hand, since all tax is paid at the entity level, a compensatory tax may have more appeal.[14] We conclude that it is not practical to attempt to retain the current law tax on distributed preference income under the shareholder allocation prototype.[15]

# CHAPTER 6: TAX-EXEMPT AND TAX-FAVORED INVESTORS

## 6.A INTRODUCTION

Current law defines many different types of tax-exempt entities (including pension funds, charities, hospitals, educational institutions and business leagues) and imposes various conditions in order for them to obtain or retain their tax-exempt status (including nondiscrimination rules, minimum payout requirements, limitations on maximum contributions and restrictions on investments). Tax exemption is generally limited to income received by the entity that is either passive in nature or substantially related to an exempt function.

Tax-exempt entities may be grouped into two general categories. One group, which includes pension funds, 401(k) plans, and similar plans (collectively, pension funds), is characterized by an exempt entity that holds claims to property on behalf of specific individuals, with the earnings of the fund untaxed as earned but taxed when distributed to the individuals. The second group, which includes charities, hospitals, educational and religious institutions, is characterized by investment income that does not inure to the benefit of any particular individuals.[1]

Tax exemption provides both groups with a higher after-tax rate of return on investment income than if the earnings were currently taxable. Retirees receive higher after-tax retirement income than if pension fund earnings were taxed currently or they had invested in taxable savings plans themselves, and charities and educational institutions can provide more services or activities than if the income on their assets were taxable. Despite the differences in the mechanics of taxing pension funds and other exempt entities, the present value benefit is the same. The pension fund tax exemption, employer deductibility of contributions to the fund and deferral of employee tax is equivalent to simply exempting from income tax the pension fund's investment income.[2]

The Code exempts these entities from income tax on all receipts other than net income from a business unrelated to the entity's exempt purpose. Such unrelated income, whether earned directly or through a partnership, is subject to the unrelated business income tax (UBIT), which generally is calculated under the regular corporate income tax rules.[3] The tax generally applies only if the business income is unrelated to the organization's exempt purpose. Thus, engaging in a particular activity might result in the imposition of UBIT on one type of exempt organization but not on another. The Federal Government and State and local governments or their instrumentalities (except colleges and universities) are exempt from all tax including UBIT. The Code explicitly excludes income from certain passive investments from UBIT, including dividends, interest, rent from real property, royalties, and gains from the sale of capital assets. Despite the general exclusion, passive income generally is subject to UBIT to the extent that it is financed with debt.

The tax-exempt sector plays a major role in U.S. capital markets, and in the corporate capital market in particular. At the end of 1990, pension funds and other exempt organizations held over one-quarter of total financial assets in the United States (Table 6.1). Holdings of the tax-exempt sector represented even larger fractions of corporate equity and corporate debt—approximately 37 percent of directly held corporate equity and 46 percent of outstanding corporate debt.

Pension funds dominate tax-exempt sector corporate investments, holding more than one-quarter of all directly held corporate stock and more than two-fifths of corporate bonds. Figure 6.1 illustrates the dramatic growth in the share of corporate debt and equity held by pension funds since the 1950s. As the share of corporate capital held by pension funds has grown, an increasing share of the associated corporate income has avoided the investor level tax.

**Table 6.1**
**Financial Assets of the Tax-Exempt Sector**
**End of Year 1990**

| | Total Credit Market Assets[1] | | Corporate Equity | | Corporate Debt[2] | |
|---|---|---|---|---|---|---|
| | (billions of dollars) | (percent) | (billions of dollars) | (percent) | (billions of dollars) | (percent) |
| Foreigners | 1,636 | 12 | 218 | 6 | 203 | 12 |
| Pension Funds[3] | 2,695 | 19 | 967 | 28 | 722 | 44 |
| IRAs & Keoghs[4] | 560 | 4 | 141 | 4 | 11 | 1 |
| Nonprofit Institutions[5] | 515 | 4 | 130 | 4 | 10 | 1 |
| Total Tax-Exempt Sector | 5,450 | 39 | 1,457 | 43 | 946 | 58 |
| Total All Sectors | 13,996 | 100 | 3,416 | 100 | 1,629 | 100 |

Department of the Treasury
Office of Tax Policy

[1]Total Credit Market Assets: total credit market debt owed by domestic nonfinancial sectors plus corporate equities (excluding mutual funds).

[2]Corporate Debt includes some foreign bonds. The total amount includes bonds held by the financial sector.

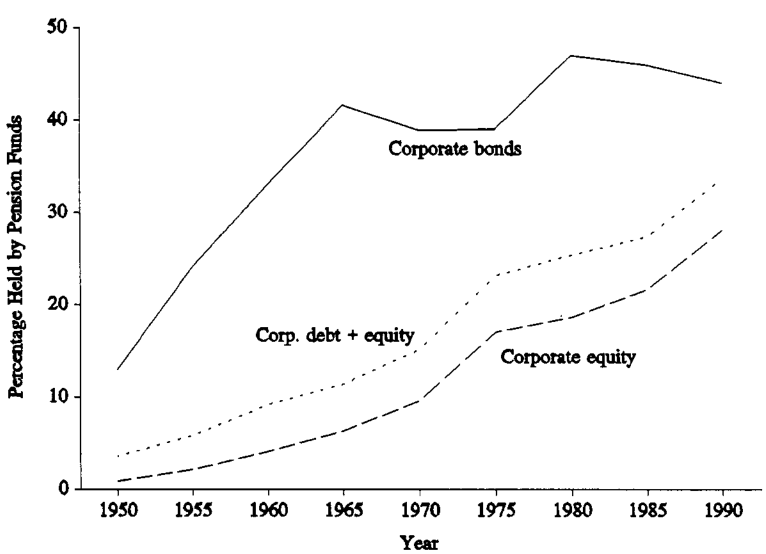
[3]Pension Funds include private pension funds (including Federal Employees Retirement Thrift Savings Fund), state and local government employee retirement funds, and pension fund reserves held by life insurance companies.

[4]Individual Retirement Accounts (IRAs) and Keogh accounts: figures estimated.

[5]Nonprofit institutions include charitable, educational, and similar institutions. Estimated as percent of household holdings in Flow of Funds.

Sources: Federal Reserve Board, Flow of Funds (March 1991 revised); Investment Company Institute, Mutual Fund Fact Book (1991), p. 60; and Office of Tax Policy calculations.

**Figure 6.1**
**Pension Fund Holdings of Corporate Capital, 1950-1990**




Sources: Hoffman (1989) and calculations based on Federal Reserve Board, Flow of Funds (March 1991 revised).

Under current law, tax-exempt investors, in fact, are not exempt from the corporate level tax on income from their corporate equity investments. Although dividends paid to tax-exempt shareholders are not taxed to the recipients, the earnings attributable to such investors are taxed at the corporate level whether or not distributed. By contrast, corporate earnings paid to tax-exempt investors as interest escape both the corporate level tax and the investor level tax.

The fundamental question addressed here is whether under an integrated tax system this treatment of corporate income of tax-exempt investors should continue, or, alternatively, whether tax-exempt investors should be subject to a tax increase or receive a tax reduction from integration. The current level of taxation of corporate equity income received by tax-exempt investors can be retained under integration as demonstrated in this Report. Integration does not necessarily require either an increase or a reduction in tax on income from capital supplied by tax-exempt entities to corporations.

On the other hand, corporate integration presents an opportunity to reexamine the incentives under current law for tax-exempt investors to prefer debt rather than equity investments in corporations. The specific question raised by corporate integration is whether the current distinction in the treatment of corporate equity investments by tax-exempt entities (which bear the corporate, but not the shareholder level tax) versus corporate debt investments (which bear neither corporate nor debtholder level tax) should be retained or decreased. An integration system best fulfills its goals if it provides uniform treatment of debt and equity investments by tax-exempt investors. Equating the tax treatment of debt and equity will require either an increase or decrease in the taxes on corporate capital supplied by tax-exempt investors or the introduction of a separate tax on investment income of these investors. As Section 6.D discusses, such a tax could be designed to maintain the current level of tax on income from corporate capital supplied by tax-exempt investors while equalizing the treatment of debt and equity.

## 6.B DISTORTIONS UNDER CURRENT LAW

Current law encourages tax-exempt investors, like taxable investors, to invest in debt rather than equity. Only two types of income from capital supplied to corporations by tax-exempt entities are actually tax-exempt. Interest paid by corporations is both deductible by the corporate payor and exempt from tax in the hands of the tax-exempt recipient. Corporate preference income distributed to tax-exempt shareholders also is exempt from tax at both the corporate and the shareholder level.[4] Non-preference income is taxed at the corporate level, but is not taxed at the shareholder level whether it is received by the exempt investor as capital gains from the sale of shares or as dividends from distributions. Thus, under current law, corporate income paid to tax-exempt investors in the form of interest is not taxed at either the corporate or investor level, while non-preference income retained or distributed to tax-exempt shareholders is subject to tax at the corporate level.

Current law does not, however, encourage tax-exempt investors to invest in equity of noncorporate rather than corporate businesses, because, in both cases, the income is subject to one level of tax. While corporate income (other than preference income) allocable to tax-exempt shareholders is subject to tax at the corporate level, the noncorporate unrelated business income of tax-exempt investors generally is subject to UBIT.[5] For tax-exempt investors who invest in equity, current law generally also does not affect their preferences for distributed or retained earnings. Because corporate income (other than preference income) is subject to current corporate level tax and both distributed and retained earnings are exempt from tax at the shareholder level, a tax-exempt shareholder has no tax incentive to prefer distributed earnings over retained earnings.

## 6.C NEUTRALITY UNDER AN INTEGRATED TAX SYSTEM

Because of the asymmetric treatment of debt and equity investments by tax-exempt entities under current law, an integrated system can achieve neutrality between debt and equity investments for tax-exempt investors only by either decreasing the tax burden on equity income or increasing the tax burden on interest. A straightforward decrease in the tax burden on equity investments might be accomplished by removing the corporate level tax on earnings distributed as dividends to tax-exempt investors. A deduction for corporate dividends, for example, would achieve this result. The contrary approach might subject interest income on corporate debt earned by tax-exempt investors to one level of tax (at either the corporate or the investor level).

The first approach, taxing neither dividends nor interest paid to tax-exempt investors, would lose substantial amounts of tax revenue relative to current law. Extending the benefits of integration to tax-exempt investors would add costs of approximately $29 billion annually under distribution-related integration and approximately $42 billion annually under shareholder allocation. This revenue loss would increase the costs of integration and would require offsetting increases in other taxes or in tax rates, which might create or increase other distortions. This approach also would distort the choice between corporate and noncorporate investment for tax-exempt investors if UBIT remained in place for noncorporate investment. If corporate dividends were tax-exempt at both the corporate and investor level, while earnings from businesses conducted directly or in partnership form were subject to UBIT, a tax-exempt investor would always prefer corporate dividends. Indeed, anti-abuse rules might be required to preclude tax-exempt organizations from avoiding UBIT altogether simply by incorporating their unrelated businesses.

The second approach, taxing both interest and dividends at a single rate, would reduce the current advantage of tax-exempt investors relative to taxable investors. Tax-exempt investors would no longer enjoy an after-tax return on a given corporate equity or debt investment higher than that available to taxable investors. The principal advantage of this approach is that it would equate the treatment of debt and equity while maintaining the neutrality between corporate and noncorporate equity for tax-exempt investors.[6]

## 6.D GENERAL RECOMMENDATIONS

This Report recommends that a level of taxation at least equal to the current taxation of corporate equity income allocated to investments by the tax-exempt sector be retained under integration. The dividend exclusion prototype, described in Chapter 2, essentially continues present law treatment of tax-exempt investors under an integrated tax system, so fully-taxed corporate profits would continue to bear one level of tax and preference income would not be taxed at either the corporate or shareholder level.[7] A similar result can be accomplished under an imputation credit system of integration, but a dividend deduction system would eliminate the current corporate level tax on distributed earnings on equity capital supplied by tax-exempt investors.[8] Under the shareholder allocation prototype described in Chapter 3, taxes are collected at the corporate level on corporate income allocable to investment by tax-exempt shareholders and no refund is provided to nontaxable shareholders.

Maintaining one level of tax on equity investments by tax-exempt entities would promote one of the primary goals of integration: achieving tax neutrality for all investors between corporate and noncorporate investments. This choice is consistent with a move to integration for taxable shareholders, because choosing to reduce the double tax burden on corporate income distributed to taxable investors does not necessarily dictate a commensurate reduction in the tax burden on tax-exempt investors. Finally, continuing to tax equity investments by the tax-exempt sector avoids the revenue loss that would result if such investments were completely tax-exempt. Increasing other tax rates to compensate for such a revenue loss would entail other inefficiencies.

Some countries that have adopted integration have chosen to tax separately corporate and other income allocable to tax-exempt investors. For example, in moving to an integrated corporate tax, Australia and New Zealand imposed a tax on the income of pension funds, thus reducing the number of tax-exempt investors. In both countries, the remaining tax-exempt investor base, such as charities, is small. Australia imposed a 15 percent tax on investment income earned by pension funds and made available the full 39 percent imputation credit from dividends as a nonrefundable offset. Australia did not project collecting more than a token amount of tax from this tax on investment income: it devised the mechanism to remove distortions between investing in domestic corporations (which pay Australian tax) and investing in foreign corporations (which generally do not). The new Australian system also removes distortions between investing in equity and investing in debt. New Zealand went further and repealed entirely the tax exemption of pension funds; they now function basically as taxable savings accounts. Under the U.K. distribution-related integration system, the corporate level tax is not completely eliminated, with the consequence that income distributed to tax-exempt shareholders bears some tax burden.[9]

This Report also encourages an effort to achieve uniform tax treatment of corporate debt and equity investments by tax-exempt investors.

Because of the important role played by the tax-exempt sector in the capital markets, failing to create neutrality for debt and equity investments by the tax-exempt sector would limit the extent to which integration could achieve tax neutrality between the two kinds of investments. This is achieved under CBIT by treating tax-exempt shareholders and debtholders generally like other suppliers of corporate capital, with tax imposed at the corporate level.[10]

One potential alternative approach would tax all corporate and noncorporate income allocable to investment by the tax-exempt sector at a rate lower than the rate applicable to taxable investors.[11] Such a tax on the investment income, including dividends and interest income, received by tax-exempt entities could be set to achieve overall revenues equivalent to those currently borne by corporate capital supplied by the tax-exempt sector. Under the imputation credit prototype discussed in Chapter 11, for example, imputation credits for corporate taxes paid would be allowed to tax-exempt shareholders. To the extent that the credit rate exceeds the tax rate on investment income, the excess credits could be used to offset tax on interest or other investment income. In addition to the substantial advantage of equating the tax treatment of debt and equity held by such investors, such an approach would allow tax-exempt investors to use shareholder level credits for corporate taxes paid to the same extent as taxable shareholders.[12] By doing so, this approach would limit both portfolio shifts and other tax planning techniques that might otherwise be induced by efforts to distinguish among taxable and tax-exempt investors in integrating the corporate income tax. A revenue neutral rate for such a system would be in the range of 6 to 8 percent depending on the prototype.[13] This would approximate the current law corporate tax burden on investments by tax-exempt shareholders.

# CHAPTER 7: TREATMENT OF FOREIGN INCOME AND SHAREHOLDERS

## 7.A INTRODUCTION

International issues are important in designing an integrated tax system because there is substantial investment by U.S. persons in foreign countries (outbound investment) and investment by foreign persons in the United States (inbound investment). At the end of 1990, private U.S. investors owned direct investments abroad with a market value of $714 billion, and $910 billion in foreign portfolio investment, while private 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 direct investments abroad in 1990, and $65.7 billion of income from their foreign portfolio investments, while foreign investors received $1.8 billion from their direct investments in the United States in 1990 and $78.5 billion from their U.S. portfolio investments.

The income from transnational investments may be taxed by both the country in which the investment is made (the host or source country) and the country of residence of the investor (the residence country). The United States uses two primary instruments for mitigating the potential problem of double taxation: the foreign tax credit and bilateral income tax treaties entered into between the United States and about 40 other countries.

<u>Taxation of foreign investment by U.S. investors</u>. The United States taxes the worldwide income of its residents.[1] The U.S. tax on income earned by U.S. corporations or individuals through foreign corporations is generally deferred until such income is repatriated through dividend or interest payments to U.S. shareholders or creditors.[2]

The United States allows taxpayers to claim a foreign tax credit for qualifying foreign income taxes paid (the direct foreign tax credit). Current law also allows corporate taxpayers that receive dividends (or include Subpart F income) from at least 10-percent owned foreign subsidiaries to claim a foreign tax credit for a ratable portion of the qualifying foreign taxes paid by the subsidiary on the income from which the dividends are paid (the indirect foreign tax credit). The portion of the foreign taxes which taxpayers may claim as an indirect credit is proportional to the fraction of the earnings of the foreign subsidiary distributed or deemed distributed. The dividend income for U.S. tax purposes is grossed up by the amount of the direct and indirect credits claimed.[3] The indirect foreign tax credit, like the dividends received deduction available domestically, prevents multiple taxation of corporate profits at the corporate level.

The Code limits the maximum foreign tax credit to prevent the foreign tax credit from offsetting taxes on domestic source income. Separate limitations apply to several different kinds of foreign source income (baskets) in order to restrict the use of foreign tax credits from high-taxed foreign source income against low-taxed foreign source income. For each basket, the Code limits the amount of foreign taxes paid on income in that basket which a taxpayer may claim as a credit in the current year to a fraction of the taxpayer's pre-credit tax on worldwide income in the same basket. The fraction is the ratio of the taxpayer's foreign source taxable income in the basket to the taxpayer's total worldwide taxable income in the same basket. Credits that a taxpayer cannot use in a given year because of the limitations may be carried back two years or forward five years. Additional limitations apply to taxpayers subject to the alternative minimum tax.

<u>Taxation of foreign investors</u>. The taxation of U.S. investment income of foreign individuals or corporations generally depends upon whether they are engaged in a trade or business in the United States. Foreign corporations and individuals engaged in a U.S. trade or business generally are

taxed on their net business income under the same rules that apply to a U.S. corporation or citizen engaged in the same business.

The treatment of domestic and foreign investors differs, however, at the shareholder and creditor level. Foreign investors not engaged in a U.S. trade or business are not subject to the individual or corporate income tax.[4] Instead, subject to significant exceptions noted below, they are subject to a 30 percent withholding tax on their gross dividend, interest and other income. Capital gains realized by a foreign investor on the sale of stock or securities (except stock in certain U.S. corporations owning U.S. real property) generally are exempt from tax.

The Code exempts from the 30 percent withholding tax qualified portfolio interest and interest earned by foreign investors on U.S. bank deposits. Interest does not qualify as portfolio interest if the investor has a 10 percent or greater equity interest in the borrower or is a controlled foreign corporation related to the borrower or if the interest is paid on a bank loan made in the ordinary course of a banking business.

Under bilateral tax treaties, interest (if not already exempt) and dividends and other income paid to residents of a treaty country may qualify for a significantly reduced rate of withholding tax. The reduced rate of withholding tax applicable to dividends is often 15 percent and may be as low as 5 percent on dividends distributed by a U.S. subsidiary to a foreign direct corporate investor. Tax treaties may reduce the rate of withholding on otherwise taxable interest income paid to foreign investors (in particular, related foreign investors) to 5 or 10 percent or, in many cases, zero.

The current U.S. tax treatment of cross-border investment generally reinforces the biases created by other features of the classical system of corporate taxation: against equity compared to debt and for retention rather than distribution of corporate earnings. Statutory exemptions for cross-border interest payments, together with more favorable treaty provisions for interest than for dividends, reinforce the bias against equity. Likewise, the potential for deferral of U.S. tax liability on non-Subpart F income reinforces the bias towards retention of such income by foreign subsidiaries.

The major international issues that must be addressed in any integrated system are:

- <u>Should foreign taxes paid by U.S. corporations be treated identically to taxes paid to the U.S. Government</u>? If so, the foreign tax credit for corporate taxes paid, in effect, would be extended to shareholders. As a consequence, income that is taxed abroad at a rate equal to or greater than the U.S. tax rate would not be subject to U.S. tax either at the corporate level or at the shareholder level.

- <u>Should the benefits of integration be extended to foreign shareholders</u>? If so, income allocable to (or paid to) foreign shareholders would be subject to only one level of U.S. tax, at either the corporate or shareholder level. If the tax is imposed only at the shareholder level, U.S. income tax treaties may substantially reduce the tax.

This Report recommends that: (1) foreign income taxes paid with respect to outbound investment not be treated the same as U.S. taxes paid for integration purposes, (2) foreign shareholders not receive by statute benefits of integration received by U.S. shareholders, and (3) the United States' income tax treaties with other countries be used as the appropriate vehicle for relaxing either of the preceding rules where reciprocal benefits are given by the foreign country to U.S. taxes or investors in their integration systems.

## 7.B OVERVIEW OF U.S. INTERNATIONAL TAX POLICY

As indicated above, cross-border investments are potentially taxable in at least two countries: the residence country (the country where the investor resides) and the source country (the country where the investment is made). Sovereignty unavoidably complicates international tax policy: a country may set its own tax policies, but not the policies of other countries, even though the policies of other countries have a direct impact on the first country's welfare. As a result, a residence country generally must respect a source country's claim to tax income that is derived within the source country's borders. However, the source country has little control over the ultimate level of aggregate taxes paid by foreign investors on profits earned in the source country. By choosing to impose additional tax on an investor's income from the source country, by exempting such income from its own tax, or by choosing some intermediate policy, the residence country, not the source country, makes the final decision about the tax burden borne by the residence country's investors.

## Normative Guidance for International Tax Policy

No consensus exists about the proper norms for capital taxation in economies with international capital and labor mobility. Integrating models of capital taxation and international trade, policymakers have suggested two principles for taxation of international investments:

- Principle 1 (Capital Export Neutrality). Investors should pay equivalent taxes on capital income, regardless of the country in which that income is earned.

- Principle 2 (Capital Import Neutrality). All investments within a country should face the same tax burden, regardless of whether they are owned by a domestic or foreign investor.

Maintaining both principles simultaneously is not a practical option, however, because it would require that capital income be taxed equally in all countries. That will never occur as long as sovereign countries establish different tax rates.

National tax systems, such as that of the United States, can approach capital export neutrality while taxing worldwide income of resident multinational enterprises (the worldwide method of taxation), if either the residence country provides credits to its enterprises for taxes remitted to foreign governments or the source country surrenders the right to tax income from foreign investments within its borders. Capital import neutrality can be achieved if the residence country decides not to tax income earned from foreign jurisdictions and allows the source country to be the sole taxing authority for international investment income.

Since capital export and capital import neutrality cannot be attained simultaneously when international differences exist in capital income taxation, a clear advantage for one or the other would be useful. However, analyses of international taxation by economists specializing in international trade generally offer no strong endorsement of one principle relative to the other.[5] Capital taxation in open economies (economies in which international borrowing and lending occur) can distort both the level of saving within an economy and its allocation among alternative investments at home and abroad. Capital import neutrality can enhance worldwide economic efficiency if domestic savings are inefficiently low by reducing the tax burden on savings.

Capital export neutrality, in contrast, enhances worldwide efficiency in the allocation of savings. It may be a guiding principle when efficiency costs of distortions in the allocation of savings are significant relative to costs of tax-induced distortion in the level of savings. Most available evidence supports the proposition that the sensitivity of domestic savings with respect to changes in net return is small relative to the sensitivity of the location of investment with respect to changes in net return.[6] Accordingly, many economists and policymakers presume that capital export neutrality offers better guidance for international tax policy. Nonetheless, given the existence of tax-induced distortions in both savings and investment, the complexity of the modern multinational enterprise (relative to two-country examples often considered in theory), and the possibility of international tax competition, some compromise between capital export and capital import neutrality is inevitable.[7]

## Outbound Investment

Since 1918, through the foreign tax credit, the United States has generally implemented the principle of capital export neutrality unilaterally and without interruption.[8] Since 1921 the foreign tax credit has been limited so it does not exceed the U.S. tax liability incurred on the foreign source income in the absence of the credit. The limitation seeks to prevent the credit from offsetting U.S. tax on U.S. source income. However, because the limitation allows a foreign tax rate that is higher than the U.S. tax on the relevant income to go unrelieved, the limitation works against the policy of capital export neutrality.

A taxpayer generally receives a foreign tax credit only for income taxes paid to a foreign government on the taxpayer's own income. Thus, a shareholder generally may claim a credit for foreign taxes withheld from a dividend payment includable in the shareholder's income but may not claim a credit for the foreign taxes paid by the corporation on the income out of which the dividend is paid. The only exception to this principle is the indirect foreign tax credit allowed for a domestic 10 percent corporate shareholder of a foreign corporation for the foreign income taxes paid by the foreign subsidiary on the income out of which the dividend is paid.[9]

In other respects, however, the U.S. taxation of outbound investment tends toward capital import neutrality—the tax rate on foreign source income of a U.S. investor is determined by the tax imposed by the source country. First, the U.S. tax regime generally allows deferral. That is, the U.S. tax on foreign source income of U.S. owned foreign companies is deferred until such profits are repatriated in the form of dividends. Deferral affects a U.S. investor's initial decision to make or forgo a foreign investment because, even if the investor is obligated to pay the residual U.S. tax (a capital export neutral result), the time for paying this tax may be postponed indefinitely. Deferral thus substantially reduces, and under some conditions virtually eliminates, the present cost of the residual U.S. tax (a capital import neutral result).[10] Deferral, however, is not significant with respect to dividends paid from current earnings, or where foreign tax rates equal or exceed the U.S. corporate rate. In addition, certain foreign corporations controlled by U.S. residents are subject to current U.S. tax on certain types of undistributed income under the Code's Subpart F rules. The advantage of deferral also is less where the domestic corporate ownership interest is less than 10 percent of the voting stock in the foreign corporation. In that case, the indirect foreign tax credit is not available. Thus, dividends will incur both the foreign corporate level tax and, after deduction of the foreign tax, the U.S. corporate level tax.

Second, the U.S. tax regime allows averaging. That is, in determining the residual U.S. tax on foreign profits, a high foreign tax imposed on one item of foreign income may be averaged against a low foreign tax imposed on another item of foreign income, as long as the different items of income are both within the same statutory basket for purposes of the foreign tax credit limitation rules. If the foreign tax rate on an item of foreign income is higher than the U.S. rate, the U.S. investor may or may not bear the cost of the higher foreign rate, depending on the opportunities for averaging. If the investor must bear the higher rate, it is placed in parity with local investors in the foreign country, a capital import neutral result. If, on the other hand, the investor is able to average the high foreign tax rate on the income in question against low foreign rates on other foreign income, then the investor will avoid the extra burden of the high foreign rate. This should render the investor capital export neutral with respect to the highly taxed foreign income (since averaging will reduce the total tax on such income to the U.S. rate, but no lower), but also should render the investor capital import neutral with respect to the lower taxed foreign income (because the investor is able to escape some of the residual U.S. tax on such income). The opportunities for averaging have been reduced since the 1986 Act created separate foreign tax credit limitation baskets for specific types of income.

## Inbound Investment

U.S. tax policy on inbound investment generally asserts a substantial source country claim to tax on certain types of income coupled with a policy of nondiscrimination against foreign investors. For foreign owned corporate investment, the United States generally imposes two levels of tax. Thus, the United States taxes the business profits of foreign owned domestic corporations or U.S. branches of foreign corporations similarly to the profits of U.S. owned domestic companies and imposes significant withholding taxes on dividends paid to foreign investors. The U.S. rules for taxing the U.S. branch of a foreign corporation also are designed to impose on the branch's profits the same amount of tax that would be imposed if the branch were a subsidiary of a U.S. corporation. The major exceptions to the general U.S. policy are the exemption of much of the interest income that is paid from U.S. sources to unrelated foreign lenders (other than banks), the decision to exempt capital gains not effectively connected with a U.S. business or attributable to a U.S. real property interest, and the reduction of withholding taxes on dividends, non-exempt interest, and royalties paid to foreigners (whether or not related) through bilateral treaties.[11]

The United States's network of bilateral income tax treaties significantly modifies the statutory orientation toward source country taxation. In general, tax treaties boost the tax claims of the residence country, largely by substantially reducing the withholding rates at source on investment income. In addition, tax treaties may require higher levels of business activity (a permanent establishment) before asserting a U.S. claim to tax business profits.[12]

## 7.C INTERNATIONAL TAX POLICY AND INTEGRATION

### Outbound Investment—Treatment of Foreign Taxes

This Report generally recommends that, in an integrated tax system, the statutory treatment of foreign taxes paid by corporations should differ from the treatment of the taxes they pay to the U.S. Government. Equal statutory treatment of foreign and U.S. corporate level taxes would significantly reduce the current U.S. tax claim against foreign source corporate profits and often would completely exempt such profits from U.S. taxation at both the corporate and shareholder levels. Such unilateral action would result in a significant departure from the prevailing allocation of tax revenues between source and residence countries.[13]

The integration systems recommended in this Report, therefore, generally retain the corporate level foreign tax credit but do not extend to shareholders the benefits of a foreign tax credit for foreign taxes paid by the corporation. However, where foreign income is taxed at a foreign rate that is lower than the current U.S. corporate rate, there would be less double taxation than under current law, because corporate level residual tax would be treated identically to any other U.S. corporate taxes.[14] Foreign source income subject to tax in the source country at source country rates higher than the U.S. rate would continue to be subject to a single level of U.S. tax when distributed. Thus, although foreign source income earned by U.S. corporations might be subject to more tax than domestic income, foreign source income generally would not be subject to double taxation to any greater extent than under current law. Retaining a single level of tax on foreign income should not harm the ability of U.S. firms to compete in foreign markets relative to current law.

Critics of continuing to impose any U.S. tax on foreign profits might contend that, because the United States currently is willing to give up entirely its tax on certain types of foreign profits, it should be willing to do so generally for foreign corporate profits in an integrated corporate tax system. This argument is not compelling, however. To be sure, the United States does not always currently insist on a single level of tax on foreign source income, as evinced by its unilateral decision to grant a foreign tax credit to individuals earning foreign income directly or through a partnership. Individual profits from foreign sources, however, have been a small fraction of the foreign source profits earned by U.S.-based multinational corporations, and the revenue loss from such a policy has therefore been small compared to that which would occur if foreign taxes paid by corporations eliminated U.S. tax at both the corporate and shareholder levels. Moreover, allowing a foreign tax credit to individuals on the foreign source income directly earned alleviates the burdensome tax structure that would otherwise arise under current law, because deferral would not be available and the foreign and U.S. taxes would both be imposed currently.

Another potential criticism is that failure to pass through foreign tax credits to shareholders would violate capital export neutrality and, hence, would be inconsistent with our underlying goal for integration: to enhance economic efficiency. As discussed above, however, it is not apparent that export neutrality does, in fact, lead to an efficient allocation of capital. In any case, if foreign tax credits were available to offset the single level of tax in an integrated system, the revenue loss would be serious—approximately $17 billion a year. Taxes would have to be raised elsewhere, and that would generate its own inefficiencies.

Finally, passing through foreign tax credits to shareholders would pose significant administrative difficulties. The foreign tax credit limitation and sourcing rules would have to be applied at the individual shareholder level both to ensure that taxpayers claimed the proper credit for foreign taxes and to prevent the U.S. Treasury from bearing the cost of high foreign tax rates. Without these rules, shareholders in corporations with foreign income that is taxed at a rate greater than the U.S. rate could use the excess credits to offset tax liability on domestic income, with the consequence that the U.S. Treasury would in effect provide domestic shareholders with refunds of corporate taxes paid to foreign countries.[15] This is a particularly serious issue because tax rates in many foreign jurisdictions are higher than current U.S. tax rates. The difficulty of ensuring the availability of adequate information concerning foreign taxes to both the shareholder and the IRS would complicate application of these rules at the shareholder level for widely held, non-U.S. controlled foreign corporations.

From a legal point of view, continuing to impose a single shareholder level of residence country taxation on foreign source income would not violate the United States' treaty commitments to eliminate double taxation by granting a foreign tax credit. Because U.S. tax treaties generally reflect an assumption that treaty partners have classical systems of corporate-shareholder taxation, the United States' treaty obligations require that U.S. corporations be allowed a foreign tax credit against the U.S. tax on foreign source income received directly by the corporation, and that individuals be allowed a credit for foreign source income received by the individual. No treaty obligation requires the United States to grant further relief with respect to foreign taxes paid or deemed paid by a domestic corporation, e.g., by eliminating the shareholder tax on a taxable dividend under the dividend exclusion prototype (or CBIT) or, if a compensatory tax is imposed under CBIT, refunding the compensatory tax. In specific circumstances, however, the United States might agree to extend, by treaty, the benefits of integration to foreign taxes on profits of U.S. multinationals.

Under the dividend exclusion prototype, a problem with maintaining a single level of U.S. tax on foreign earnings is a continued bias in favor of the noncorporate, rather than the corporate, form for foreign investment, although, as a practical matter, this problem may not be very serious. Individuals would be entitled to a foreign tax credit for foreign taxes imposed on their direct investments but not for taxes imposed on the investments of corporations of which they are shareholders. Thus, by not treating foreign corporate taxes equivalently to U.S. corporate taxes, an incentive to structure foreign investment through partnerships would continue. If the corporate form could not be avoided, there also would continue to be an incentive to make foreign investments in the form of debt, which would reduce the foreign tax base and convert foreign profits to domestic profits. Large investors might achieve similar effects by using rental or royalty payments or by aggressive transfer pricing.

The dividend exclusion and imputation credit prototypes implement our policy recommendations by maintaining the current foreign tax credit rules and by limiting the amounts of excludable dividends to corporate income on which U.S. taxes have been paid (or limiting shareholder imputation credits to U.S. taxes paid).[16] In effect, dividends paid out of foreign source income not previously subject to U.S. tax because of foreign tax credits would be taxed fully at the shareholder level, as under current law. Under CBIT, the U.S. tax may alternatively be imposed through a compensatory tax at the corporate level on distributions of foreign source income shielded from regular CBIT by the foreign tax credit.[17] In either case, corporations are allowed to treat dividends as paid first out of U.S. taxed income. Under the shareholder allocation prototype, foreign taxes, in essence, would be treated as equivalent to U.S. taxes, and this is among the reasons that this prototype is not recommended in this Report.[18]

## Inbound Investment—Treatment of Foreign Investors

The basic issue that an integration proposal must resolve for inbound investment is whether, by statute, the United States should continue to collect two levels of tax on foreign owned corporate profits or whether foreign investors should receive benefits of integration similar to domestic investors.[19] For the reasons set forth below, this Report recommends that, except in the case of CBIT, foreign shareholders not be granted integration benefits by statute, but instead that this issue be addressed on a bilateral basis through treaty negotiations. Most of the major trading partners of the United States that have integrated their corporate tax regimes have followed this approach.[20]

At least two basic obstacles restrain unilateral extension of integration benefits to foreign shareholders. The first is the inherent limitation on any source country's taxation of foreign investors. The residence country, not the source country, ultimately decides the tax burden that should be borne by its resident investors. As a consequence, if the United States unilaterally extended the benefits of integration to foreign shareholders, it would abandon its right to source country taxation of dividends with no assurance that the foreign investors would not be subject to a second level of tax in their country of residence. Substantial revenue would be lost without any necessary increase in efficiency of capital allocation.

The second obstacle is the interaction between a U.S. integration system and existing treaty obligations. For example, extending a refundable imputation credit to foreign shareholders by statute, combined with traditionally low treaty withholding rates on dividends, could significantly reduce the aggregate U.S. tax on profits distributed to foreign shareholders, without any comparable reduction in foreign taxes on U.S. investments in the treaty country.[21]

Thus, there is no reason for the United States by statute unilaterally to extend the benefits of integration to foreign shareholders. Integration seeks to provide relief for investors using the corporate form, not for foreign governments. If a second level of tax is to be collected, no obvious conceptual or practical reason exists why the source country should sacrifice its claim to this tax revenue for the sake of consistency.

Several of our treaty partners adopting imputation credit systems have concluded that refusing to extend integration benefits by statute to foreign shareholders residing in treaty countries would not violate the provisions of tax treaties that prohibit discrimination based on capital ownership. These countries argue that, under an imputation credit system, all profits are taxed at the corporate level at the same rate (34 percent, for example), without regard to "capital ownership," and allowing or denying the imputation credit to the shareholders is an issue of how to tax the shareholder, not the corporation. No treaty requires that foreign shareholders receive the same tax credits as domestic shareholders. Thus, there is no treaty violation. Similar arguments could be made about the dividend exclusion prototype.[22]

As Chapter 2 indicates, the dividend exclusion prototype generally would not provide any integration benefits to foreign shareholders, because current withholding taxes would continue to apply.[23] Similarly, inbound investment in an imputation credit system would remain subject to two levels of U.S. tax because imputation credits would not be made available to foreigners and current withholding taxes would continue to apply. Neither approach would treat inbound investment more harshly than under current law, because deferral of the second level of tax would continue.[24] A dividend deduction system, on the other hand, would automatically extend the benefits of integration to foreign shareholders, unless a rule were adopted to deny the deduction for dividends paid to foreigners — a rule that would violate U.S. treaty obligations. The shareholder allocation prototype avoids extending the benefits of integration to foreign shareholders by imposing corporate level tax, continuing to impose withholding tax on dividends, and denying refunds of corporate taxes paid to foreign shareholders.[25]

In contrast, to ensure parity between debt and equity, the CBIT prototype generally removes the withholding tax on both dividends and interest of CBIT entities and repeals the branch profits tax. The result is that both debt and equity income would be subject to tax once.

The United States may consider extending the benefits of integration to foreign shareholders resident in countries that have treaties with the United States. The fundamental policy issue in deciding whether and how to extend integration by treaty to foreign shareholders is how to divide the tax revenue from corporate profits between the source country and the residence country. As noted above, traditional treaty rules reflect an allocation of revenue based on the classical, two-tier tax system for corporations and shareholders: the source country generally has the exclusive right to tax business profits earned therein by a domestic corporation and the two countries divide the right to tax the profits when distributed, with the greater share of this revenue going to the residence country. Integration, of course, alters the original pool of tax revenue by decreasing the total (assuming no offsetting rate increases) and by reallocating it between the shareholder and corporation. Thus, moving to an integrated corporate tax system may upset the balance of interests traditionally reflected in the treaty rules of the United States.

Various methods can be devised for extending integration by treaty to inbound and outbound investment, and these different methods will produce differing allocations of the taxes collected from the corporation between the source country and the residence country. For example, the dividend exclusion prototype could be adopted to permit the source country to retain its corporate tax revenues: the source country would eliminate its withholding tax on distributions to treaty residents and the residence country would credit the source country taxes against the direct and ultimate shareholders' tax liabilities in the residence country and collect any residual tax. An alternative approach would impose a tax on foreign shareholders at a rate that would approximate the current level of revenues now collected by the United States on U.S. source corporate income from foreign investments and allow a credit against this tax for corporate level taxes paid.[26]

# Chapter 8: The Treatment of Capital Gains in an Integrated Tax System

Moving from a classical to an integrated corporate tax system raises issues relating to the taxation of capital gains on sales of corporate stock. While each of the integration prototypes reduces the biases of the classical system, rules selected for taxation of capital gains on sales of corporate stock will affect the degree of neutrality achieved by each prototype. Taxing shareholder level capital gains on stock attributable to earnings that have been taxed at the corporate level is not appropriate in an integrated system. Taxing such gains on stock could perpetuate the classical system's biases against the corporate form and against investments in equity rather than debt. In addition, a higher effective tax rate on retained earnings could provide a tax incentive for corporations to distribute earnings as dividends. On the other hand, a failure to tax shareholder level stock gains may result in significant deferral or even elimination of tax attributable to unrealized corporate asset appreciation.[1]

## 8.A TAXATION OF CAPITAL GAINS ATTRIBUTABLE TO RETAINED TAXABLE EARNINGS

When a corporation retains earnings, its stock will generally increase in value. There is some controversy about the extent to which an incremental dollar of retained earnings translates into share appreciation.[2] In integration prototypes that tax earnings at the corporate level, e.g., the dividend exclusion and CBIT prototypes, dividends would not generally be taxed again at the investor level. Under these prototypes, to preserve neutrality in the taxation of corporate capital income, shareholders' capital gains attributable to retained earnings that have already been taxed fully at the corporate level should not be taxed again at the shareholder level. Imposition of a capital gains tax in this case would be a double tax on the retained earnings of the corporation.

The second level of tax, however, may prove temporary. If the corporation subsequently distributes the retained earnings, the value of the stock may decline to reflect the distribution of corporate assets. As a consequence, the tax on the selling shareholder's gain may be effectively reversed by an offsetting capital loss of the purchasing shareholder. The extent to which the capital loss reverses the double tax will depend on the timing of the distribution of the retained earnings and of the realization and treatment of the capital loss.[3]

When the tax reduction from the later capital loss precisely offsets the tax on the earlier capital gain, the system will collect only one tax on corporate earnings. However, a subsequent capital loss deduction allowed to a taxpayer different from the one who originally is taxed on the capital gain will often be an imperfect offset. For example, the tax on the gain may occur in a year earlier than the tax reduction from the capital loss. The acceleration of tax may even approximate, in present value terms, double taxation if there is a substantial period between the payment of capital gains tax by the first shareholder and the recognition of an offsetting capital loss by a subsequent shareholder. In addition, limits on the deductibility of capital losses may prevent the purchasing shareholder from fully using the offsetting capital loss. The additional burden imposed by a capital gains tax also depends on the marginal tax rates of the purchaser and seller of stock,[4] and the fact that shareholders with different marginal tax rates will generally face identical market prices for their stock further complicates analysis of the extent of double taxation.

## 8.B SOURCES OF CAPITAL GAINS OTHER THAN TAXABLE RETAINED EARNINGS

Not all capital gains from increases in the value of corporate equity arise from accumulated retained earnings. Gains from other sources may imply different tax consequences than those applicable solely to gains from fully-taxed retained earnings.

First, capital gains on corporate stock may be attributable to retained preference income. In that case, taxing capital gains on corporate stock does not impose a second level of tax, because no tax has been paid at the corporate level. Taxing such capital gains produces a single tax on those earnings at the shareholder level. If, as we recommend in Chapter 5, integration should not extend corporate level preferences to shareholders, such gains should be taxed. Providing relief for capital gains attributable to retained preference income would exacerbate the incentive to retain rather than distribute preference income or to distribute preference income in a nondividend distribution in which capital gain treatment might be available.[5]

Second, capital gains may be attributable to real unrealized appreciation in the value of corporate assets. In that case, the unrealized corporate level gain, in effect, will be realized first at the shareholder level upon the disposition of the stock. The gain also will be realized at the corporate level when the corporation disposes of the asset. Although such gains eventually will be taxed at the corporate level, in a realization-based income tax system, taxing the shareholder level gain seems appropriate, since that is the first realization event with respect to the appreciation. It may, however, be appropriate to prevent double taxation when the corporation subsequently disposes of the appreciated asset.[6]

Third, capital gains may be attributable to changes in the anticipated value of corporate earnings, due, for example, to management changes or revised estimates of profits from new products or inventions. Tax considerations for gains attributable to such factors are similar to those concerning unrealized appreciation in tangible corporate assets. Accordingly, taxing the appreciation when the shareholder sells the stock seems appropriate.

Finally, taxable capital gains may result from inflation. In an unindexed system, capital gains tax liability can result simply because nominal asset values rise with inflation, although a taxpayer may have no increase in real income. Taxing such gains can lead to high effective tax rates on capital gains. Indeed, granting relief to capital gains to offset the effects of inflation has been one of the principal justifications advanced for measures such as lower rates on capital gains or indexation of such gains.[7]

## 8.C ADJUSTMENTS TO ELIMINATE DOUBLE TAXATION OF RETAINED CORPORATE EARNINGS

Although avoiding the double taxation of corporate retained earnings is an important factor to be taken into account, how capital gains are treated in an integrated corporate tax system will turn ultimately on the resolution of basic policy issues that have long been controversial under the income tax. Considerations such as the desire to stimulate investment and entrepreneurship and to avoid the overtaxation of inflationary gains support preferential rates or exclusions for all or a part of capital gains income. On the other hand, some analysts will contend that capital gains and ordinary income should be taxed similarly.

Integration of the corporate income tax can proceed and will serve to reduce substantially the distortions of the current system whichever of these options for taxing capital gains is chosen. However, in designing an integrated corporate tax, one must consider the treatment of capital gains, as well as dividends, in developing rules that minimize distortions in corporate and individual financial behavior.

As discussed in Chapter 3, the shareholder allocation prototype would allocate corporate taxable income to shareholders each year and would provide a system of shareholder level basis adjustments similar to those used for partnerships or S corporations under current law.[8] Share basis would increase to reflect the corporation's taxable income and certain preference income and would decrease to reflect distributions. Thus, under such a system, any capital gains on sale of corporate stock would be attributable to preference items for which no basis adjustment is allowed, unrealized appreciation, or inflation.

On the contrary, the dividend exclusion prototype, set forth in Chapter 2, does not provide any adjustments to share basis to reflect the corporation's retention of income that has been taxed at the corporate level. As a consequence, taxing capital gains could impose an additional shareholder level tax on retained earnings that have already been taxed in full at the corporate level. Because retained fully-taxed earnings would face a greater tax burden than distributed earnings, corporations would have an incentive to distribute rather than retain fully-taxed earnings. This problem can be limited by allowing a dividend reinvestment plan (DRIP), which would permit a corporation to declare deemed dividends to the extent of its EDA balance and treat the amount of dividend as reinvested in the corporation. Under such a system, a shareholder would be treated as receiving an excludable dividend and would increase stock basis to reflect the deemed recontribution. Chapter 9 discusses DRIPs in detail.

If corporations were to use a DRIP to declare deemed dividends equal to their fully-taxed income each year, the resulting basis adjustments would ensure that such income would not be taxed again as capital gains. If, however, nontax considerations lead corporations not to elect DRIP treatment for all their fully-taxed earnings, an elective DRIP would not eliminate the potential additional tax on retained corporate earnings. For example, a corporation that expects to earn substantial preference or foreign source income shielded by foreign tax credits might want to retain some EDA balance to enable it to continue to pay excludable cash dividends in future years. If no DRIP is allowed, or if it is expected that corporations will not elect to make deemed distributions of all fully-taxed income, one could reduce or eliminate the potential disadvantage for retained earnings by adopting a preferential rate (or, equivalently, a partial exclusion) for capital gains.

Taxing capital gains on equity and debt investments in business entities creates special issues under CBIT. If a compensatory tax is imposed under CBIT, all business income would be taxed at the entity level, and investors would exclude from income all dividends and interest payments received. In that case, taxing capital gains would create an even greater disparity between retained and distributed income than under the dividend exclusion prototype. Thus, if CBIT includes a compensatory tax, a complete investor level exemption for capital gains (and nonrecognition of losses) on equity and debt would be consistent with CBIT's general exemption from investor level tax of dividends and interest. If CBIT does not include a compensatory tax, but instead taxes dividends and interest considered to be paid out of corporate preference income at the investor level (see Section 4.D), the case for relief for capital gains is essentially the same as under the dividend exclusion prototype.

If CBIT includes a compensatory tax, exempting gains and losses from the sale of equity interests in CBIT entities could be justified on the ground that those gains and losses either have been, or will be, taken into account in calculating the income tax imposed at the entity level. Retained taxable income has already been subject to tax, retained preference income will be subject to compensatory tax under CBIT when distributed, and unrealized appreciation represents anticipated higher future earnings that will be subject to entity level tax if and when they are realized.[9] Exempting capital gains on CBIT equity and debt would promote simplicity in the CBIT prototype. For example, exempting capital gains on CBIT debt and equity would remove the need for a DRIP mechanism to allow holders to increase basis to reflect earnings taxed at the corporate level.

The principal disadvantage of exempting gains on CBIT equity is the potential for deferral of tax on appreciation in an entity's assets. A realization-based tax system may allow a significant delay between the realization of gain by an equity investor (through the sale of his equity interest) and the realization of future earnings or built-in gain at the entity level. Foregoing the opportunity to tax gains realized upon a sale of an equity interest thus increases the potential for the deferral of tax on unrealized appreciation at the entity level.[10] Although additional realization rules at the entity level could limit deferral,[11] sale of an equity interest traditionally has been viewed as an appropriate realization event and the more traditional solution to the problem of double taxation has been to adjust entity level asset basis to reflect investor level realization.[12]

CBIT also raises issues relating to capital gains on debt. Some, but not all, changes in the value of debt reflect gains and losses that have been or will be taxed at the corporate level.[13] For example, one source of capital gains on debt is an increase in the creditworthiness of the issuer, which may reflect an increase in the corporation's expected future earnings. If an increase in creditworthiness is due to earnings that will be taxed at the corporate level, the issues created by taxing capital gains on debt are similar to those for equity.[14] Capital gains and losses on debt (and corresponding losses and gains to issuers) also may arise from unexpected movements in market interest rates.[15] The movement to a CBIT system does not demand an exclusion of gains on CBIT debt that are due to changes in interest rates, and it is impossible as a practical matter to distinguish between gains attributable to interest rate movements and gains attributable to other sources.[16]

## 8.D OTHER COUNTRIES

Many countries recognize the possible distortion caused by taxing capital gains on sales of corporate stock and have taken measures to mitigate this effect. Table 8.1 shows the tax treatment of capital gains of the G-7 countries with integrated tax systems. All the countries provide some preferential treatment for capital gains on corporate stock through a lower effective tax rate. For example, Canada, France, and Germany all provide for an alternative or reduced tax rate applied to such gains. These reductions can be substantial. In Germany, for example, all gain on securities held more than 6 months may be excluded. The United Kingdom does not permit a reduction in its marginal tax rate, although the tax base is indexed for inflation, but instead allows a specific "dollar" exemption. Gains exceeding the exemption are taxed at the applicable marginal rate.

## 8.E SHARE REPURCHASES

The differences in taxation of gains from similar transactions complicates analysis of the proper treatment of capital gains on corporate stock under integration. The treatment of share repurchases is one example. A shareholder who sells stock to a person other than the corporation that issued the stock or who receives a liquidating distribution generally can recover the basis in the stock against the amount realized on the sale. In contrast, current law may treat a redemption of stock by the issuing corporation as a dividend or as a sale of stock. A redemption generally qualifies for sale treatment if it is "not essentially equivalent" to a dividend or is substantially disproportionate among shareholders.[17] For redemptions treated as a dividend, no basis recovery is permitted (although, generally, the basis in the redeemed stock is allocated to the remaining stock and will be recovered eventually).

Current law favors share repurchases because dividends are taxable to shareholders in full, while redemptions generally permit recovery of basis by shareholders and may permit taxation of gain at the maximum rate of 28 percent for long-term capital gains (rather than at the higher marginal rates for ordinary income).[18]

In general, each of the integration prototypes should greatly reduce current law's incentive to engage in share repurchases. Shareholder allocation integration, which treats both distributions and sales of stock as tax free to the extent of

**Table 8.1**
**Taxation of Individuals on Long-Term Gains on Securities**
Select Foreign Countries

| Foreign Country | Amount of Gain Exempt | Maximum Individual Tax Rate (Capital Gains)[1] |
|---|---|---|
| France | All, if the sale proceeds do not exceed FF307,760 ($55,323)[2] | 16% |
| United Kingdom | All inflationary gains plus an annual exemption of £5,000 ($8,885) of non-inflationary gains | 40% |
| Canada | 25% exclusion, plus a lifetime exemption of C$100,000 ($88,480) | 22% |
| Germany | All gain on securities held more than 6 months[2] | 0% |

Department of the Treasury
Office of Tax Policy

[1]National tax only. Subnational taxes are relevant in Canada only. Provincial taxes (non-deductible) amount to roughly 50 percent of the Federal tax.

[2]The exemption does not apply in certain cases where the seller held a "substantial interest" in the corporation whose shares are being sold.

share basis and capital gain thereafter, would treat share repurchases and dividends similarly.[19] The dividend exclusion prototype, which treats dividends paid out of fully-taxed earnings as tax free to shareholders, generally would encourage corporations to distribute fully-taxed earnings to taxable shareholders as dividends rather than through share repurchases. Corporations that had exhausted their EDA balance and could pay only taxable dividends, however, would have an incentive to distribute earnings through share repurchases. Even corporations with sufficient EDA balances might desire to make selective share repurchases from tax-exempt shareholders to distribute earnings without reducing the corporation's EDA.[20] The incentives for share repurchases under CBIT are generally the same as those under the dividend exclusion prototype, except that the incentive to make share repurchases out of preference income may be more pronounced if a compensatory tax is imposed on dividends but not on share repurchases. Avoiding the compensatory tax would allow preference income to be distributed to tax-exempt and foreign investors without tax at either the corporate or the shareholder level.

One way to eliminate the remaining incentive for share repurchases under the dividend exclusion and CBIT prototypes would be to treat redemptions like dividends. In that case, share repurchases, like dividends, by a corporation with sufficient earnings and profits would not permit basis recovery. Share repurchases would be tax-free to shareholders to the extent of the corporation's fully-taxed income (and would reduce the corporation's EDA). Any portion of payments to repurchase shares that were made out of preference income would be taxable to shareholders, in a dividend exclusion system, or subject to compensatory tax or an investor level tax, in CBIT.[21] This result may be inappropriate, however, in a system in which capital gains are subject to tax, because a shareholder's basis would be taken into account on a sale to a third party, but not in a corporate repurchase. In theory, dividend treatment could be extended to all sales of shares, including sales to persons other than the issuing corporation. However, it may be impractical to extend dividend treatment to third-party sales, given the large volume of daily trading in corporate stock.[22] Limiting dividend treatment to redemptions would, however, create disparities between sales of stock to the issuing corporation and to third parties.

The treatment of capital gains also may affect the desirability of measures to equalize the treatment of dividends and share repurchases under the dividend exclusion and CBIT prototypes. A preferential rate for capital gains, for example, might reduce, but not eliminate, the disincentive for share repurchases out of fully-taxed income while increasing the incentive for share repurchases out of preference income. On balance, we believe that any of the integration prototypes will sufficiently decrease incentives for share repurchases as compared to current law that policymakers may avoid adopting any additional rules and let the passage of time demonstrate whether the shifting of EDA balances among shareholders requires additional measures.[23]

## 8.F CAPITAL LOSSES

In general, the treatment of capital losses on corporate stock under integration should parallel the treatment of capital gains. As Section 8.A discusses, a purchaser's capital loss may serve to reverse the tax imposed on a seller's capital gain attributable to retained earnings that have previously been taxed at the corporate level. However, if relief is provided for capital gains on corporate stock, the corresponding loss need not be allowed in full as an offset. For example, an exemption (or partial exclusion) for capital gains on corporate stock might imply a disallowance (or partial disallowance) of capital losses on corporate stock. Policymakers may, however, decide to tax capital gains on corporate stock, on the grounds that the second level of tax on retained earnings may prove temporary and that preferential treatment could exempt from tax other gains (like some of those discussed in Section 8.B) that may appropriately be taxed under integration.

Other capital losses on corporate stock may arise from unrealized depreciation in corporate assets, just as capital gains may arise from unrealized appreciation.[24] As Section 8.B notes, in a realization-based tax system, it seems appropriate to allow such losses, although it may be appropriate to make adjustments to prevent a second loss at the corporate level, e.g., by adjusting corporate asset basis. As under current law, the desirability of such measures must be weighted against their complexity.[25]

# CHAPTER 9: DIVIDEND REINVESTMENT PLANS

Under the dividend exclusion and CBIT prototypes, corporations (and other entities subject to CBIT) may desire to retain earnings but allow their shareholders to increase share basis to reflect earnings which have been taxed at the corporate level. Allowing basis adjustments would reduce the extent to which taxes on investor capital gains would be a second tax on retained earnings and would reduce the tax incentive for corporations (and other CBIT entities) to distribute fully-taxed income. See Chapter 8. We contemplate that this would be permitted through an elective dividend reinvestment plan (DRIP).[1] DRIPs may be adopted by corporations under current law; such plans commonly are used by mutual funds and utilities. Because dividends are taxable to shareholders under current law, participation in DRIPs generally requires an election by the shareholder. Unlike existing DRIP arrangements, however, deemed dividends reinvested under an integration prototype would not be taxable to shareholders and the DRIP could be adopted by the corporation (or CBIT entity) without the consent of the individual shareholder.[2] Adopting a DRIP would simply represent a corporate decision to reduce the corporate EDA in order to increase share basis.

## 9.A MECHANICS

By adopting a DRIP, a corporation would elect to treat shareholders as receiving excludable dividends in an aggregate amount not to exceed the balance in the corporation's EDA. The amount deemed distributed would be deducted from the EDA. The shareholders would then be deemed to recontribute the distributed amount, and their share basis would increase by the amount of the deemed distribution. Share basis would increase only by the amount deemed reinvested (rather than by the corporation's pre-tax earnings), because that would be the result had the shareholder actually reinvested a dividend.

Mechanically, the electing corporation would declare deemed dividends in the same manner that it declares actual dividends. A corporation would choose the amount of deemed dividends and the classes of stock on which they would be paid. The corporation's ability to stream deemed dividends to taxable shareholders would be constrained by the anti-streaming rules generally applicable under the prototypes for payments of excludable dividends.[3] The corporation would allocate the deemed dividends to holders of stock on the chosen record date and would provide information reports to those shareholders showing the amount of the deemed dividend and the associated basis increase.

Dividends are generally paid on a per share basis, and the share basis increase under the DRIP also would be on a per share basis. It would be desirable to have a uniform convention governing the allocation of such basis, e.g., equally to each share or in proportion to the existing basis.

> <u>Example 1</u>. Corporation X adopts a DRIP and makes a deemed distribution of $100 to Shareholder A. The fair market value of X shares on the date of the deemed distribution is $20 per share. A owns 10 shares of X which he purchased in two lots, Lot A (5 shares at $4 each) and Lot B (5 shares at $6 each). If basis is allocated on a per share basis, the basis of each Lot A share will be $14 and each Lot B share will be $16.

Although a shareholder may have purchased various shares of a corporation's stock for different amounts, the treatment of each share under current law as having a separate basis may be questioned. If the shares are economically equivalent, it may be appropriate to require the shareholder to recognize the same gain or loss regardless of which shares are actually sold. For example, a DRIP could be used to reduce basis disparities.

> <u>Example 2</u>. The facts are the same as in Example 1, except that the fair market value of X shares on the date of the deemed distribution is $15 per share. The DRIP basis increase could be allocated between the Lot A and Lot B shares so that the shares in each lot have a basis of $15.

For some shareholders (particularly those with recently purchased shares), a DRIP may create share basis in excess of fair market value, with the result that capital losses will be realized when the shares are sold. Such losses may serve the same function as those discussed in Section 8.A, simply "reversing" the double tax imposed on the seller of shares. In other cases, however, it may be appropriate to craft anti-abuse rules to prevent a DRIP from being used to create basis in excess of fair market value.[4]

The dividend exclusion and CBIT prototypes generally adopt stacking rules that treat distributions as made first from fully-taxed income. If a DRIP is adopted, further stacking rules would be necessary to determine whether cash distributions on a class of stock following deemed dividends on that class of stock are first a recovery of basis from the DRIP or out of other earnings. Thus, issuers would keep an account of deemed dividends made on each class of stock (the deemed dividend account), in addition to the EDA.[5] To simplify the operation of these accounts and minimize the double taxation of retained earnings, we recommend that all cash distributions, including cash distributions on shares on which deemed dividends have previously been paid, be treated first as payments out of any remaining balance in the corporation's EDA. Then cash distributions on a class of stock on which deemed dividends had been paid would be treated as a return of capital to the extent of the balance in the deemed dividend account for that class of stock. The deemed dividend account would be reduced by the amount of dividends treated as a return of capital under this rule. Distributions in excess of the deemed dividend account for a class of stock would be governed by the prototype's rules applicable to distributions in excess of the EDA.[6]

## 9.B DESIGN CONSIDERATIONS

We anticipate that deemed distributions will, in practice, be made only to holders of common (or at least participating) equity, because holders of preferred stock typically require cash dividends. Restrictions limiting DRIP distributions to common and participating equity could be considered if it were feared that DRIPs could permit inappropriate losses, e.g., distributions on preferred stock bearing limited dividends and a fixed liquidation or redemption value might create such a result.[7]

In addition, DRIPs could be made mandatory on the theory that double taxation of retained earnings through capital gains taxation could be minimized by forcing basis allocations as promptly as possible.[8] However, there seems to be little reason why corporations should not be permitted to control this, as other aspects, of their distribution policy.

# CHAPTER 10: TRANSITION CONSIDERATIONS

## 10.A INTRODUCTION

Under current law, investors and corporations generally have made decisions and commitments based on the two-tier corporate tax system. Investors' decisions to invest in corporate or noncorporate entities or in debt rather than stock, and corporations' decisions to distribute earnings, to issue debt or equity, or to recognize gains inherent in appreciated assets all likely have been made with an expectation that corporate equity income will likely continue to be subject to tax at two levels. Introduction of an integrated system will alter these expectations. We believe that a transition period is appropriate to prevent undue dislocation and to mitigate transitional gains and losses.

We anticipate that shifts in investors' portfolios will occur under any integration proposal and, in some cases, such shifts may be substantial. While the magnitude of such shifts will vary with the degree of difference between the integration proposal and current law, prudence suggests that phased-in implementation will permit adjustment to the new system while mitigating transition gains and losses. It also will provide an opportunity for midcourse corrections, if needed. A phase-in appears to be the simplest form of transition for both taxpayers and administrators to implement. It will not require complicated rules of uncertain duration for preenactment assets.

## 10.B TAXATION OF TRANSITIONAL GAINS AND LOSSES

Some believe that it is important for transitional rules to deal explicitly with gains and losses arising from the shift to an integrated system.[1] Several sources of such transition gains and losses can be identified. First, the shift to integration may affect the value of corporate shares.[2] Second, at the time of the shift, corporations may hold assets with unrealized built-in gains or losses and hence face different tax consequences upon realization than under existing law. (Absent specific transitional rules for built-in gains and losses, the second effect will likely become a part of the first effect.) Finally, some corporations may have retained earnings which have been realized and taxed while others may have distributed such earnings. The former may gain advantage if the retained earnings are not taxed on distribution.[3]

While we favor a phase-in of integration primarily to allow for gradual portfolio shifting and to allow assessment of integration's impact as it is implemented, we do not favor other explicit transitional rules to deal with transition gain and loss. Phase-in itself will mitigate the impact of any change in share values.[4]

Built-in gains and losses are likely to be reflected in share value; in any event, the differing tax consequences that will occur arise primarily by virtue of the realization concept fundamental to current income tax law. Prior law changes (including significant rate changes) generally have not attempted to capture this form of transition gain (other than through phase-in) and we believe that result is appropriate in the shift to integration as well.

Differences in earnings distribution policies are likely to be significant only in certain forms of integration. They could be significant, for example, in the shareholder allocation prototype. Because that prototype taxes only current corporate income and treats distributions as a return of capital, corporations that retained earnings realized under current law could be significantly favored over those that distributed such earnings. In contrast, the dividend exclusion and CBIT prototypes' EDA mechanisms will cause distributions from earnings retained before the establishment of the EDA to be taxable to the shareholder when distributed.[5] Accordingly, both the dividend exclusion prototype and CBIT will produce results for pre-integration retained earnings similar to current law.[6]

As an alternative, some form of grandfathering of existing assets or activities could be used to limit or eliminate transition gains and losses from the shift to integration. Under such an approach, current law treatment would be retained for assets that otherwise would be treated more favorably under integration to preserve asset values that reflect the classical corporate tax system. In moving to integration, however, a permanent grandfather rule would require maintaining a distinction between pre-enactment and post-enactment assets and equity interests and, in CBIT, old and new debt as well. Making such distinctions over an extended period would create difficult, if not impossible, reporting burdens and administrative complexity and would inevitably result in uneven enforcement.[7] Such an approach also could require an extensive array of rules to prevent transformation of old equity into new equity and to govern conversions of non-corporate entities to corporate status.[8] More importantly, preserving a dual system to limit the benefits of integration to new equity, would thwart the goal of economic reform by perpetuating the very distortions the new system seeks to eliminate.[9] We have rejected such an approach on grounds of both efficiency and simplicity.

## 10.C PHASE-IN OF INTEGRATION

Phase-ins have been used in recent legislation to moderate the harsh effects of significant changes in the tax law. For example, the passive loss disallowance rules, the personal interest disallowance rules, and the new investment interest limitations adopted in the Tax Reform Act of 1986 all were phased in.[10]

We generally recommend that a phase-in approach be used to implement the transition from the classical system to an integrated corporate tax. A phase-in approach would moderate the transition effects of integration, while avoiding the serious drawbacks of limiting integration to new equity. While some transition gains and losses may occur, fundamental structural changes in the tax law, such as those proposed here, simply are not feasible if substantial changes in values of taxpayers' assets must be avoided. Indeed, such changes have typically been ignored in connection with rate changes that raise similar concerns. A phase-in also would mitigate the revenue effects relative to immediate change. A phase-in would delay application of the new rules, however, and the delay would reduce the present value of the desired economic changes.

Under a phase-in approach, integration would be introduced gradually over a designated period. This approach would reduce the magnitude of transition gains and losses. A phase-in would not distinguish between old and new equity or, in the CBIT prototype, old and new debt. Although there would be some delay in full implementation of integration under a phase-in approach, this delay would be of limited duration, in contrast to the virtually indefinite delay that would result from limiting integration to new equity. The length of the phase-in period should depend on a variety of factors, including the particular integration prototype adopted. An appropriate period should be selected by striking a balance between the need to mitigate the disruption to the status quo and the desire to achieve as expeditiously as possible the full value of the anticipated gains of the new system, taking into account administrative costs.

The dividend exclusion prototype could readily be phased in. The EDA would automatically limit the amounts of dividends excludable by shareholders to the amount of earnings taxed after enactment, although stacking distributions first against the EDA would tend to accelerate the benefits of integration. See Section 2.B. Additional rules distinguishing pre-enactment from post-enactment earnings would not be necessary. Because the dividend exclusion prototype requires relatively few changes to current law, the appropriate phase-in period for that prototype might be relatively short, e.g., 3 to 5 years. Mechanically, a phase-in approach would allow a corporation to pay excludable dividends to the extent of its EDA balance but would limit additions to the EDA to reflect the phase-in, e.g., amounts based on 25 percent of corporate taxes paid in the first year after enactment, 50 percent in the second year, and so on.[11]

In contrast, a phase-in of the shareholder allocation prototype appears complex. Attributing a portion of corporate tax to shareholders in a manner that would increase the portion of corporate income so taxed over time, would require a complex system for tracking corporate income and making share basis adjustments, for example, to determine how subsequent distributions of phase-in years' earnings would be taxed. On balance, if a shareholder allocation system were desired, it might be preferable to enact the system in its entirety with a delayed effective date. A delayed effective date would have effects similar to a phased-in effective date in reducing transition gains and losses, would allow taxpayers an opportunity to plan for the shift, while avoiding the complexity of a phase-in of the shareholder allocation prototype.[12]

The CBIT prototype generally eliminates the investor level tax on dividends and interest and disallows the interest deduction to corporations and other CBIT businesses. In addition to the transition gains and losses that might occur under the other integration prototypes, under CBIT lenders to CBIT entities might enjoy an increase in the value of existing debt with the elimination of tax on interest received. The magnitude of the increase would depend on a variety of factors, including the remaining term of the debt. From the borrower's perspective, the disallowance of interest deductions would effectively increase the cost of borrowing for corporations unable to call their bonds or otherwise refinance their debt.[13]

CBIT, therefore, should probably be phased in over a longer period than would be appropriate for the dividend exclusion prototype. Longer phase-ins have greater effect in reducing transition gains and losses. Because, as detailed in Chapter 4, a CBIT regime will continue to have certain types of includable interest (such as interest on Treasury securities) even when fully phased in, proportionate adjustments during the phase-in period would add complexity but should not create insurmountable recordkeeping problems for investors.

Although eliminating the interest deduction ultimately could make certain limitations on interest deductibility applicable to CBIT entities unnecessary,[14] they would remain important during the phase-in period. Indeed, a phase-in of CBIT may require some strengthening of rules to prevent acceleration of interest deductions to earlier years of the phase-in, as well as deferral of interest income into later years of the phase-in. Transition rules also would have to address the timing mismatches that arise where interest has been deducted by the payor but not yet included in income by the lender or where interest has been included by the lender but not yet deducted by the payor. Alternatively, transition to CBIT could be accomplished by beginning with implementation of the dividend exclusion prototype.

## 10.D MECHANICS OF A PHASE-IN

Dividend Exclusion Prototype. A dividend exclusion could be phased in over 4 years, for example, by crediting the EDA with an increasing percentage of the fully phased-in EDA amount in each transition year, i.e., 25 percent of the formula amount in the first year, 50 percent in the second, 75 percent in the third. Offsetting revenues could be phased in on the same schedule. By limiting additions to the EDA at the corporate level, shareholder level phase-in will not be required. However, only 25 percent of income taxed at the corporate level in the first year could be distributed tax-free to shareholders. Distributions in excess of this amount, like other distributions in excess of the EDA, would be taxable to the shareholder.

CBIT. CBIT is self-financing through the disallowance of the entity level interest deduction. Accordingly, the CBIT phase-in must coordinate the dividend and interest exclusions for shareholders with entity level interest disallowance. For each year of the CBIT phase-in, the EDA would be credited with an increasing percentage of the fully phased-in EDA amount and the same percentage of corporate interest deductions would be disallowed, i.e., 10 percent in the first year, 20 percent in the second, etc.. In addition, it would be necessary to credit the EDA with an additional amount equal to the phase-in percentage for the year multiplied by the sum of the allowable interest deduction for the year plus interest paid during the year but deducted in a year before phase-in begins.[15] Absent this adjustment, the CBIT compensatory tax or investor level tax on distributions in excess of the EDA would treat allowable interest like a preference and the income it offsets would be taxed when distributed. Unlike the dividend exclusion prototype, CBIT requires investor level phase-in to mitigate and smooth portfolio shifts during the phase-in period. Thus, debtholders would exclude 10 percent of interest received from a CBIT entity in the first year while shareholders would exclude 10 percent of dividends received.

Example 1. A CBIT entity earns $109 of gross income and has $10 of interest expense in the first year of a 10 year phase-in of CBIT. If the CBIT phase-in percentage were 10 percent, the CBIT entity would deduct $9 of interest ($10 minus (10 percent of $10)). It would thus have taxable income of $100 and pay CBIT of $31.

The amount added to the entity's EDA is $7.80, computed as follows:[16]

$6.90 (10% of ($31/.31−$31))
+.90 (10% of $9 interest allowed as a deduction)
$7.80

Debtholders would be entitled to exclude $1.00 of the $10.00 in interest they receive, thereby reducing the EDA to $6.80.[17] If the entity distributed its remaining after-tax earnings of $68 ($109 minus $10 interest minus $31 tax) to shareholders, shareholders could exclude $6.80 from income, thereby reducing the EDA to zero.

Example 2. The facts are the same as in Example 1 except that the entity made no distribution to shareholders in the first year and it has identical income and interest in the second year. Thus, it has $109 of gross income and is allowed an $8 interest deduction, resulting in $101 of taxable income.

The entity's EDA is computed as follows:

$ 6.80 (balance of EDA from year 1)
13.94 (20% of ($31.31/.31−$31.31))
1.60 (20% of $8 interest allowed)
$22.34

Debtholders in this year would be entitled to exclude $2.00 of the $10.00 in interest they receive, reducing the EDA to $20.34. If the entity distributed its $68 in after-tax earnings from year 1 plus its $67.69 in after-tax earnings from year 2 ($109 minus $10 interest minus $31.31 tax), shareholders would be entitled to exclude 20 percent of the $135.69 dividend or $27.14. This amount exceeds the EDA balance of $20.34 because only 10 percent of the earnings from year one are reflected in the EDA. To compensate for the 20 percent exclusion at the shareholder level, a 31 percent compensatory tax of $2.11 is imposed on the $6.80 differential. (Thus, the differential amount is treated like retained earnings from pre-CBIT years.)

Example 3. The facts are the same as in Example 1, except that the entity earns $20 in preference income in addition to the $109 in gross income. Thus, its after-tax earnings available for distribution to shareholders in year 1 would be $88 ($68+ $20). If it distributed the entire $88 in year 1, shareholders could exclude 10 percent of that amount, or $8.80. As a result, a 31 percent compensatory tax of $.62 is imposed on the $2.00 by which the shareholder exclusion exceeded the EDA balance ($8.80−6.80). This amount also is 10 percent of the entity's preference income.

As the foregoing examples indicate, a uniform investor level phase-in of CBIT could be more easily accomplished if the prototype includes a compensatory tax. If CBIT does not include a compensatory tax, and instead investors are subject to tax on preference and sheltered foreign source income, a phase-in might be accomplished by limiting the portion of dividends and interest that are excludable to the lesser of (1) the phase-in percentage multiplied by the amount of the payment and (2) the EDA balance. As a consequence, all payments would be excludable up to the phase-in percentage to the extent of the EDA, and all payments thereafter would be taxable.