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Taxation of Legal Persons and their Owners

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It is also obvious that the type of rules which we have been discussing, although they are unquestionably rules of binding law, have in no way the character of religious commandments, laid down absolutely, obeyed rigidly and integrally.The bundles of fish, the measures of yams, or bunches of taro, can only be roughly assessed, and naturally the quantities exchanged vary according to whether the fishing season or the harvest is more abundant.

—Branislaw Malinowski

I. Introduction

A. In General

Two of the perennial issues in tax policy debates are whether a specific tax should be formally imposed on enterprise profits and collected from enterprise earnings, and, if so, how it should be constructed. Levying a separate tax on the earnings of large corporations is almost universal practice,¹ often existing at both national and subnational levels, and in fact predates the imposition of universal income taxes on individuals in some jurisdictions.² Yet, the tax is not without its detractors, and suggestions for its reform or even repeal are often heard.

¹See *supra* Introduction, note 10.

²The corporate tax in the United States was first imposed in 1909, four years before the personal income tax was introduced. Historically, the tax was justified as equivalent to a license fee or benefit tax, imposed for the privileges flowing from the creation by the state of a separate person. Those benefits include perpetual life despite changes of investors, limited liability for investors, transferable interests with standardized (but variable) rights for ease of transfer and the ability to sue (and be sued) in the corporation's own name. That justification has generally been regarded as insufficient because there is little relationship between the value of the privilege and the size of corporate profits.

Another view accepts the legal fiction—that a separate person has been created by the process of incorporation—and the imposition of the separate tax simply affirms this fiction in the tax context. This rationale too is regarded as unsatisfactory today because it conflicts with modern financial theory, which simply regards the enterprise as a group of investors acting collectively under one or more legal structures. The legal fiction of the separate legal person is simply inappropriate in a tax context.

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Given the prevalence of the corporate tax, it may seem curious that there is such a debate, and so this introduction will outline some of the main points of contention before their more detailed examination in the body of the chapter. At the policy level, critics have pointed to the perceived deficiencies of the tax, and their list is indeed long and daunting—the so-called economic double taxation of corporate income (when enterprise profits are taxed, as are distributions of those taxed profits), the conjectural incidence of the tax (because its effects might be shifted to shareholders, workers, or consumers), the indeterminate and discretionary amount of tax payable (because the amount of tax varies with such factors as the capital structure of the corporation and the timing and proportion of distributions and retentions), the apparent incentive for corporations to finance their activities through debt (because interest is usually deductible while dividends are not) and to retain earnings (because retained earnings are not taxed as dividends but are usually taxed at a lower effective rate as capital gains), and the possible tax-induced distortions of the way economic activities are organized and conducted (avoiding corporate form for less transparent but more lightly-taxed alternatives).

Despite the shortcomings of the tax—the significance of which is still the subject of much debate—its supporters have pointed to several important benefits. They argue that it could approximate the economist’s ideal tax on pure “economic rents”—that is, a tax on the excess of revenue over the corporation’s total input cost, including the cost of capital. Such a tax would have no distortionary effects because it taxes pure profit. Even detractors of the tax acknowledge that there are serious obstacles to removing it, not the least of which is the substantial windfall that would be conferred on holders of equity interests if the tax were removed. Other important obstacles to its removal arise from interdependencies: changing the corporate tax would also require changing the personal income tax and international tax systems. First, under personal income taxes as they typically currently operate, the enterprise tax is the principal means of preventing deferral of tax and arbitrage of ordinary income into preferentially taxed capital gains. In other words, the enterprise tax is necessary to protect the tax base of the personal income tax. Next, it is an important source of revenue from nonresidents under the existing allocation of taxing rights between countries. The current system allocates rights to tax capital income from equity investments primarily to the source country, and rights to tax capital income from debt investments primarily to the residence country. Unilaterally abandoning the right of the source country by repealing the corporate tax would confer an unrequited windfall on the residence country.

The other aspect to the debate is more operational—if the tax is to exist, how should it be constructed? At one end of the spectrum, the “separate entity view” would construct and operate the personal and corporate taxes independently. The other, the “conduit” view discussed below, would adjust the taxes to recognize the existence and operation of both. At present, and on balance, the conduit view has probably emerged in a majority of countries as the most satisfactory theoretical paradigm for imposing tax on income derived from an equity investment in a business enterprise.³ Ultimately, if the

³For example, two successive government reports in Australia, the Asprey Committee in 1972 and the Draft White Paper in 1985, suggested that the ideal treatment for income derived through entities was to approximate the conduit approach—“[the] ideal arrangement ... would recognize for income tax purposes

conduit view is accepted, its implementation must lead to one of the three theoretical options—imposing tax at the investor level only, imposing tax at the enterprise level only, or imposing tax at both levels, with the corollary of adjusting one tax for the effects of the other.

This chapter considers these policy and operational questions. Section II examines imposing tax at the investor level only and discusses why a tax imposed at the enterprise level, rather than at the shareholder level only, has generally been regarded as necessary. Section III considers in more detail whether important benefits can be achieved by a tax imposed at the enterprise level only. Section IV examines some possible adverse consequences likely to flow from the decision to use an enterprise-level tax that makers of tax policy and tax officials must be aware of and, more important, be prepared to manage. Section V examines systems that have both enterprise-level and investor-level taxes, and some of the options for structuring the interaction between them. Section VI discusses the typology and effect of distributions in their interactions with different enterprise and investor systems. Section VII examines how to define the taxpayer. Section VIII draws some general conclusions.

B. Relationship Between Enterprise Income and Investor Income

Most countries permit various legal structures for organizing profit-making enterprises. These include sole proprietorships, different types of partnerships, companies, and trusts. Modern financial theory views each form of enterprise as a group of investors acting collectively under one or more legal structures. Those structures are all based on contract law and include partnership law, trust or foundation law, and company law.⁴ The traditional forms of organizing an investment include equity, debt, and leases⁵ of movable, immovable, and intellectual property. Each different form of investment,

the shareholder's interest in both the distributed and undistributed earnings of the company and would tax the combined amount at each shareholder's marginal tax rate; the company would be taxed only as a withholding arrangement to collect personal tax on the income." Australia, Reform of the Australian Tax System ¶ 17.9 (1985) [hereinafter Draft White Paper]. In contrast, the United States has always had a completely separate system and continues to do so despite a number of recommendations by the U.S. Treasury Department to the contrary. See, e.g., U.S. Dep't of the Treasury, Blueprints for Basic Tax Reform (January 1977) [hereinafter Blueprints] (arguing for full integration between corporate and personal income taxation); Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth 117–20 (November 1984) [hereinafter Treasury I] (arguing for partial integration); The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985) [hereinafter Treasury II]; Department of the Treasury, Integration of Individual and Corporate Tax Systems: Taxing Business Income Once 27–35 (1992) [hereinafter U.S. Treasury Report] (arguing for full integration).

⁴The theory that each business enterprise is the product of different contractual relationships among investors was first advanced in the English-speaking world by the economist Ronald Coase. See R.H. Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937).

⁵The term "lease" is used in a broad sense that would include a rental agreement or a licensing agreement as well as finance leases and operating leases.

whether stock or partnership interest, bank loan or bond, or lease, creates for the investor a different type of claim to the income and property of the joint business enterprise.⁶

Traditionally, equity holders receive their income in the form of a mixture of periodic payments (partnership distributions or dividends) and increases, or perhaps decreases, in the value of their investment (capital gains or losses). Depending on the local law, equity investments in companies can take other traditional forms, such as preferred stock.⁷ The bondholder or banker is typically entitled both to a fixed rate of return on his or her loan and to repayment of the original amount invested; he or she may sue the company if these amounts are not paid.⁸ A typical creditor generally has no direct say in managing the company.⁹ However, a creditor may also experience increases or decreases in the value of his or her investment depending on changes in the creditworthiness of the company, as well as on changes in interest rates or in rates of inflation.¹⁰

⁶For example, the typical partner or common stockholder has no right to receive either a fixed rate of partnership distributions or dividends, or a return from the partnership or company of his or her equity contribution. The common stockholder does, however, have other rights: he or she is entitled to what is left of the partnership or company property after other investors have been paid what they are legally entitled to. The partner or stockholder has some direct say in how the company is managed, thereby providing a mechanism for increasing the likelihood of higher rates of return. Limited partners do not participate in the day-to-day running of the partnership, but their liability, as with stockholders in companies, is limited to the amount of their investment. See Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835 (1988).

⁷Preferred stockholders are paid dividends before other types of equity investors, but those dividends are limited by a cap. See generally Richard A. Brealey & Stewart C. Meyers, *Principles of Corporate Finance* 303–05 (3d ed. 1988).

⁸As will be discussed at greater length *infra*, there may be no clear dividing line between “equity” and “debt.” See generally Franklin Allen, *The Changing Nature of Debt and Equity: A Financial Perspective*, in *Are the Distinctions Between Debt and Equity Disappearing?* 12 (Richard W. Kopcke & Eric S. Rosengrew, eds. 1989), and Charles P. Normandin, *The Changing Nature of Debt and Equity: A Legal Perspective*, in *id.* at 49. However, statutes, regulations, and courts have often tried. In the United States, the Court of Appeals in *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) defined debt as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof.” See also David Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 404 (1971). In the United Kingdom, the Court of Appeal in *Lomax v. Peter Dixon & Co, Ltd* [1943] 2 All ER 255, 259–62, noted that each case of whether a payment constitutes interest must be “decided on the facts,” and that the relevant factors in making such a determination would be the contract, the term of the loan, the stipulated rate of interest, and the nature of the capital risk. See also Butterworths UK Tax Guide 1990–91, at 338–90 (John Tiley 9th ed. 1990) [hereinafter Butterworths Guide]. The doctrines developed in case law go beyond “thin capitalization,” where equity investors also contribute debt capital.

⁹However, most substantial creditors may, through the terms and conditions of the loan agreement, exercise considerable control over certain aspects of management.

¹⁰The simple unsecured creditor is only one type of traditional debt investor. There are also secured creditors, who typically have a better chance of getting paid than do unsecured creditors. A secured creditor may also experience increases or decreases in the value of his or her investment depending upon changes in the value of the creditor’s security interest. The change in value will be more acute for

A lessor is in a legal position similar but superior to that of a creditor whose note is secured by assets. He or she may also see the value of the investment vary on the basis of the value of the security or leased good, as well as the general creditworthiness of the company.¹¹ A lease can shift the risk of loss from the owner to the person who leases the asset, while the owner may retain the opportunity of increase in value.

Different legitimate market-based reasons exist for packaging investments in different economic forms.¹² Risk is among the most important. As risk increases, investors will demand compensation for assuming that risk. Unsecured loans are riskier than secured loans or leases; partnership interests and common stock may have the greatest risk of all, but also the greatest opportunity for gain.

Changes in the value of the interest of any particular investor should be equal to the investor's share of the change in the total value of the enterprise. In other words, the value of an investor's interest will equal the total change in value of the enterprise minus everyone else's share. However, to make this calculation, one must first determine the income or loss of the enterprise. Forms of investment that have been traditionally referred to as "debt" or "leases" periodically pay or accrue interest, rent, or royalties to the investor. Therefore, the change in the value of the taxpayer's investment in the enterprise can be determined largely from the amount of interest, rent, or royalties that has been paid or accrued to him or her. Debt that is accrued over time, but that is not currently payable, can be recalculated so that the "reinvested" portion of the unpaid interest is included.¹³ However, as noted above, the value of the debt or lease investment may not be completely reflected in the stated interest or rent. Even in simple debt

nonrecourse creditors. A lower debt-to-equity ratio means that there is a greater amount of funds in the business (from the equity capital) to serve as a "cushion" for payment of fixed obligations, which reduces the likelihood of default on the obligations. Other factors affecting the level of risk include the history of payment of the interest and the use of the advanced funds. See David V. Ceryak, *Note: Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes*, 66 Ind. L.J. 273, 283–84 (1990).

¹¹Rent compensates the lessor for any accruing capital loss plus the opportunity cost of the asset. See George V. Mundstock, *Taxation of Business Rent*, 11 Va. Tax. Rev. 683, 684–85 (1993); George V. Mundstock, *The Mistaxation of Rent: Eliminating the Lease/Loan Distinction*, 53 Tax Notes 353, 353–54 (1991).

¹²See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 310–11 (1976).

¹³For example, in the United States, original issue discount is accrued over the lifetime of the debt and is compounded semiannually. See USA IRC § 1272(a). See generally David C. Garlock, *A Practical Guide to the Original Issue Discount Regulations* (1993). A similar regime exists in the United Kingdom. See GBR ICTA § 57, sched. 4; Butterworths Guide, *supra* note 8, at 397–405. Similar treatment is afforded in Australia. See AUS ITAA Div. 16E. See also Graeme S. Cooper, *Tax Accounting for Deductions*, 5 Aust. Tax F. 23 (1988).

relationships, changes in the creditworthiness of the enterprise, or changes in interest rates, will affect the value of the underlying indebtedness.¹⁴

The legal structures of investments have become increasingly varied and complex and have mixed many of the traditional attributes of equity, debt, and lease.¹⁵ Examples include debt with call options or contingent interest, shared appreciation mortgages, and notional principal contracts. Instruments that allocate risk in different ways are constantly being created.¹⁶ In the more advanced economies, these instruments have a long history. However, even in developing markets, there has been a proliferation of forms of financial instruments representing different types of investments in for-profit enterprise. The internationalization of finance and financial advice has resulted in the prompt spreading of those diverse investment forms throughout the world, or at least to those jurisdictions whose legal structure can accommodate them. As investments become more complicated, the difference between the stated “current yield” and the actual net income of the investor can become quite great.¹⁷

The various types of equity investors are entitled to the income of the enterprise minus the amounts paid or accrued to creditors and lessors. Because of the occasionally bewildering forms of equity participation, exactly how this income is to be divided may be clear only to the lawyers who draft the forms of participation. Nevertheless, the earnings of the equity participants are the principal object of the taxation of legal persons.

¹⁴The difference between pure interest income and gain or loss from interest rate changes is relatively easy to determine. However, unless the debt is an instrument publicly quoted on an exchange, changes in default risk are difficult to determine. See generally David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1164 (1986).

¹⁵A high-yield high-risk “bond,” such as a deeply discounted debt instrument, may more closely resemble traditional equity than a low-yield redeemable cumulative preference share. See generally Jeremy I. Bulow, et al, *Distinguishing Debt from Equity in the Junk Bond Era*, in *Debt, Taxes and Corporate Restructuring* 135 (John B. Shoven & Joel Waldfogel, eds. 1990). In economic terms, these are all investments, and returns on investments, with different allocations of risk of gain or loss. While the economic realities of investments can be described with some accuracy, it is often difficult to put these realities into clear legal categories.

¹⁶See the discussion of these forms of investment, and the relationship to risk allocation, in Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 Tax L. Rev. 401, 404, 429–31 (1989), and Alvin C. Warren, Jr., *Commentary: Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 483–89 (1993).

¹⁷Leif Mutén refers to it as “the floating borderline between capital gain and current yield, which is barely discernable...[in] sophisticated financial instruments.” Leif Mutén, *International Experience of How Taxes Influence the Movement of Private Capital*, 8 Tax Notes Int'l 743 (1992). However, with regard to fixed-interest debt instruments with a final redemption date, the variation is limited to downside risk over the life of the instrument. Equity, in the form of either securities or direct ownership, constitutes a residual claim to the assets themselves and may fluctuate freely in value; there is no inherent limit on fluctuations. Debt, however, constitutes a finite stream of payments already specified in nominal terms. Debt can decline to zero, but its value cannot exceed the undiscounted sum of nominal payments. With debt, while market value may deviate, the sum of deviations over time will be zero. See Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 Tax L. Rev. 313, 358–59 (1992).

II. Enterprise Income Taxation as a Withholding Tax on Investors

In principle, it would be possible to tax all income of a business enterprise directly to its equity investors by treating all business enterprises as “flow-through” entities and allocating income to investors on a yearly basis.¹⁸ However, treating the business enterprise as a separate taxable entity has a number of advantages over flow-through treatment. One problem with flow-through treatment is that it may be difficult to allocate earnings among a large number of increasingly bewildering types of equity holdings. Another is that, as the number of equity investors increases, allocation becomes more difficult.¹⁹ As a result, no country has implemented such an approach.

Some or all of the enterprise earnings may be paid out to the equity investors, often at the option of enterprise managers or the investors themselves.²⁰ Taxing such distributions does not pose any great difficulty; they can simply be added to the income tax base of the shareholder.²¹ A problem arises with the earnings retained by the enterprise. Most of the value of retained earnings is expressed primarily as increases in the value of the interests of those equity investors who have the legal right to the earnings retained by the company.²² It would, in theory at least, be possible to tax the equity investor on the change in the value of the equity participation.²³ The tax base of such a system would include not only the amount of retained taxable earnings of the enterprise, but total economic income as well, including earnings not typically included in the income tax base, such as unrealized gains in the value of assets.²⁴ It would also include changes in the value of the equity interest that are not related to the economic income of the enterprise, for example, a systemic shift in stock market prices if the interest is a

¹⁸See *infra* sec. V(B)(6); ch. 21.

¹⁹These arguments, as well as others, are summarized in U.S. Treasury Report, *supra* note 3, at 27–35.

²⁰In the case of preferred stock, payment typically is not optional.

²¹See *supra* ch. 16.

²²Of course, some of the value can be realized by other investors. A company that retains earnings is likely to be more creditworthy, and the value of its bonds would therefore be likely to increase.

²³Changes in the value of debt investments could also be taxed on an accrual basis. See Sims, *supra* note 17, at 336, 338, 356–57. However, valuation problems could be insurmountable, as they may be with equity interests.

²⁴This would also include any special tax benefits provided the enterprise, such as the excess of tax depreciation over economic depreciation. See U.S. Treasury Report, *supra* note 3, at 82, and The American Law Institute, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes: Reporter's Study of Corporate Tax Integration (Alvin C. Warren, Jr., Reporter: 1993) [hereinafter ALI Integration Report], at 129–32.

traded share.²⁵ Such a change in value would have to be assessed as part of the tax base annually; if not, the taxpayer would benefit from the time value of money on the deferred taxes.²⁶

A number of suggestions have been made in favor of such accrual taxation of gains (and losses) on ownership interests in business enterprises. Yet, while such systems might be practicable for equity interests that are regularly traded with enough liquidity to determine a price, they would be difficult indeed for other interests.²⁷ For other equity interests, it might be possible to make periodic valuations and to adjust them for errors once the interest is actually traded, or whenever a fair market value can be ascertained with certainty.²⁸ However, a system of periodic valuation would ignore the possibility that the value of the interest can shift, perhaps even wildly, during the holding period.²⁹ This can create difficult problems for tax administration.³⁰

Even if one could accurately determine changes in the value of equity interests on an annual basis, including these changes in the tax base would still be problematic. First, and perhaps most important, is the problem of collection. Taxes on capital gains are among the most difficult to enforce and collect. Except where there is direct reporting to the tax administration from exchanges or from broker-dealers, each individual

²⁵See the discussion of “speculative” gains in Michael L. Schler, *Taxing Corporate Income Once (Or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Models*, 47 Tax L. Rev. 509, 525 (1992).

²⁶See Henry Simons, *Personal Income Taxation* 100 (1938).

²⁷Such a system is outlined in David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 Yale L.J. 623 (1967). However, there could be strategic selling of traded securities as a way of driving down the price on the valuation date. This could be countered by taking an average price over a limited time period. See also Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 Stan. L. Rev. 857, 871-76 (1982); Victor Thuronyi, *The Taxation of Corporate Income—A Proposal for Reform*, 2 Am. J. Tax Pol’y 109 (1983). Such proposals have also been made for debt interests. As noted above, in many instances it is difficult to determine whether a particular interest is “equity” or “debt”; it can also be difficult to divide instruments with characteristics of both into their equity and debt parts. See the general discussion of such instruments and how they might be taxed in Warren, *supra* note 16, at 474–82.

²⁸The correction would have to include the time value of money. This could be done by adjusting the amount of tax due by imputing an interest rate during the time that the taxpayer held the asset. See Mary L. Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 727, 728–31, 733 (1990). Cf. USA IRC §§ 1291–1297 (imputed interest rate to account for the benefit of tax deferral).

²⁹The more volatile the value of the asset, the more frequently it must be assessed if over- or under taxation is to be avoided. Because risky assets do not reveal their “value path,” there are many possible paths between the starting and ending value and, for each possible path, there is a different continuous tax. Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implications*, 99 Yale L. J. 1817, 1822, 1865–79 (1990). See also Fellows, *supra* note 28, at 744.

³⁰But see Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?* 47 Tax L. Rev. 377 (1992), who argue that real value paths might be constructable using computers if the data are available.

taxpayers must voluntarily disclose the amount of gain or loss. The taxpayer must then remit the correct amount of tax. Even in the United States, which has a relatively effective tax administration, taxpayer compliance in reporting capital gains on traded securities and remitting the required tax is low. The most likely reasons are the lack of withholding for such tax and the absence of accurate information reporting.³¹ And, because there may be a plethora of equity investors, the problem of administration is magnified. Obviously, the less sophisticated the tax administration, or the less likely taxpayers are to report income voluntarily, the worse this problem becomes.

A second problem would result from any difference in tax treatment between ownership interests in business enterprise and business income earned directly or through flow-through entities. As noted earlier, accrual taxation of ownership interests would include not only what is commonly accounted for as taxable income, but also accrual taxation of unrealized gains in the value of assets held by the enterprise.³² While proposals have also been made for accrual taxation of all assets used in the course of business,³³ no tax jurisdiction has adopted the rule. If the effective tax rate on the income of business enterprise were substantially different depending on the form of the enterprise (flow-through or non-flow-through), there would be a tax-induced preference to operate in the form that produced the lower effective tax rate. For equity, efficiency, and administrative reasons, such tax incentives should usually be avoided.

The problems inherent in taxing equity interests on an accrual basis can be avoided by levying a tax on the income of the business enterprise as a surrogate for the tax that equity participants would pay if all company income were distributed. In that way, the enterprise would not be able to defer tax simply by not paying dividends. If the enterprise tax were levied at the same effective rate as the tax paid on dividend income by the owners of the enterprise, there would be no deferral benefits. Because most direct equity investors are likely to be taxed either at the top marginal personal rate or at a final schedular rate, business enterprises should also be taxed at this top or schedular rate.³⁴ A

³¹See Steven Klepper & David Nagin, *The Role of Tax Practitioners in Tax Compliance*, 22 Pol'y Sciences 167 (1989); G.A. Feffer et al., *Proposals to Deter and Detect the Underground Cash Economy*, in *Income Tax Compliance: A Report of the ABA Section on Taxation*, Invitational Conference on Income Tax Compliance (P. Sawicki, ed. 1983); Steven Klepper et al., *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J.L. & Econ. 205 (1991).

³²The Meade Committee in the United Kingdom defined a true profit tax base as “the real current profits of the corporation, whether these be distributed or undistributed. It involves the deduction from gross profits of net interest on debt, an allowance for true economic depreciation...a calculation of real accrued capital gains made by the company on its assets [plus inflation adjustment].” Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* 229 (1978) (Report of the Meade Committee) [hereinafter Meade Committee Report].

³³David J. Shakow argues that all business assets should be subject to accrual taxation. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1119–23 (1986). See also Strnad, *supra* note 29, at 1903–04, and Fellows, *supra* note 28, at 741–42.

³⁴A detailed discussion on rate relationships can be found in Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 717 (1981). See also 4 Report of the Royal Commission on Taxation [Canada] 51–57 (1966).

single-rate tax on business income would obviate the need to distinguish among different types of equity holders and, at least initially, to allocate income among such holders.

Income already taxed at the enterprise level may eventually be distributed to physical persons. If the tax system elects to levy a schedular, final tax on income from capital, the tax paid at the enterprise level can serve as that final tax on any distributions. If, instead, such income is taxed at progressive marginal rates, the tax paid at the enterprise level can serve as a withholding tax, for which a credit can be given the investor and for which a refund can be paid if necessary.³⁵

Using a separate enterprise tax as either a final schedular tax or a withholding tax has proved to be an effective way of collecting tax on business income. Such a tax is typically levied as a separate legal liability on the enterprise. Because there are fewer enterprises than there are investors, and because they are more easily identifiable, having an enterprise as the principal taxpayer makes administration much easier than having only the investors as legal taxpayers. It also makes it much easier for the tax administration to distribute or collect adjustments resulting from audit.³⁶

A number of technical reasons also favor a separate business enterprise tax over flow-through treatment. The first is that losses suffered at the enterprise level may be prevented from flowing through to equity investors and will then not be set off against other, taxable income.³⁷ Second, transactions that might not typically be viewed as giving rise to taxable income in the case of flow-through entities can more readily be deemed to do so under a separate enterprise tax. The most important of these is the entity may make distributions to its investors of economic income that was not taxed at the enterprise level. For example, income that benefits from tax incentives, or from the inexact science of tax bookkeeping (such as unintended acceleration of depreciation or income from unrealized capital gains), would not normally be taxed currently. However, under a separate system of business enterprise taxation, if such income were distributed as a dividend it might then be subject to tax.³⁸

³⁵The conclusion that a separate company tax should serve as a withholding tax on the earnings of equity investors has recently been advanced in the European Union's Ruding Committee Report and in the American Law Institute's Federal Income Tax Project. Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation [Onno Ruding, Chairman] 31–32 (1992), [hereinafter Ruding Committee Report]; ALI Integration Report, *supra* note 24. However, the U.S. Treasury recently advanced the theory that a final, separate company tax, without deductions for interest, could serve as a part of a schedular tax on income from capital. *See generally* U.S. Treasury Report, *supra* note 3; Nicholas Brady, *Letter to Congress*, in Department of the Treasury, Treasury Integration Recommendation 2 (1992) [hereinafter U.S. Treasury Recommendation].

³⁶*See* George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 Tax L. Rev. 431, 431–33 (1992).

³⁷*See id.*

³⁸*See infra* sec. V(B)(1).

However, treating a business enterprise as a separate taxable entity, even if the tax raised is then treated as a prepayment or withholding of tax on income eventually received by the equity investor, can create a number of serious administrative problems. These problems vary depending on (1) whether investors who are physical persons are to be taxed at graduated rates on a global income basis or at a final schedular rate, and (2) how close a connection is made between the tax on the business enterprise and the tax due at the level of both the equity investor and the nonequity investor. The elaboration of these problems, and how they might be dealt with in an income tax law, constitutes the principal subject of this chapter.

Most jurisdictions employ a system of flow-through taxation for certain types of business enterprise and separate taxation for others.³⁹ The choice of which business enterprises to subject to business entity tax and which to tax on a flow-through basis depends on a number of considerations. The greater the difference in outcome between the separate entity tax and flow-through treatment, the greater the incentive for taxpayers to engage in tax planning by selecting the more favorable form.⁴⁰ Such tax planning may make tax administration more difficult and may affect the economy adversely if more efficient legal forms of business enterprise are eschewed in favor of those that are less efficient, but tax preferred. While inefficiencies may result from requiring small partnerships to be treated as separate taxpayers, as a general matter, making the net of inclusion for separate business enterprise tax as wide as possible will, in most instances, ease tax administration. For example, including all legal persons and entities engaged in business or profit-making activities (depending on how such organizations are defined under the applicable law), unless they have a very small number of owners, may be preferable to providing flow-through treatment for all partnerships.

³⁹See *infra* ch. 21. Guidelines as to which entities are subject to company tax are discussed in app. A.

⁴⁰For example, in the United States, where failure to achieve flow-through taxation means not only that losses do not flow through to equity holders, but that business earnings are subject to a second level of taxation on distribution, there has been a particularly strong incentive for enterprises to organize so as to avoid such double taxation. See Francis J. Worth & Kenneth L. Harris, *The Emerging Use of the Limited Liability Company*, 70 *Taxes* 377 (1992).

III. Separate Taxation of Business Enterprises and of Distributions to Investors

While theory suggests that, in general, an enterprise income tax should be levied only as a withholding tax or a final schedular tax for business income of legal persons, a number of major income tax systems continue to apply the “classical” system of separate taxes on the income of certain business enterprises and physical persons, resulting in double taxation of that income.⁴¹ A number of arguments have been advanced in favor of the classical system.

A. Tax on Economic Rents

Some economists have supported the imposition of a separate business enterprise tax in order to capture “economic rents”, or pure profits, which an investor earns in excess of the “cost of money”—that is, the given risk-free rate of return to capital.⁴² In theory, economic rents can be taxed without adversely affecting investment because they represent a return in excess of that otherwise required to make the investment.⁴³

Taxing both enterprise income and enterprise distributions would not necessarily tax economic rents. Instead, a system of double taxation would more likely result in inaccurate taxation of the amount paid to equity investors. With equity investments, the risk of low dividends or capital losses will largely be offset by the possibility of dividends or capital gains that are higher than the risk-free cost of money. Therefore, over time, earnings will include compensation for that risk. In other words, part of the excess of the return to equity investment over the risk-free average cost of capital is

⁴¹For example, the United States has always had a completely separate system and continues to have one despite a number of recommendations by the U.S. Treasury Department to the contrary. *See, e.g.*, Blueprints, *supra* note 3 (arguing for full integration between corporate and personal income taxation); Treasury I, *supra* note 3, at 117–20 (arguing for partial integration); U.S. Treasury Report, *supra* note 3 (arguing for full integration). Although the Japanese moved from a system of integration to a fully separate system in 1990, the general movement has been in the opposite direction—from a separate system to a fully integrated one. For example, France integrated its system in 1965, the United Kingdom in 1973, Germany in 1976, Australia in 1987, and New Zealand a year later. *See* K.C. Messere, Tax Policy in OECD Countries: Choices and Conflicts 346 (1993). Reports from both the OECD and the EU have, although sometimes obliquely, supported full integration over separate income taxation; Meade Committee Report, *supra* note 32; OECD, Taxing Profits in a Global Economy: Domestic and International Issues 25–30 (1991) [hereinafter OECD Report]; Ruding Committee Report, *supra* note 35, at 31–34.

⁴²Another way of putting it is that economic rents are the part of a return on an investment that exceeds the amount needed to induce the investment in the first place. A patent, for example, can produce economic rents.

⁴³For example, if the cost of money is 8 percent, any amount in excess of 8 percent can be taxed away before the investor will select another investment, which, by definition, pays only 8 percent. *See* Ruding Committee Report, *supra* note 35, at 31–32; OECD Report, *supra* note 41, at 21–23 (1991). *See also* Richard Musgrave, The Theory of Public Finance 262–67 (1959); Carl Shoup, Public Finance 266–69 (1969).

likely to be not economic rents, but a risk premium. Taxing this risk premium as economic rent could cause substantial distortions.⁴⁴ Methods have been developed to tax such rent; however, these methods appear seriously flawed.⁴⁵

B. Subsidy Recapture

Some commentators have tried to justify a separate enterprise tax as a surrogate levy for the cost of government goods and services provided to those enterprises.⁴⁶ The argument is that all investors operate in an environment deeply affected by free government benefits and that the level of government spending may increase the profitability of economic activity. This additional charge would, it is reasoned, ensure that the government does not distort the market allocation of resources.

It is difficult to see how the cost of government services provided to enterprises can be realistically related to additional income that is attributable to the equity holders of

⁴⁴For example, if the risk-free cost of capital is 5 percent, then an investor will be willing to put her or his money into a risky investment if the chances are, on average, that she or he will receive 5 percent. Assume that a person at a 40 percent marginal tax rate invests \$100 in a company and that income in excess of the cost of capital is taxed away as economic rents. If, in year 1, the company's return on equity were 10 percent, and if it then distributed all of its earnings, the company would pay tax of 5, and the stockholder would pay tax of 2 (40 percent x 5), for a total tax of 7. However, assume that the extra 5 percent earned in year 1 did not constitute economic rents, but a risk premium for investing in equity. The next year the investor would be as likely to earn nothing as she was to earn 10 percent the year before. Therefore, assume that the company had no earnings in year 2. Neither company nor investor would owe any tax. That would mean that, over a two-year period, the investor would have paid tax at a rate of 70 percent. This approach would clearly result in a bias away from risky investments.

⁴⁵One is to permit companies to deduct the full cost of all capital investments. The effect of such a deduction would be to eliminate company tax on earnings equal to the risk-free cost of money. In other words, only returns on capital in excess of the cost of money, represented by the present value of a full deduction for capital investment, would be subject to tax. Such a tax on rents would not look like a withholding tax on company income. However, it could be added as a separate tax to a withholding tax on company income. See Meade Committee Report *supra* note 32, at 232–33. However, there are a number of caveats: (1) tax rates must remain the same, (2) the tax savings from the expensed asset must be invested at the same rate of return, (3) there must be no preexisting assets on which income can be exempted, (4) all expensed assets must be subject to taxation on disinvestment, (5) the taxpayer must benefit fully from a current deduction, and (6) the investor must be able to borrow any needed funds at a fixed rate of interest. Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv. L. Rev. 1575, 1597–605 (1979).

Even if such a redesigned company tax on rents were added to a withholding tax on company income, there could still be an adverse effect on the economy. For innovation to occur, a higher rate of return from innovative ideas may be necessary. This is not just compensation for risk; it is also compensation for the labor that goes into innovation, but for which there has been no other compensation. This theory holds only if the innovators (or those who select them) have an equity participation in their product, something that anecdotal evidence suggests is often the case. The theory can be extended to portfolio equity investors. They are able to pick “winners” only because they apply their own labor to pick them. If these profits were taxed as rents, a decrease in innovation, and the money to finance it, would result.

⁴⁶This argument has been raised directly with the authors by a number of officials in countries in Eastern Europe and Asia.

those enterprises. The argument seems to be that the total benefits provided free to the company would equal the total company income tax collected and that a particular enterprise's share of the benefits would equal its share of the tax. This relationship seems highly implausible. Specially designed excise taxes (or alternatively charges for the services) would be a more efficient way of compensating for such benefits.

C. Increased Vertical Equity

Some have argued that, because companies tend to be owned by the wealthy, company taxes should constitute a separate tax so that the vertical equity or fairness of the overall tax system can thereby be increased. A higher tax on all forms of income from capital would increase overall progressivity. Presumably, the most effective way of increasing the vertical equity of an income tax system is to increase its progressivity on all forms of income. However, under double taxation, only equity investments are subject to a separate tax. Removing existing tax benefits that favor the wealthy or imposing a more progressive income tax rate structure or, perhaps, a wealth tax would be more likely to raise the overall progressivity of the tax system than would taxing the income from equity capital twice.

D. Retention of Existing Double Taxation

Some have argued that, while a separate enterprise tax regime is not preferable in theory, if one is established it should be retained, at least for existing equity.⁴⁷ First, eliminating double taxation would reduce revenues.⁴⁸ Second, it could result in a windfall to current equity holders because the effect of double taxation would already have been capitalized by a reduction in the price of equity.⁴⁹ Equity investors will have demanded that other investors compensate them for the double tax burden they bear, so that the after-tax rate of return on equity would equal the after-tax rate of return on other investment forms. If the separate corporate tax were removed, equity investors would receive a windfall as the value of equity increased.

⁴⁷American Law Institute, Federal Income Tax Project, Reporter's Study Draft—Subchapter C (Proposals on Corporate Acquisitions and Dispositions) 327 (1989).

⁴⁸This is probably one of the most important arguments against eliminating double taxation in industrialized countries such as the United States as well as in developing countries. *See, e.g.*, U.S. Treasury Report, *supra* note 3, at 33. In Ghana, until 1975, the Income Tax Law provided for complete integration of company and personal income taxes. An official tax commission stated in 1977 that it was unable to establish the rationale for adopting the classical system in 1975. However, once enacted, the classical system was difficult to repeal for revenue reasons. *See* Seth E. Terkper, *Ghana, Trends in Tax Reform (1985–93)*, 8 Tax Notes Int'l 1267 (9 May 1994). *See also* Meade Committee Report, *supra* note 32, at 227–29.

⁴⁹*Id.* *See also* American Law Institute, Federal Income Tax Project, Reporter's Study Draft—Subchapter C (Supplemental Study) (1989); Report of the Royal Commission on Taxation to the Federal Government of Canada (Kenneth Le M. Carter, Chairman), Dec. 1966 [hereinafter Carter Commission Report], ch 19.

While these arguments have merit, the effort to preserve a separate tax on old equity is unlikely to be worth avoiding the inequity of potential windfall benefits. First, potential losses in revenue can be made up with higher rates, or by eliminating investment incentives and other tax expenditures; jurisdictions that have recently eliminated double taxation have relied primarily on the latter technique.⁵⁰ Second, investors take many forms of risk: one is that the tax system will change in a manner that affects them. If total revenues from capital income do not decrease, then eliminating double taxation will shift wealth from debt investors to equity investors, a risk that both forms of investors would probably have anticipated and for which some discounting may already have occurred. In addition, some have suggested that the burden of the separate enterprise tax is often substantially reduced through tax planning and that the amount of windfall shifting would therefore be small.

IV. Problems with Retaining Double Taxation of Business Income

A. Aggravation of Tax Planning

A system of double taxation of equity income creates incentives to avoid double taxation through tax planning, and may involve opportunities to avoid tax altogether. Among the techniques are the following:

- (1) Choosing business forms that are not subject to double taxation, where feasible. For example, commercial laws may allow taxpayers to set up entities that will be treated as transparent for tax purposes—partnerships or trusts might be available options—and that have enough of the properties investors want, particularly limited liability and free transferability of interests.
- (2) Raising capital through legal forms that allow deduction of payments to investors, such as rental payments and interest. As was mentioned above, modern financial instruments give taxpayers opportunities to structure their investment in a form that is classified as debt, so that the return on the investment reduces the corporate tax base, but that has enough of the desired attributes of equity, particularly the opportunity to share in the potential gains from corporate success.
- (3) Distributing earnings to equity investors through techniques that do not give rise to the second tax.⁵¹ Corporate law may allow corporations to return amounts to investors through a variety of devices, including the redemption of redeemable preferred stock, partial reductions of capital, or the repurchase of common stock. These amounts will be a desirable substitute for a distribution of a similar amount that is labeled a dividend.

⁵⁰See Dale W. Jorgenson, *Tax Reform and the Cost of Capital: An International Comparison*, 6 Tax Notes Int'l 981 (1993); David R. Tillinghast, *Corporate - Shareholder Integration as an Obstacle to the International Flow of Equity Capital*, 5 Tax Notes Int'l 509, 510 (1992).

⁵¹See ALI Integration Report, *supra* note 24, at 21; George R. Zodrow, *On the "Traditional" and "New" Views of Dividend Taxation*, 44 Nat'l Tax J. 497, 501 (1991).

- (4) Making deductible payments to investors (and their associates) in their capacity as directors or employees. Small businesses in particular will be able to reduce the corporate tax base by paying salaries to owner-managers and to family members, thus achieving two benefits—a reduction in the corporate tax base and the splitting of income within the family.⁵²
- (5) Retaining, rather than distributing, profits. The event that triggers imposition of the personal income tax will usually be the payment of a dividend or the sale of shares.

Insofar as it is possible for the corporation's managers to delay triggering this event by retaining profits, the shareholder tax can be delayed and thus reduced.

Such incentives can lead to inefficiencies in the operation of enterprises. How significant these inefficiencies prove to be depends upon the circumstances—a more benign view of these devices regards them as self-help remedies employed by investors to alleviate the problem of double taxation informally.

These issues are symptomatic of the problems that arise whenever one legally defined form of investment is taxed at a higher rate—taxpayers will usually try to recharacterize that investment as a form taxed at a lower rate. This legal recharacterization is time consuming, expensive for the tax administration to prevent, and frequently a losing battle. These problems do not necessarily go away once taxation of equity income is limited to a single level of tax. As long as the final, effective rates of tax on different types of income from business enterprise are different, these problems will exist. While eliminating the second level of tax generally reduces the incentive to recharacterize interests to a preferred type, as long as final effective tax rates differ, the incentives will remain, albeit in a less virulent form.

That is to say, even if a system is formally designed to tax business enterprise income once, the way in which the system is designed may result in income being taxed differently depending on whether capital is in the legal form of equity or debt or lease, or on whether earnings are distributed to equity investors other than through normal distributions.

B. Profit Retention

More generally, two concerns have been expressed about the overall economic impact of the corporate tax on economic activity. One is that it tempts corporate managers to retain rather than distribute profits. The other is that it encourages the financing of investment through debt rather than equity.

The effect of the corporate tax on required rates of return and, by inference, on the cost of capital can be illustrated in the following example. Assume a corporate tax rate of 30 percent and a personal income tax rate of 40 percent. Assume also that investors have

⁵²See *supra* ch. 14, secs. IX, X.

enough other investment opportunities with the same risk profile and that the corporation needs to provide investors with an after-tax return of 6 percent to induce them to part with their savings. In these circumstances, the investment would need to offer a pre-tax return of 8.5 percent [$6/(1-0.30)$] if it could be financed out of retained earnings and the corporation did not need to distribute profits, 10 percent [$6/(1-0.40)$] if the investment were to be financed through debt, and more than 14.3 percent [$6/(1-0.3)(1-0.4)$] if the corporation needed to finance the investment with new equity and investors expected to receive dividends.

Not surprisingly, therefore, commentators have tried to assess the consequences of the incentive to retain profits. Insofar as retained earnings are used to finance corporate expansion, they serve as a substitute for raising that capital through formal borrowing, leasing, or further equity issues. These substitutes are likely to be conducted under the scrutiny of the market—bankers will examine the corporation’s solvency and cash flow before making further loans, underwriters and investment houses will examine the prospectus for a further share or bond issue, and so on. This scrutiny is not applied when the managers of the corporation can choose how much profit to retain. The fear is that the tax system will encourage managers of existing mature companies to retain funds unnecessarily and invest in projects that are less than optimal in order to use the excess funds. These retained earnings should instead be liberated for the use of fast-growing innovative companies.⁵³ Some argue, however, that retained earnings are a source of additional private savings within an economy.

There is no unequivocal evidence that these outcomes have occurred systematically and that, where they do occur, it is the tax system rather than independent corporate financial policy that is the motivating cause. There are competing visions of the economic effects of these incentives. According to the so-called traditional view, the increased tax cost associated with dividend payouts is likely to be significant, and corporations will therefore tend to rely on retained earnings. When retained earnings prove to be inadequate, and corporations have to issue further equity, they will have to raise their payout ratios to meet the added tax costs, increasing their cost of capital. But an important qualification to this prognosis is the recognition that systemic factors may prevent excess profit retention from becoming a problem—nonfiscal considerations may outweigh the fiscal advantages. The market may not allow shareholder distributions to be deferred indefinitely, and shareholders may insist on receiving some return as an indication of the ongoing soundness of the corporation.⁵⁴

An alternate vision, the so-called new view of corporate taxation, argues that because the tax disadvantages of dividend payouts are well known, corporations will indeed finance their activities largely through retained earnings. Paradoxically, however,

⁵³See generally OECD Report, *supra* note 41, at 25; Sijbren Cnossen, *Corporation Tax in OECD Countries*, in *Company Tax Systems 73–77* (John G. Head & Richard E. Krever eds. 1997).

⁵⁴See generally Richard A. Brealey & Stewart C. Meyers, *Principles of Corporate Finance*, ch. 16 (4th ed. 1991); Frank H. Easterbrook, *Two Agency-Cost Explanations of Corporate Dividends*, 74 *Am. Econ. Rev.* 650 (1984); Merton H. Miller & Myron C. Scholes, *Dividends and Taxes*, 6 *J. Fin. Econ.* 333 (1978).

the higher taxation of dividends will be of little consequence.⁵⁵ According to this theory, shareholders might save the personal income tax on the dividends they would otherwise have received, but, adopting a longer-term view, they have simply converted the immediate tax on distributions into a deferred capital gains tax liability that will be triggered on the disposal of their investment. If this is so, buyers of the security will discount it to reflect the deferred liability, and so the additional tax is capitalized into the price of the share. The additional tax is a real cost that the original holder of the share will bear whether or not the distribution is paid. The buyer of the share recoups the additional tax because he or she has been able to buy the share at a reduced price, reflecting the implicit tax liability. If this new view is correct, the additional tax on distributions becomes almost irrelevant for mature companies because the existing shareholders are affected in both cases and the buyer is not affected in either case.

C. Debt and Equity

The final question is whether the corporate tax system encourages firms to finance their investments excessively through debt. If so, it is feared that firms would be vulnerable to bankruptcy in times of economic downturn and that increased numbers of bankruptcies would exacerbate the destabilization of the national economy during such a period.

Whether there is an incentive to finance new investments through debt or retained earnings, and how significant it is, will depend on the differences between the tax treatment of the investor under the personal income tax and the corporate tax—that is, the corporate tax rate on retained earnings must be compared with the personal income tax rate on interest income

In an international context, the substitution of debt for equity has additional consequences. For an individual country, it implies the diminution of the domestic tax base because the return on corporate equity is taxed in the source country through the imposition of the corporate tax on the resident corporation. The return on corporate debt, by contrast, is often taxed only in the residence country because the interest reduces the domestic corporate tax base and there will often be no withholding (or only limited withholding) on interest payments paid to another country. The result is that the investor's country of residence instead of the source country will tax the interest payment.⁵⁶

V. Relationship Between Enterprise Income and Investor Income

A. Single Schedular Tax on Income from Capital

⁵⁵James Poterba & Lawrence Summers, *The Economic Effects of Dividend Taxation* in E. Altman & M. Subrahmanyam (eds.), *Recent Developments in Corporate Finance* (1985); Zodrow, *supra* note 51; Leif Mutén, *Bolagsbeskattning och kapitalkostnader* (1968) (The Corporate Income Tax and the Cost of Capital).

⁵⁶*See supra* ch. 18.

1. Equity Interests

As noted earlier, there are two basic systems for taxing income derived from an equity investment in a business enterprise. The first is to tax the income at a single rate that is applied to all investors and applied on a schedular basis to the net income of the enterprise. The second is to tax the income at different rates (typically graduated) depending on the circumstances of each investor; that is, the particular rate applied is determined by reference to the investor's total net income. Typically, then, the income from the business enterprise is added to the total net income of the investor, and the appropriate rate is applied on the basis of that total net income. Which system is chosen and how the system is implemented are exceptionally important to the operation of the enterprise income tax. A related issue is which system is used to tax income from deductible debt (or lease) investments.

Chapter 14 discusses a number of issues surrounding the choice between taxing income at schedular rates or at multiple, typically graduated, rates applied to a global income base. In addition to those issues, there is often considerable support for exempting not-for-profit organizations and pension funds from income tax. However, it should be noted that the economic and social arguments in favor of such exemptions are often less than fully convincing.⁵⁷ In addition, existing bilateral double taxation agreements might provide for varying rates of tax depending on the residency of the investor. It is, however, quite possible, and perhaps even advisable, to exempt nonresidents from any withholding tax (in addition, that is, to enterprise level tax).⁵⁸ There have also been a number of concerns that a schedular tax is less equitable than a graduated tax. However, schedular tax on income from property or capital, with a progressive tax on income from labor, has been advanced as a technique that would combine the added fairness of progressive taxation with the simplicity of schedular taxation.⁵⁹ In spite of these arguments, it might still be difficult to fully implement a policy of a single, schedular rate of tax on income from business enterprise.⁶⁰

The main administrative benefit of a single schedular rate is that the tax can largely be levied at the company level, without reference to the investor. As will be discussed later in this chapter, in particular, when a single schedular tax rate is combined with a highly effective enterprise tax and full imputation, problems involving levying

⁵⁷See Richard K. Gordon, *Law Reform and Privatization*, 13 Boston Univ. Int'l L. J. 264 (1995)

⁵⁸See *supra* ch. 18. The elimination of additional withholding tax on distributions of non-residents is the system used in Singapore, for example.

⁵⁹See, e.g., 4 Carter Commission Report, *supra* note 49, at 51–57; OECD Report, *supra* note 41, at 32; U.S. Treasury Report, *supra* note 3, at 2–4.

⁶⁰For example, the U.S. Treasury recommended a single rate of tax on all business income, primarily because it would aid in the administration of the income tax. Nevertheless, it bows to political reality by failing to recommend one at the present time. See U.S. Treasury Report, *supra* note 3, at 2–4.

taxes on distributions at the shareholder level more or less disappear. As can be imagined, this makes for perhaps the easiest type of enterprise-shareholder tax system to implement. There are two possible exceptions to this rule. The first involves the taxation of capital gains and losses realized by the investor when he or she sells the equity investment. However, as will be discussed, the more effective the enterprise tax, the less important the investor level capital gains tax. In such cases, one can probably exempt most investors most of the time from tax on such gains without much loss of revenue or equity.

The second exception is that, if income from each separate business enterprise is taxed on a schedular basis, the losses associated with an investor's share in an unprofitable enterprise will not be used to offset the income of a profitable enterprise. This will raise concerns of tax administration and taxpayer equity, as investors try to accomplish this offset by other means. This problem is, by and large, not completely solvable unless losses of all business enterprises are flowed through along with income. Because levying a tax on business income is designed in part to avoid having to allocate earnings and losses among equity investors, the problem of schedular taxation is shared by all separate enterprise income tax systems.

The most obvious problem with multiple rates is that discussed briefly earlier: to avoid the deferral problems that the entity tax is designed to combat, the rate of entity income tax must be the highest rate at which investors are taxed. Thus, some investors will be taxed at rates higher than the marginal rate that applies to their other income. The problem does not come up if there is a single rate of tax.⁶¹

A single rate of tax on all earnings from equity investments is clearly preferable from a tax administration viewpoint. The problems that need to be addressed under a multiple-rate system are discussed later in the chapter.

2. Debt and Lease Interests

Taxing *all* income, including that from debt and leases, at the same schedular rate eases administration markedly. First, one of the more difficult and complex areas in tax administration involves distinguishing equity interests from debt. While limiting taxation of income from equity investments to a single level of tax is an essential step toward equal taxation of equity and debt, it is not the only issue. If income from both equity and debt investments is taxed once, but the income from one or the other is taxed at a different rate, an incentive will still exist to design the legal form of the investment to fit

⁶¹Many systems, particularly transition economies, that subject at least some business enterprise income to double taxation do so by levying a final withholding tax on the amount of the distribution, often at a rate lower than the top marginal rate of individuals. However, the rates of the final withholding tax vary among nonresident taxpayers, and the tax does not generally apply to investors that are legal persons. *See, e.g.* KAZ TC Arts. 31–33. Systems that tax enterprise income only once, at a single schedular rate, do not need to levy an additional withholding tax. *See* McLure et al., *Taxation of Income from Business and Capital in Colombia* 91–95 (1990). The Dominican Republic imposes a withholding tax that is essentially an advance corporate tax, because the corporation receives a credit for it. *See* DOM TC §§ 297, 299, 308.

the category of income that is taxed at that reduced rate. It is in part for this reason that the U.S. Treasury Report recommended that the income from both equity and debt investments be taxed identically, at a single schedular rate.⁶² The usual administrative response to different tax treatment for income from equity and debt interests is to establish rules of “thin capitalization” or “earnings stripping.”⁶³

Even if the income from both debt and equity investments is taxed formally at the same rate, the method by which an entity income tax is typically levied causes the tax treatment of income from equity and debt investments to differ in some cases. This is because the general treatment of income accruing to a debt investor is to allow the entity to deduct the interest accrued or paid.⁶⁴ The deduction at the entity level ensures that the interest is not subject to tax at that level. Instead, the interest income can be taxed as income to the lender.⁶⁵ By contrast, income on equity investments is generally taxed at the entity level and perhaps also at the shareholder level.

The tax administration problem arises under three circumstances. One of these arises from the mismatching of preference income and deductions: the income of the taxpayer entity is largely tax exempt, while deductible interest (or lease) payments that can be used against income that is not tax exempt are allowed. This issue will be addressed below.⁶⁶ The others arise because of the different treatment of income from equity investment and debt investment, shareholder and creditor; even if these categories are taxed formally at the same schedular rate, they are not taxed at the same effective rate.

Deductions are clearly worth more to taxpayers who are in higher tax brackets.⁶⁷ If a deduction by one taxpayer is followed by an equivalent inclusion for another, as is generally the case with interest payments, overall taxes will be reduced if the taxpayer paying the deductible amount is in a higher rate bracket than the recipient of the payment. There will then be an incentive for those paying at the higher rate to accrue as many deductions as possible. They can then share the benefits with those paying the lower rate. Of course, if the borrowing can be structured so that a deduction by the borrower is not followed immediately by an inclusion by the lender, a tax benefit will accrue even if the lender is taxed at the same rate.

⁶²See *infra* note 88.

⁶³See *supra* ch. 18.

⁶⁴Where, in the exceptional case, interest on debt is not deducted, it will usually be capitalized into the cost of an appropriate asset, to be subtracted in calculating the gain or loss made on the disposal of the asset.

⁶⁵See generally the discussion in chs. 14 and 16 on interest expense.

⁶⁶See *infra* sec. V(A)(3)(A).

⁶⁷For examples, see William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 337-41 (1972).

The borrowing taxpayer can structure investments in a number of ways to increase or accelerate deductions. First, the taxpayer can overstate total amounts of interest. As discussed earlier, payment of interest is directly related to risk.⁶⁸ Even if inflation risk is eliminated from taxation through adjustment,⁶⁹ differences in default risk will result in different interest rates being paid by different borrowers.⁷⁰ Therefore, it can be difficult for tax authorities to determine how much of a payment would constitute actual economic interest and how much a return of invested capital.

Debt instruments can also be designed to accelerate interest payments in early years. One way is to structure the instrument so that it pays interest through discount. The payer can then seek to accrue interest on an annual basis without including the compounding effects of the discount. Although both of these avoidance techniques can be countered with proper accounting rules for interest imputation,⁷¹ financial product innovation has made such accounting increasingly difficult.

If, however, both the borrower and the lender are taxed at the same schedular rate on this periodic income, the incentive to shift income is eliminated. Any benefit that the debtor might derive by mischaracterizing interest in order to take a deduction when one is not legitimately due is canceled by the taxation of such income to the creditor.⁷² Also, and of great importance, the schedular tax on the creditor can be levied at source.

Identical rates of schedular tax on equity and interest earnings (as well as among different types of interest)⁷³ would not end all problems of the allocation of payments between interest and principal or of interest over time. This is because it is impossible to effect a single, schedular tax at the entity level. Normally under an entity-level tax, losses at the entity level do not flow through to the investor.⁷⁴ Therefore, if the entity has

⁶⁸See *supra* sec. I.

⁶⁹See vol. 1, ch. 13.

⁷⁰Some commentators have suggested that, over the past 60 years in the United States, the real risk-free rate of return has been less than 1 percent, with an inflation risk of only 3.1 percent. With nominal interest rates for most borrowers often vastly exceeding this amount, the difference can largely be attributed to default risk. See Bankman & Griffith, *supra* note 30, at 337–38, 387–90.

⁷¹See the discussion regarding discounted instruments, *supra* note 13. See also the discussion of accrual accounting of interest in ch. 16.

⁷²See the discussion of mismeasurement and accrual of interest income and its relationship to different effective rates for debtor and creditor, in Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest*, 44 Tax L. Rev. 335, 335–37, 348, 367 (1989), and in Shaviro, *supra* note 16, at 432–33.

⁷³If rates differ among creditors, allocation of payments between interest and principal and temporal allocation of interest will continue to be necessary. See U.S. Treasury Report, *supra* note 3, at 53–54.

⁷⁴There are possible exceptions where the equity investor might be able to realize the loss. See *infra* note 79. However, even if losses did flow through, the investor might not have enough other income against which the loss can be taken, and from which a benefit would accrue for the deduction. Although many tax

no taxable income, and if any carrybacks for current losses do not result in a refund, an interest deduction at the entity level may not be worth any current tax benefit.⁷⁵ In such cases, there will be an incentive for the creditor to reduce or eliminate interest payments by mischaracterizing interest as principal or by delaying interest deductions.⁷⁶

There are two major reasons that an entity may have no taxable income. First, it may be a for-profit business enterprise, but have no taxable income⁷⁷ either because it has no economic income or because it benefits from tax preferences—deferral or complete exemption. If the entity has no economic income, mischaracterization of interest and principal or delay in accruing interest should not be a significant tax policy concern. The reason that the entity would mischaracterize interest and principal is that the genuine, economic loss resulting from the payment of interest could not be effectively reflected in a reduction in the tax base. Under a Haig-Simons analysis, a decline in wealth should be reflected in a decrease in the taxpayer's tax base.⁷⁸ It is only the practical operation of the entity-level tax that prevents this loss from being accrued. Therefore, with certain exceptions,⁷⁹ the equity owner is unfairly penalized for being unable to realize the value of the deduction for any interest actually accrued or paid. If there is an offsetting reduction in the tax owed by the creditor, there will be no net loss to the exchequer; any shifting of tax benefits between entity and creditor can be adjusted by the two actors. If the creditor's tax is collected through withholding at source the adjustment could be implemented quite easily.⁸⁰

systems permit taxpayers to carry back losses for a refund if they had paid tax in previous years, or to carry forward losses against income tax due in the future, it is likely that no existing income tax system allows for a refund for business losses if no tax has been paid in the past or if none is paid in the future. Even in the latter case, a deduction that can be taken in the future bears the loss of time value of money.

⁷⁵There may be other reasons for an entity losing the benefit of a current deduction for interest, such as earnings stripping rules or interest “quarantining” rules governing borrowings used to finance investments in income-preferred assets. *See infra* sec.V(A)(3)(A).

⁷⁶Of course, the benefit received by the creditor can then be shared with the entity.

⁷⁷Including as a result of loss carrybacks. *See supra* note 74.

⁷⁸*See generally* Stephen Lewis, *Taxation for Development* 57–58, 87–90 (1984); David Bradford, *Untangling the Income Tax* 15–43 (1986).

⁷⁹These exceptions relate to whether the entity, or its equity investor, can realize the loss in another way. One way would be for the investor to sell his or her interest at a loss, with the loss being reflected in the interest payment or accrual made at the entity level. If this loss can be used to reduce taxes at the investor level, such as through the application of a capital gains tax at the investor level that permits the deduction of losses, then the value of the interest deduction can, in fact, be used.

⁸⁰This also raises the question of deductibility of interest by the physical person investor or flow-through entity on debt to acquire equity interests in entities subject to separate taxation. *See supra* ch. 16, sec.VI(A).

Second, the entity may be a governmental, charitable, or other entity that is statutorily exempt from tax.⁸¹ Pension funds are also typically exempt from income taxation. The problem posed by exempt entities may be reduced by taxing them on their investment income, which may well be advisable from a purely economic perspective as well. Such taxation would create a tax base from which the entity could deduct interest expenses.⁸²

It is also possible that there is economic income at the entity level, but that this income is “tax preferred”, such that no tax is currently due. The preference can be intentional; for example, provisions in the law may exempt some income from tax, tax some income at a lower rate, or delay the inclusion of some income until a later time. Some income may be unavoidably subject to a timing preference because of the deferral of tax on unrealized capital gains. In these instances, there will also be an incentive to understate deductions at the enterprise level, so as to have a mirror understatement of income at the creditor level. Unlike the earlier case, the tax administration should be concerned about understatements of income tax at the creditor level.

These problems can be minimized by reducing or eliminating special tax benefits. However, if a realization system of taxation is retained for most capital gains, the problems will never be eliminated, although this chapter will argue that the distortions caused by the realization event system can be greatly minimized by marking certain financial assets to market, and by taking into income currently total borrowings in excess of the total adjusted cost of assets. However, if these ideas are not implemented or only partially implemented, the tax administration will have to ensure that interest accrues to the creditor.

As noted earlier, it is difficult to impute interest on debt whenever a risk premium is due. It is also increasingly difficult to impute interest on many financial instruments. One possible solution is to require a minimum imputation of interest on all debt instruments, based on the amount of capital invested. This minimum imputation could be based on a provision in the income tax code that would give the tax administration the authority to impute an interest component on any debt obligation of a legal person.⁸³

One possible technique for more completely equating the tax treatment of income from equity and debt might be to extend deductibility treatment to returns on equity investments. Some proposals have arisen in the past to do so, particularly to partially

⁸¹See *infra* appendix A.

⁸²The general issue of taxing otherwise exempt entities on their investment income is discussed *infra* in appendix A.

⁸³See, e.g., USA IRC §§ 7872, 462(a) and (g). Continental systems such as the French and German have separate, although general, rules for imputation of interest income for legal and for physical persons, as well as specific rules for imputation of interest between or among related parties. See chs. 14, 16.

integrate entity and investor taxes.⁸⁴ Extending deductibility treatment would not solve the problems discussed above. If the entity had no taxable income, there would still be a benefit to the debt investor and therefore, by extension, to the equity investor who might share the benefit. However, with regard to distributed income, equivalent treatment would certainly prevail. No major income tax system currently affords such treatment, for a number of reasons. Two of the most important are the passing along of foreign tax credits to investors and the treatment afforded nonresident equity investors under most double taxation agreements.⁸⁵ Dividend deduction models are largely missing from the world tax scene.

Some have suggested that equation of treatment could be reversed; instead of allowing a deduction for payments of earnings on equity investments at the enterprise level, deductions for interest expense could be disallowed. The 1991 U.S. Treasury Report on integrating company and investor taxes recommended taxing income from both equity and debt investments entirely at the entity level by denying a deduction for interest payments. This would turn the entity tax into a comprehensive business income tax.⁸⁶ The problems of understating interest or delaying its payment or accrual would disappear in that the interest deduction would no longer formally be part of the income tax system. However, the net economic result would be the same; the recipient would be able to defer tax on interest income when the entity had economic, but not taxable, income.⁸⁷ Once again, the obvious answer is to, where possible, apply a system whereby taxable and economic income most closely approximate each other.

Eliminating deductions for interest could be a technique for ensuring that, at least with regard to interest accrued, such payments would be taxed at the same rate, that is, the entity rate. In this sense, disallowing deductions is analogous to integration schemes that tax entity income only and exempt the distribution from tax at the shareholder level. Such treatment would certainly reduce debt-equity and earnings-stripping problems. However, such a system has not yet been attempted in any major tax jurisdiction (except partially, as part of a regime to prevent earnings stripping.)⁸⁸ Once again, much of the

⁸⁴In 1984, the U.S. Treasury recommended a 50 percent deduction for dividends, *see* Treasury I, *supra* note 3, at 136–37, while the White House recommended a 10 percent deduction, *see* Treasury II, *supra* note 3, at 122–26.

⁸⁵*See supra* ch. 18. A deduction for an imputed return on equity is allowed in Croatia. *See* HRV PT §§ 7–9; Manfred Stöckler and Harald Wissel, *Die Gewinnbesteuerung in der Republik Kroatien*, *Internationale Wirtschafts-Briefe* 527 (June 14, 1995).

⁸⁶The comprehensive business income tax would levy tax on a schedular basis at the entity level on both debt and equity investments by denying a deduction for interest, levying a single tax on entity income, and exempting from tax at the investor level both equity distributions and interest payments. U.S. Treasury Report, *supra* note 3, at 39–58.

⁸⁷This would be because, without accrual of taxable interest to the creditor, no tax would be levied on that interest.

⁸⁸*See* the discussion regarding earnings-stripping provisions in chs. 16, 18.

reason for this may stem from the existence of double taxation agreements and the problems that would arise if all interest income were effectively taxed to nonresidents at the enterprise rate of tax, rather than at the rates specified by those agreements.⁸⁹ However, treating interest in this way is logically consistent with taxing equity income only at the entity level and—if a decision is made to tax income from capital at a single rate and if the international dimensions can be negotiated—may constitute the easiest system of entity taxation to administer.

3. Treatment of Preferred Income

A. DEDUCTIONS FOR INTEREST EXPENSE

As noted earlier, problems arise with regard to the like tax treatment of debt and equity, or of different types of debt and different types of equity, when the entity has tax-preferred income. The tax effect on the equity investor may also be problematic. If the tax on the “preferred” income is deferred or if this income is tax exempt, there will be an incorrect tax result, either a reduction in tax (because of the time value of money) or a complete exemption. However, the taxpayer may be able to finance the investment with borrowed money. Normally, the payment or accrual of interest leads to a real decline in wealth. As noted earlier, under a Haig-Simons analysis, a decline in wealth should be reflected in a decrease in the taxpayer’s tax base.⁹⁰ However, a taxpayer with no taxable income cannot benefit from the deduction. The benefit of the exclusion afforded the taxpayer on the preferred income would be reduced by the denial of interest deductions. While it is unlikely that denying the interest deduction would have the same effect as the benefit afforded through the preferred income, it would have the effect of a partially compensating disallowance.⁹¹ However, if the taxpayer has other *taxable* income, the taxpayer may use the interest deductions against this income, thereby avoiding tax on this income as well.⁹² The effect would be to eliminate the (only partially) compensating distortion caused by the inability to benefit from the deduction of interest, which may compound the problem of having preferred income in the first place.

Tax policy analysts normally recommend for reasons of economic efficiency and administrative ease, eliminating tax preferences whenever politically possible. If all preferences were eliminated, in theory at least, this mismatching problem would cease to exist. And, although many tax systems have attempted to travel far in the direction of eliminating preferences, the problem of tax deferral under the mixed accrual/realization

⁸⁹Moreover, problems may arise in applying a foreign tax credit for the creditors. See the discussion of these regimes in ch. 18.

⁹⁰See *supra* note 78.

⁹¹To do so is to “to achieve a second-best state through the creation of compensating distortions.” Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 983–84 (1967).

⁹²See Shakow, *supra* note 33, at 1165.

event system of accounting is unlikely to go away entirely. This means that a taxpayer can borrow against assets that have appreciated in value, but on which the gain has not been taxed, while still being able to deduct interest. This situation has been described as allowing the taxpayer to “realize” the gain (by borrowing against it) without having to pay tax on it.⁹³

Chapter 16 discusses techniques of “quarantining” or otherwise disallowing interest deductions when they relate to the financing of tax-preferred income.⁹⁴ An alternative approach is to recharacterize not the deduction of interest, but the borrowing itself.

As noted earlier, tax-preferred income can take a number of different forms, the main ones being statutory incentives (which the legislature can avoid enacting) and preferences related to the realization event (which are difficult to avoid). The benefit of the latter is not permanent, but is related to timing. In effect, by delaying the taxation of accrued gains, the taxpayer benefits from the time value of the deferred tax. When the taxpayer realizes the gain by selling or transferring the gain asset, tax is incurred; obviously, if possible, the taxpayer would prefer to avoid such a taxable event.

However, if the taxpayer needs cash, he or she can instead borrow the money. In effect, borrowing the money is analogous to selling or transferring the asset. Instead of quarantining interest by disallowing a deduction in a “compensating distortion,” it would be possible to treat the borrowing as a realization event, at least to the extent that the borrowing exceeds the adjusted cost (book value or written-down value) of the asset. If the borrowing is secured by a single asset, the amount of gain could be determined on the basis of that asset alone. To the extent that the borrowing is not secured by a single asset, the amount of the gain could be determined on the basis of all assets held by the taxpayer.

For example, if the taxpayer holds a single asset with an adjusted cost of \$10 and borrows \$20, he or she would include \$10 in taxable income. The asset’s cost basis would be increased to \$20, and the full amount of interest due on the \$20 debt would be deductible. If the taxpayer has a large number of assets, with a total adjusted cost of

⁹³Although there is also a shift in risk to the lender. See Shaviro, *supra* note 16, at 442–43.

⁹⁴As ch. 16 discusses, many jurisdictions limit interest deductions for financing tax-preferred income. The U.S. Internal Revenue Code provides for one of the most exhaustive limits on interest deductibility. See USA IRC §§ 56(b)(1)(C) (limitation on interest deduction for purposes of minimum tax); 163(d) (limitation on deduction of interest on investment indebtedness); 170(f)(5) (limitation on deductibility of interest on debt incurred to purchase or carry bond given to charity when interest relates to period during which donor is not taxed on income from bond); 264 (disallowance of deduction for interest on indebtedness related to insurance contracts); 265 (disallowance of deduction for interest on indebtedness related to tax-exempt income); *cf.* USA IRC §§ 263A(f) (capitalization of construction-period interest); 246A (limitation on dividends received deduction for debt-financed portfolio stock); 291(e)(1)(B) (partial disallowance as tax preference of interest on debt incurred by financial institutions to purchase or carry tax-exempt bonds); 1277 (deferral of interest deduction allocable to accrued market discount); 1282 (deferral of interest deduction allocable to accrued discount); 7701(f) (regulations to be prescribed to prevent avoidance through related parties of provisions that deal with linking borrowing to investment).

\$100,000, and borrows \$200,000, he or she would include \$100,000 in income, and the adjusted cost of all assets would be increased by \$100,000. However, because each individual asset would have to be adjusted, the \$100,000 increase would have to be apportioned among all the assets, for example, on a proportional basis.⁹⁵

Although no jurisdiction currently treats borrowing as a realization event, the logic of such an approach seems compelling. It would have additional benefits with regard to taxing economic earnings at the entity level that are distributed to the equity investor; this issue will be dealt with at greater length below.

In addition to this technique, other accounting methods can be used to reduce the amount of accrued but unrealized capital gains (and losses as well). The most important of these is to require enterprises to mark assets to market whenever reasonable. In particular, such marking to market could be done for foreign exchange, precious metals, and securities and financial derivatives for which a listed price could be easily obtained.

B. TAXATION OF EQUITY DISTRIBUTIONS FROM PREFERENCE INCOME

Tax-preferred income of flow-through entities can normally be distributed to the investor without any immediate additional tax consequence, although typically there are consequences for the taxation of capital gains and losses when the entity interest is transferred.⁹⁶ For investors in entities without flow-through treatment, similar tax rules could apply; all income tax would be levied at the entity level on the preferred income.⁹⁷ If the preferred income were of the permanent, or exclusion variety, no tax would ever be paid. If the preferred income were of the deferral type, tax would be paid when the preference expired at the entity level.

⁹⁵Using the formula: amount of increase in adjusted cost of a particular asset = adjusted cost of the particular asset/sum of adjusted costs of all assets X total increase of adjusted cost of all assets. Such a formula is used in the United States when a company is purchased through the sale of its shares. To ensure that the adjusted cost of the assets of the company equals the adjusted cost of the shares of the company, the company may “step up” the adjusted cost of its assets. See USA IRC § 338(a) and (b)(1), (4), and (5). See also Treas. Reg. §§ 1.338-3(b), 1.338-4. See also the discussion of related issues in ch. 20. This ensures that gain on the assets is paid only once and results in better correlation of what the Americans call “inside basis” (the adjusted cost of assets held by the enterprise) and “outside basis” (the adjusted cost of the equity interests in the enterprise). Cf. *infra* ch. 21, sec. II(G). Such a system of comparing total adjusted costs of assets with total borrowings can perhaps be more easily implemented if the balance sheet method of entity taxation is used. See *supra* ch. 16. In fact, an adjustment for an increase in adjusted cost for each individual asset can be analogized to the balance sheet inflation adjustment described in vol. 1, ch. 13.

⁹⁶Typically, the adjusted cost of the entity equity interest is reduced by the distribution. Once the adjusted cost drops to less than zero, the difference between the cost and zero may be included in income. When the equity interest is transferred, there may be a taxable capital gain (or loss) on the transfer. See ch. 21.

⁹⁷Once again, excluding the issue of taxing capital gains and losses on the transfer of an entity interest.

Such tax treatment of the distribution of preference income to equity investors is extremely rare.⁹⁸ In the vast majority of jurisdictions, tax is levied on distributions out of income that was not already fully subject to tax at the entity level. Tax can be levied in various ways, and those variations have considerable effect on the administration of the tax (see discussion below). However, levying tax on such untaxed income has two basic and important effects on tax administration, one somewhat positive and one quite negative. Therefore, before examining the specific effects of different forms of implementation, we discuss why distributions of preference income should be taxed in the first place.

Various arguments have been raised as to why distributions from preference income should be taxed.⁹⁹ One reason is that specifically enacted tax preferences may have been designed to encourage investment. Whenever a business entity distributes such income, the implication may be that it is to be used for consumption and not for investment. Therefore, a tax should be levied. Another argument, which applies only to systems that tax all distributions of *economic* income not previously taxed, is that any income arising from timing preferences that can be realized without otherwise incurring entity income tax (primarily through borrowing) should be taxed as if the distribution were a realization event. Finally, if equity holders are taxed at different rates, distributions should always be subject to tax to ensure that a higher-rate investor will pay tax at the higher rate on such distributions.¹⁰⁰

Again, of course, these problems are reduced, or may disappear entirely, as the amount of preference income is curtailed or eliminated.

B. Multiple Taxes on Income from Capital

A single schedular tax on capital income derived through legal persons may be considered unacceptable for a variety of reasons, not the least of which is the difficulty of finding an acceptable single rate. The “conduit view” is not fully implemented if the single tax rate imposes higher tax burdens on low-income investors or reduces the tax burden of high-income investors.¹⁰¹

⁹⁸One of the few examples is the treatment afforded partnerships (and similar legal forms) in Indonesia. IDN IT § 4(1).

⁹⁹See U.S. Treasury Report, *supra* note 3, at 18–21; ALI Integration Report, *supra* note 24, at 58–66.

¹⁰⁰*Id.*

¹⁰¹Although this section focuses on the relationship between individual investors and legal persons, the issues discussed below and the choice of mechanism also arise when the investment is made through the mediation of another legal person. In other words, these kinds of mechanisms are even more necessary to prevent the cascading of corporate taxes and dividend withholding taxes as corporate earnings are passed through a chain of corporations to the individual who is the ultimate investor.

Consequently, many countries find it necessary to operate in tandem both the enterprise-level profit tax and the investor-level personal income tax. This section reviews some of the more commonly used options for reducing or eliminating the double taxation of capital income that these systems can induce. It describes in detail some of the principal interaction mechanisms between the enterprise and personal income tax used in the taxation systems of various countries. Except for one case, the interaction mechanisms attempt to deal only with the double tax on distributions and leave untouched the double tax on retained corporate profits.¹⁰² Given that the issue they try to resolve is the double taxation of equity, they deal only with returns on equity investments, not interest or rent.

Even with these restrictions, it is common to see a wide variety of idiosyncratic mechanisms for integrating the enterprise and individual tax, and so this section will describe the most important features of a few representative types seen in practice.¹⁰³ The design of these interaction systems involves many issues, but the most important are the following:

- The level at which the relief is to be provided. The mechanism for reducing double tax on dividends can operate at either the enterprise or the shareholder level.

¹⁰²The after-tax return to the shareholder will depend significantly upon the form in which profits are made available to shareholders: cash distribution, distribution of enterprise assets in lieu of cash, allotment of new shares paid for from profits, redemption of existing shares paid for from profits, retention of profits, and so on. In the following discussion, it is assumed that the enterprise's managers choose only the first and last alternatives, distributing some fraction of the enterprise's profits as cash and retaining any balance for reinvestment. It will also be assumed that the cash distribution is not a liquidating distribution (or that, if it is, the distribution is dealt with in an identical manner to a cash distribution).

It is also assumed that all distributions made are taxable so as to prevent managers from recharacterizing detected evasion as the return of capital to shareholders. This assumption accords with the probable wish of the enterprise's managers that shareholders believe that the distribution is from profits, not a return of their investment.

¹⁰³There is a voluminous body of literature on this issue. For descriptions of various methods of interaction and differing taxonomy, see generally 4 Carter Commission Report, *supra* note 49, at ch. 19; Blueprints, *supra* note 3; OECD, Company Tax Systems in OECD Member Countries 9–11 (1973); Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719 (1981); George F. Break, *Integration of the Corporate and Personal Income Taxes*, 22 Nat'l Tax J. 39 (1969); Charles E. McLure Jr., *The Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532 (1975); Charles E. McLure Jr., *Integration of the Income Taxes: How and Why*, 2 J. of Corporate Tax'n 429 (1976); Charles E. McLure Jr., *Must Corporate Income Be Taxed Twice?* (1979); J. Pechman, *Federal Tax Policy* 179–89 (5th ed. 1987); Richard M. Bird, *Taxing Corporations* (1980); Martin Norr, *The Taxation of Corporations and Shareholders* (1982); OECD, *Theoretical and Empirical Aspects of Corporate Taxation*, chs. 1, 2 (1973); Martin Feldstein, *Capital Taxation*, ch. 8 (1983); Congressional Budget Office, *Revising the Corporate Income Tax*, ch. 8 (R. Lucke ed., 1985); Julian Alworth, *Piecemeal Corporation Tax Reform: A Survey*, in *The Political Economy of Taxation* 72–73 (Alan Peacock & Francisco Forte eds., 1981); Alan J. Auerbach, *Debt, Equity and the Taxation of Corporate Cash Flows*, in *Debt, Taxes and Corporate Restructuring* 108–26 (John B. Shoven & Joel Waldfogel, eds. 1990); R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice* 395–98 (4th ed., 1984); Richard J. Vann, *Eliminating the Double Tax on Dividends: Legal and Practical Issues*, chs. 4, 5 (1986); Sijbren Cnossen, *Alternative Forms of Corporation Tax*, 1 Australian Tax Forum 253 (1984); Peter Harris, *Corporate/Shareholder Income Taxation* (1996).

- The form that the relief is to take. Generally, the options are to use a tax deduction, a tax credit or an exemption system. A subsidiary issue is whether the application of relief is to be made conditional upon some tracking or verification of other tax payments.
- Whether the relief is to be afforded to nonresident shareholders. The extent to which nonresidents can be further burdened, especially by withholding taxes, will often be controlled by any applicable tax treaties, but the extent to which they may be benefited is largely a matter for domestic law.¹⁰⁴
- Whether relief is to be afforded to income from equity investments derived by tax-exempt investors.
- Whether different types of shareholders are to be treated differently. These mechanisms often distinguish corporate from individual shareholders, and resident from nonresident shareholders, but other possible distinctions might differentiate holders of controlling interests from holders of portfolio interests.
- The treatment of corporate tax preferences. Tax preferences can be preserved in full for the benefit of shareholders, be preserved but at a reduced value, or be recaptured entirely at the shareholder level.
- The treatment of foreign-source income. This income can be viewed as raising issues similar to those surrounding corporate tax preferences. In both cases, domestic corporate tax is not paid on income that is to be distributed or retained (although for foreign-source income, some foreign tax may well have been paid), but the arguments about imposing tax on the distributions are slightly different.

The analysis concentrates on the major aspect of the problem and the topic of this chapter—the treatment of income earned by resident individual shareholders—but is expanded, where relevant, to examine the position of nonresident individual shareholders and income earned by intermediaries, such as other enterprises.¹⁰⁵

The idiosyncrasies of the mechanisms that countries have adopted (not to mention the peculiarities of nomenclature¹⁰⁶) make it difficult to generalize. Nonetheless, once the classical system is abandoned, the mechanisms for recognizing the impact of both enterprise- and shareholder-level income tax can be combined into a few illustrative

¹⁰⁴If nonresidents are not to benefit, there may be an issue about whether denying benefits to nonresidents is allowed under the tax treaties of the country. Many tax treaties will contain rules prohibiting discrimination against the nationals of the other treaty partner, and it is a matter of debate whether this denial would breach the nondiscrimination provisions of the treaty. The United Kingdom deliberately chose to implement its interaction mechanism at the enterprise level to avoid this issue.

¹⁰⁵Many jurisdictions will use a combination of systems—using one for individuals another for corporations or other intermediaries, and yet another for nonresident shareholders. For example, the United States employs a classical system for individual shareholders and a partial dividend-received deduction system for corporations; Canada employs an imputation system for individual shareholders and a full dividend-received deduction system for corporations; Australia employs an imputation system for individual shareholders and a tax credit system for corporate shareholders.

¹⁰⁶See Messere, *supra* note 41, at 342–43 (lamenting the imprecise usage in this area).

groups: split-rate systems and dividend-paid deduction systems, dividend-received exemption or dividend-received deduction systems, dividend-imputation systems, and full integration systems.¹⁰⁷ The first three are often referred to as systems for dividend relief—adjusting the combined tax rate on distributions—while the last, integration, is more ambitious—reducing the combined tax rate on all enterprise profits.

Table 1. Interaction Systems

Classical System	Dividend Relief System for Distributed Profits		Integration System for All Profits
	<i>Corporate level</i>	<i>Shareholder level</i>	
	Dividend-paid deduction system	Split-rate system	Dividend-received exemption / deduction system
			Imputation system

There are virtues and vices to each interaction system, which explains why a standard regime has not emerged.¹⁰⁸ To illustrate, systems that reduce the enterprise’s primary tax liability (such as dividend-paid deduction systems) will benefit both resident and nonresident shareholders equally, a result the source country may dislike.¹⁰⁹ Systems

¹⁰⁷Even the number of interaction mechanisms is a matter for debate. See Pechman, *supra* note 103, at 175–81 (who says there are five groups but lists six); OECD, *Company Tax Systems*, *supra* note 103, at 10 (which lists three). The discussion will not pursue some of the more unusual types of interaction mechanism that have been proposed at various times but not yet implemented.

¹⁰⁸For example, the U.S. Treasury praised the imputation systems for their “flexibility to respond to different policy judgments on the most important issues of integration.” U.S. Treasury Report, *supra* note 3, at 93. The systems may also be seeking objectives beyond those described above as the defects of the classical system, and possibly also objectives different from each other. For example, it is claimed that imputation systems in Europe were introduced to encourage more people to hold shares, to increase compliance with the corporate tax, and to encourage capital-export and capital-import neutrality within the European Union. See Bird, *supra* note 103, at 232–35; Harry G. Gourevitch, *Corporate Tax Integration: The European Experience*, 31 *Tax Lawyer* 65 (1977); Hugh J. Ault, *Introduction, in Imputation Systems—Objectives and Consequences* 10 (Hugh J. Ault ed., 1983) (“it was generally hoped that a more favorable treatment of dividend distributions would increase investment in corporate stock, especially on the part of small investors”); Cnossen, *The Imputation System in the EEC, in Comparative Tax Studies: Essays in Honor of Richard Goode* 85, 105 (S. Cnossen ed. 1983) (“it seems desirable that shareholdings be spread more widely than is the case at present. The imputation system might promote that objective.”). The different goals that various interaction mechanisms may be pursuing are most apparent in the more unusual systems suggested, such as the Institute of Fiscal Studies’ ACE system, which creates a notional deduction to the corporation for the value of shareholder equity employed by the corporation, with the principal objective of equalizing the return to investors on debt and equity. See Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s* (1991); see also *supra* note 85. The U.S. Treasury report set out with the explicit goals of retaining the implicit tax collected at the corporate level on tax-exempt investors, taxing business income only once (rather than in two offsetting installments). U.S. Treasury Report, *supra* note 3, at 13.

¹⁰⁹Cnossen, *supra* note 108, at 92, for example, notes that “under the imputation system the double tax is mitigated at the level of the shareholder. It would also have been possible, of course, to provide relief at the corporate level by providing a deduction for dividends paid in computing taxable profits.... This

that reduce the enterprise's primary tax liability would also reduce the implied tax paid at the enterprise level by tax-exempt investors.¹¹⁰ Dividend-paid deductions would need to be targeted to deny the tax benefit when distributions are paid to tax exempt entities or nonresidents if the double taxation of dividends is to be sustained for these groups. Dividend-received deduction systems and some imputation systems will not ensure that the enterprise has actually paid any tax on the dividend received by the shareholder although they do preserve the full nominal value of enterprise tax incentives for shareholders.¹¹¹ Some systems can result in overtaxation of the enterprise when the tax collected exceeds the enterprise's own tax liability, while others require elaborate record keeping.¹¹² Integration systems, which tax shareholders on the value of retentions, can cause solvency problems for individual shareholders when distributions are small but profits are large and are generally considered impractical for large corporations in part because of the difficulties of administering them¹¹³ and because the substantial international treaty network assumes that nonresident shareholders are not currently taxed on retentions.¹¹⁴

avenue, which should yield the same result as imputation, has not been followed, however, because governments did not want foreign shareholders to share automatically in the relief." See also Bird, *supra* note 103, at 232–35, 239; OECD, *Company Tax Systems*, *supra* note 103, at 23–30; U.S. Treasury Report, *supra* note 3, at ch. 7.

¹¹⁰This latter concern seems to have played a major role in the decision of the U.S. Treasury to suggest a dividend-exemption system, because it collects at least some tax from otherwise exempt investors. U.S. Treasury Report, *supra* note 3, at ch. 6.

¹¹¹Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 *Tax Law.* 195 (1990); Pechman, *supra* note 103, at 180; U.S. Treasury Report, *supra* note 3, at 93 ("an imputation credit can extend the benefits of integration to tax-exempt and foreign shareholders by allowing refundability of imputation credits or it can deny such benefits by denying refunds").

¹¹²This is particularly true of the imputation systems in Australia, France, and Germany. See Avi-Yonah, *supra* note 111, at 214 ("as the German example shows, however, tracking of income can lead to very complicated account-keeping requirements").

¹¹³See Pechman, *supra* note 103, at 179 ("experts agree that it would not be practical to extend the partnership method to large, publicly held corporations with complex capital structures, frequent changes in ownership, and thousands or millions of stockholders"); Auerbach, *supra* note 103, at 105 (describing proposals for integration as "pure in concept, ambitious in scope, and unadopted in practice"); 4 Carter Commission Report, *supra* note 49, ch. 19 (recommending an optional profit-attribution system because of the solvency and administrative problems); Vann, *supra* note 103, at 30–34.

Some others believe that these administrative difficulties have been overstated. John G. Head & Richard M. Bird, *Tax Policy Options in the 1980s*, in *Comparative Tax Studies* 16 (Sjibren Cnossen ed., 1983) ("although the difficulties are considerable, there appear to be no insuperable problems"); Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 *Harv. J. L. & Pub. Pol.* 1009 (1989); Peter L. Swan, *An Australian View on Integration*, in *Taxation Issues of the 1980s* (J.G. Head ed., 1983). It is interesting to note that the U.S. Treasury considered even an imputation system unnecessarily difficult to administer. U.S. Treasury Report, *supra* note 3, at 93.

¹¹⁴See 4 Carter Commission Report, *supra* note 49, ch. 19.

Not surprisingly, therefore, in a 1993 study, the OECD found representative types of almost all possible systems among the corporate tax systems of its (then) 24 member countries (see Table 2 for a classification of the systems then existing).

Table 2. Degree of Reduction of Economic Double Taxation (Central Government

<i>None or very little</i>	<i>Reduction of economic double taxation</i>		<i>Elimination of economic double taxation</i>			
	Corporate level		Shareholder level		Corporate level	Shareholder level
Classical System	Split rate system	Partial dividend deduction system	Partial imputation system	Partial shareholder relief schemes	Zero rate system	Full imputation system
Belgium	Germany	Iceland	France	Austria	Greece	Australia
Luxembourg		Spain	Ireland	Canada	Norway	Finland
Netherlands		Sweden		Denmark		Germany
Switzerland				Iceland		Italy
United States				Japan		New Zealand
				Portugal		Turkey

Source: OECD, Taxation in OECD Countries Table 9, at 67 (1993).

The variety of interaction systems that existed in 1993 suggests that the effects of each system on the after-tax returns to shareholders and the cost of enterprise capital will differ. This section analyzes the classical system and four systems of enterprise and shareholder interaction. The models described are stylized to capture the fundamental relationships of the systems discussed, rather than being precise descriptions of the exact rules employed in any particular jurisdiction.

1. *Separate (or Classical) System of Enterprise Tax*

The pure classical system is declining in industrial countries' tax systems.¹¹⁵ Among the countries of the EU, Belgium, the Netherlands, Luxembourg, and Sweden¹¹⁶ retain the classical system, but only for distributions to individual shareholders.¹¹⁷

¹¹⁵The United States is the most obvious example of a country that still retains the classical system for individual shareholders, although even it has had a fully integrated system for small corporations in Subchapter S of the Internal Revenue Code 1986. But in respect of larger corporations with more than one class of shares, non-resident shareholders or passive income, the United States moved clearly against the current trend toward interaction in 1986 by eliminating the \$100 dividend-received deduction for individual shareholders. IRC § 116 (repealed). The United States also reduced the size of the deduction for corporate shareholders in some cases from 80 percent to 70 percent of dividends received depending upon the degree of affiliation between the companies. For corporate shareholders, the United States still retains the dividend received deduction system; IRC § 243. For a discussion of the Netherlands and Luxembourg, see J-M Tirard, Corporate Taxation in EC Countries, 1990–91, at 12–13 (1991).

¹¹⁶Sweden, inspired by the full imputation systems applied in Finland and Norway, exempted dividend income in the hands of shareholders in 1994, only to restore the full classical system (without the previous partial deduction system) from 1995.—L.M.

A. RESIDENTIAL INDIVIDUALS

In a pure classical system, there is no formal interaction between the enterprise and individual income taxes, and each is levied without explicit regard for the operation of the other. But even in a classical system, there may be implicit recognition of the dual operation of both taxes in the rate imposed under either tax or in the definition of its base. For example, a lower marginal rate imposed upon an individual's capital income or substantial investment concessions offered to industry may each be a method for recognizing the existence of the two layers of tax. The first reduces total tax by encouraging retention of profits by the enterprise and extraction of gain by the individual selling the shares, while the second reduces the total tax collected from the enterprise¹¹⁸

The first option can be seen in the following example.

Example

Assume that the enterprise tax rate is 33 percent, the top marginal rate under the personal income tax is 50 percent, and dividends are taxed at a flat rate of 25 percent imposed on individual shareholders (or perhaps collected by withholding at source). This rate alignment offers a good approximation of the after-tax return [$\$100 \times (1 - 0.33)(1 - 0.25) = \50.25] that would be earned if the income from the investment had been earned by a high-income shareholder directly [$\$50$].

Such a system would probably, however, have several serious consequences. First, it might discourage distributions of enterprise profits—indeed, some rule would probably be needed to oblige distributions. If distributions were not obliged, serious strain would be placed on the administration of the capital gains tax as the means of collecting the deferred tax on retained earnings. It would also deliver a sizable benefit to tax-exempt institutions because the enterprise tax is the principal tax that they pay on capital income.

¹¹⁷See generally, OECD Report, *supra* note 41, at 9–41; McLure, Must Corporate Income Be Taxed Twice?, *supra* note 103, ch. 3.

¹¹⁸See Myron S. Scholes & Mark A. Wolfson, *Taxes and Business Strategy* 56–57 (1992).

The position of a shareholder in such a system can be expressed algebraically as follows. Under the classical system, the enterprise pays tax (T_c) on its taxable profits (P), and the individual resident shareholder pays income tax (T_i) at progressive marginal rates on the proportion (d) of after-tax profits distributed by the enterprise as dividends. Retained profits ($1 - d$), reflected as accretions to the value of the shares, are taxed as capital gains (T_g) on a deferred basis when the shares are sold by the shareholder, and are sometimes taxed at a lower nominal rate.¹¹⁹ Given an enterprise tax system bearing these features, the return (R) to an individual shareholder after payment of enterprise tax on all profits and personal tax on distributions and retentions is¹²⁰

$$R = dP(1 - T_c)(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

B. PREFERENCE INCOME

Because the enterprise and the shareholder are taxed separately, this system applies also to distributions of untaxed income, such as income that enjoys tax preferences or foreign-source income that is not subject to tax in the residence country.¹²¹ Earnings that are untaxed or not fully taxed at the enterprise level would, nevertheless, be subject to full shareholder tax:

$$R = dP(1 - T_i) + (1 - d)P(1 - T_g).$$

C. NONRESIDENT SHAREHOLDERS

As the example illustrates, one can achieve the same result as under conduit treatment by reducing the enterprise rate below the top individual rate and imposing a withholding tax on distributions. Another reason for adjusting the personal tax rather than the enterprise tax is the position of nonresident shareholders. For nonresidents, the enterprise tax rate is an important determinant of the total tax that they will pay to the source country, and reducing it will confer a substantial benefit on them. Treaties generally allocate the enterprise tax to the source country and limit its ability to impose substantial withholding taxes on payments to nonresident shareholders.¹²² Consequently,

¹¹⁹The effect of deferral is the same as formally imposing a lower rate, or as the revenue authority's making an interest-free loan of the unpaid tax to the taxpayer. Hence, the discussion will treat (T_g) as being a rate less than (T_i), even though this may not appear formally to be the case.

¹²⁰Robert R. Officer, *The Australian Imputation System for Company Tax and Its Likely Effect on Shareholders, Financing, and Investment*, 7 Aust. Tax F. 353, 376–77 (1990).

¹²¹To facilitate the discussion, foreign income will be called “not taxable” as a shorthand reference to the results of the system for eliminating double tax on foreign-source income. Most countries will have in their domestic laws (and supplemented by international double tax treaties) either a credit system to reduce domestic tax on foreign income or a formal exemption system for foreign income. When foreign income has been comparably taxed at source, and either of these domestic system applies, the result is that no further residence country tax will be imposed on the income.

¹²²See Article 10, Model Tax Convention on Income and on Capital, OECD Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, Paris (updated as of Sept. 1, 1995[hereinafter OECD Model Treaty]. See *supra* ch. 18.

a country's treaties and the international norms for taxing enterprise income will most likely make it impossible for the country to impose substantial additional taxes on a nonresident shareholder to compensate for a low enterprise tax rate.

2. Dividend-Paid Deduction System

A dividend-paid deduction system operates at the enterprise level to impose different rates on an enterprise's distributed and undistributed profits. The system achieves this result by giving to the enterprise a tax deduction for distributions made and then imposing tax on the distribution at the shareholder level.¹²³ A tax deduction for distributed profits means that the profits incur no tax at the enterprise level and are effectively taxed as if they were payments of interest by the enterprise.¹²⁴

A. RESIDENT INDIVIDUALS

Under a dividend-paid deduction system, the enterprise is able to reduce its taxable profits by the amount of any distribution. The enterprise therefore pays no tax on distributed profits, but pays tax at the enterprise rate on retentions. This system has some of the same effects as a split-rate system (discussed below) under which the rate on distributed profits is set at zero. The individual shareholder who is a resident pays income tax at marginal rates on the proportion of profits distributed by the enterprise as dividends, and any retained profits already taxed to the enterprise are taxed as a capital gain on a deferred basis to the shareholder. No deduction or tax credit is given to the shareholder for taxes paid by the enterprise. The after-tax return of an individual shareholder after payment of enterprise tax on all profits and personal tax on distributions and retentions is

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

Again, tax-exempt investors will benefit from the elimination of all tax on distributed earnings.

¹²³See Norr, *supra* note 103, at ch. 5/C. Before June 1992, Greece, for example, had a dividend-paid deduction system. Tirard, *supra* note 115, at 102–03. A dividend-paid deduction system is used in Iceland and Hungary and was used in the United States in 1936–37. See Cnossen, *supra* note 103, at 54–55; Pechman, *supra* note 103, at 176–77.

¹²⁴See Cnossen, *supra* note 103, at 92 (noting that the effect of a dividend deduction system is to treat equity as debt, giving the enterprise a deduction for its dividend payments as it does for its interest payments).

B. PREFERENCE INCOME

Other forms of untaxed income, such as income enjoying tax preferences or foreign-source income that is not taxable in the residence country, would be subject to enterprise tax only if retained.

Example

Assume a corporation has operating profits in the current year of \$30,000, but taxable profits of \$24,000 (prior to making any dividend payment) because of a \$6,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus \$6,000 if it makes no distributions. If, in the current year, the company retains \$12,000, its tax liability is \$3,000 [25 percent of \$12,000]. The shareholder will pay tax at personal rates on the \$12,000 of taxable profit that is distributed. Tax will thus be collected currently on \$24,000, part from the corporation at enterprise tax rates and part from the shareholders at their marginal rates. The other \$6,000 of nontaxable operating profit will be taxed as a capital gain to the shareholder when the gain is realized, reducing the value of the tax preference from a permanent to a temporary reduction of tax.

Such a system raises a few stacking and ordering issues, which the example below addresses:

Example

Assume a corporation has operating profits in the current year of \$30,000, but taxable profits of \$20,000 (prior to making any dividend payment) because of a \$10,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus \$5,000 if it makes no distributions. If the corporation distributes \$25,000, two related questions arise: what is the treatment of the \$5,000 in the hands of the shareholder, and does the enterprise generate a carryover loss from this transaction? It has an additional deduction of \$25,000, which exceeds its taxable profits of \$20,000.

The answer should depend on whether the government wishes the enterprise tax preference to be lost or not. If it is to be recaptured, the shareholder should be taxable on the \$25,000, and the enterprise should not recognize a loss from this transaction. If the preference is to be preserved and enjoyed immediately, the shareholder should be exempt from tax, but the enterprise should not have a further deduction. There is an intermediate point, however, that would preserve the preference, but at a reduced value. That position would tax the entire \$25,000 distribution to the shareholder under the personal income tax, but allow the enterprise to carry forward the \$5,000 as a loss against future income.

A further complication would arise if the enterprise had retained profits from prior years.

Example

Assume a corporation has operating profits in the current year of \$30,000, but taxable profits of \$20,000 (prior to making any dividend payment) because of a \$10,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus \$5,000 if it makes no distributions. The corporation has \$2,000 in retained profits from a prior year. The corporation distributes \$32,000.

The same questions would arise: What is the treatment of the \$12,000 in the hands of the shareholder, and does the corporation generate a carryover loss from this transaction, given that it has a further deduction of \$12,000 that exceeds its taxable profit? The added complication is that the \$2,000 of retained earnings was presumably already taxed to the corporation the previous year and perhaps ought not be taxed again if distributed now. An ordering rule would be necessary to resolve this question, one that would identify (and perhaps immunize) the amount paid from taxed retained profits and then identify and deal with the \$10,000 paid from the preference income.

C. NONRESIDENT SHAREHOLDERS

One important qualification to the desirability of a dividend-paid deduction system is the position of nonresident shareholders. Current international tax practice is to allocate the enterprise tax to the source country, while a dividend-paid deduction system will effectively abandon any entity-level tax on distributed earnings. Consequently, substantial withholding taxes on a nonresident shareholder would be needed to compensate for the reduction in the enterprise tax. Such an option might be limited by treaties.¹²⁵

3. *Split-Rate Systems*

Split-rate systems reduce the enterprise tax payable on distributed profits or formally impose tax only on retained earnings.¹²⁶ The same effect can also be achieved with a tax surcharge on undistributed enterprise profits.¹²⁷

¹²⁵See *supra* ch. 18.

¹²⁶For example, Germany and Hungary apply different rates to distributed and undistributed profits, Germany applying a higher rate on retentions and Hungary a higher rate on distributions. Tirard, *supra* note 115, at 71–72, 87–88; Cnossen, *supra* note 103, at 54–55. This was also the first of many suggested interaction mechanisms proposed for uniform adoption in Europe. Tax Harmonization in the Common Market (Neumark Report) (1963). See Bird, *supra* note 103, at 227–28.

¹²⁷See Norr, *supra* note 103, ch. 5/B. For example, a further tax was imposed on retained profits in both Australia and the United States. AUS ITAA Div. 7 (repealed). This was not done apparently to formalize the interaction of the corporate tax and personal income tax although it had the effect of reducing one distortion from the lack of coordination—different rates applying to retained and distributed earnings. The surcharge was imposed to encourage distribution so that there was no gain from sheltering income within the corporation and the classical system could collect the further tax from the shareholders.

A. RESIDENT INDIVIDUALS

Under a split-rate system, the enterprise pays tax on its retained profits (T_{cr}), but generally faces a lower rate of tax (T_{cd}) on the proportion of pretax profits distributed as dividends.¹²⁸ A resident individual pays income tax at ordinary marginal rates on distributions (T_i), while retained profits are taxed as capital gain (T_g) on a deferred basis to the shareholder, offsetting to some extent the higher rate paid by the enterprise when the profits are earned.¹²⁹ The after-tax return to a resident individual shareholder is¹³⁰

$$R = dP(1 - T_{cd})(1 - T_i) + (1 - d)P(1 - T_{cr})(1 - T_g)$$

A lower corporate rate on distributions, combined with an increased personal income tax on distributions, is likely to suffer from some of the same problems alluded to in the discussion of the classical system—it might discourage distributions of enterprise profits. Again, tax-exempt institutions would benefit from the lower tax on distributed capital income.

B. PREFERENCE INCOME

As in a dividend-paid deduction system, distributions of other forms of untaxed income, such as income that enjoys enterprise tax preferences or foreign-source income that is not taxable in the residence country, would be subject to enterprise tax only if retained. The same stacking and ordering issues would also arise. The after-tax return on preference income would be

$$R = dP(1 - T_i) + (1 - d)P(1 - T_{cr})(1 - T_g).$$

C. NONRESIDENT SHAREHOLDERS

As with a dividend-paid deduction system, split-rate systems can confer benefits on nonresident shareholders that withholding taxes may not be able to offset.¹³¹

¹²⁸This system is used in France and Germany, although in both countries in combination with an imputation system. There is also a disparity in actual practice, with Germany imposing a lower rate on distributed profits, while France imposes a lower rate on retained profits.

¹²⁹In some cases, $T_g = 0$, for example, in countries like Germany that generally do not tax capital gains of individuals, except for cases of substantial participation.

¹³⁰In the discussion that follows, an issue arises about whether the division of profits (P) occurs before or after the tax is subtracted—that is, does the shareholder receive d percent of after-tax profits or d percent of P , from which tax is taken out? For the purposes of the subsequent presentation, it is assumed that the shareholder receives d percent of P , the pretax profits, and the tax applicable to each share is then taken out at the appropriate rate.

¹³¹Germany found that its split-rate system offered excessive benefits to foreign-owned companies, which could distribute profits taxed at T_{cd} , enjoy reduced withholding tax, and reinvest without being subject to tax in their home countries. For example, keeping up a high enough withholding tax in these cases reportedly cost Germany dearly in its treaty negotiations with the United States.

4. Dividend-Received Deduction (or Dividend-Exemption) System

The systems discussed above all reduce the enterprise-level tax paid on distributions. Dividend-exemption or dividend-received deduction systems operate at the shareholder level,¹³² by giving the shareholder a deduction from income for some or all of the distributions received or by exempting some or all dividends received from tax.¹³³ This type of system was in place in the United States until 1986 for a limited amount of dividends received by individuals¹³⁴ and is still retained in many countries as the means for adjusting the total tax paid on dividends flowing through chains of enterprise¹³⁵ or as a general integration mechanism.¹³⁶ Because these systems leave the enterprise's tax liability untouched, they solve some of the problems surrounding tax-exempt and nonresident shareholders mentioned in the prior discussion, but they also raise new issues.

In a dividend-received deduction system, as under the classical system, the enterprise still pays tax on the profits it derives during the year. The shareholder includes in income dividends received. A deduction from income is, however, given to resident shareholders for enterprise distributions received, which may be as much as the amount of dividends received but is sometimes limited.¹³⁷ In a dividend-exemption system, a percentage of (or all) dividends received are exempt in the hands of the shareholder. In both systems, retained enterprise earnings are taxed to the enterprise and to the shareholder under the capital gains tax, with no adjustment for the enterprise tax already paid.

¹³²A version of this system, allowing a deduction for 50 percent of dividends paid, was proposed for the United States in 1984. See Treasury I, *supra* note 3. It was later revised to a deduction for 10 percent of the amount of dividends paid. See Treasury II, *supra* note 3. See Bird, *supra* note 103, at 235-36; Avi-Yonah, *supra* note 111; U.S. Treasury Report, *supra* note 3, at ch. 12A.

¹³³See Norr, *supra* note 103, at ch. 6/B. Belgium and the United States, for example, have a dividend-received deduction system for intercorporate dividend distributions; Denmark has an exemption system.

¹³⁴See USA IRC §116 (repealed).

¹³⁵This is the case in Canada and the United States. In Australia, the deduction of the dividend is replaced by an automatic credit of the amount of tax payable on the dividend. The effect of this credit system is the same as an automatic, full dividend-received deduction.

¹³⁶See, e.g., Charles McLure et al., *The Taxation of Income from Business and Capital in Colombia* 91-95 (1990).

¹³⁷See USA IRC §116 (repealed) (which limited the individual's deduction to the lesser of the amount of dividends received or \$100).

A. RESIDENT INDIVIDUALS

If the deduction available to the shareholder is for the entire amount of the dividend received, the position of the shareholder after payment of enterprise and personal income tax on the profits is

$$R = dP(1 - T_c) + (1 - d)P(1 - T_c)(1 - T_g).$$

For tax-exempt shareholders, the position now changes from that reached under the systems described above. Because the enterprise tax remains intact and the adjustment occurs under the shareholder's tax, no benefit is conferred on tax-exempt shareholders through the interaction mechanism—the benefit of their exemption is not increased because no tax deduction is available to a tax-exempt entity.

B. PREFERENCE INCOME AND FOREIGN-SOURCE INCOME

When a resident enterprise distributes preference income, the value of the preference is retained and passed through to the shareholders—the enterprise pays no tax on this income because of the incentive, and the investor pays no tax because of the dividend-received deduction.

When a resident enterprise is distributing foreign-source income, the effect of the foreign tax credit system (or system of exemption for foreign income) will in most cases replicate the outcome for preference income; that is, the resident shareholder will receive the dividend income free of further (residence country) enterprise tax and is entitled to a deduction for the amount of the dividend received. The position of the shareholder becomes

$$R = dP + (1 - d)P(1 - T_c)(1 - T_g).$$

But when the shareholder invests directly in a foreign enterprise, there is an added complication. In many countries, dividends received do not qualify for the dividend-received deduction if the paying enterprise is not also a resident. Where this is the rule, and any withholding tax on the dividend is fully creditable in the residence country, the position of the shareholder approximates the position of a shareholder under the classical system, with the important exception that the enterprise tax paid is the foreign enterprise tax (T_{fc}), rather than the domestic enterprise tax. The after-tax position thus becomes

$$R = dP(1 - T_{fc})(1 - T_i) + (1 - d)P(1 - T_{fc})(1 - T_g).$$

This result need not be the case, of course. The tax system of the residence country might simply include dividends received and then allow a deduction as its means of eliminating double taxation. The effect would be similar to an exemption system for foreign dividends.¹³⁸

¹³⁸One important difference would arise, however, if other provisions in the tax system denied a deduction for interest on money used to derive exempt income and if foreign dividends were treated as exempt. In this case, interest on loans used to finance investments that yielded dividends from foreign enterprises

C. NONRESIDENT SHAREHOLDERS

When a nonresident shareholder invests in a domestic enterprise, the relationship between the (source country) enterprise tax and the (residence country) investor-level tax is principally a matter for the residence country to resolve because the international norm, as well as most tax treaties, allocate the enterprise tax exclusively to the source country and limit the ability of the source country to impose withholding taxes on dividends. Indeed, some countries will take that position to its logical conclusion and choose not to impose any withholding taxes on dividends paid to nonresidents.

5. Imputation Systems

The four systems just described adjust the double taxation of distributed earnings by effecting changes at either the enterprise or the shareholder level. Many countries now operate tax credit or tax imputation systems¹³⁹ that retain both the separate enterprise tax and the personal tax but treat the payments of one tax as also satisfying a tax liability arising under the other. They achieve this by giving a tax credit of some amount, either to the shareholder or to the enterprise, reflecting more or less accurately the amount of tax that the profits have already borne.¹⁴⁰ This section examines three versions of the wide variety of imputation systems.

Imputation systems should not be confused with simple withholding systems in which the enterprise is obliged to withhold tax on distributions and the tax withheld is credited to the shareholder. The difference between imputation and withholding systems is that a pure withholding system is simply a collection mechanism on behalf of the shareholder, and not an attempt to change the consequences of the separate or classical system. For example, most European jurisdictions see the need both to impose a withholding tax at a constant rate on enterprise distributions and to have some other interaction mechanism, such as an imputation system that attributes payments of the enterprise's own tax liability to the shareholders or a dividend deduction system. Even the Netherlands, which retains the classical system, has a withholding system in which

would be nondeductible. That result would not necessarily follow if the law contained no similar provision for interest on money used to derive income that was both included and then deducted.

¹³⁹Some of the countries with an imputation system are Australia, Canada, Finland, France, Germany, Ireland, New Zealand, Norway, and the United Kingdom. See generally Cnossen, *supra* note 103, Table 1.

¹⁴⁰As will be seen below, some countries, such as Australia, simply impute company taxes paid and then require the shareholder to pay over any additional tax due on untaxed distributions. Other countries apply an additional withholding amount or "compensatory tax" on distributions out of accounting income that have not borne company tax. Called simply withholding in New Zealand, the Advance Corporation Tax (ACT) in the United Kingdom, the *précompte mobilier* in France, the *imposta di congualio* in Italy, and the *Ausschüttungsbelastung* in Germany, its principal point is to enforce collection of tax on distributed income not taxed at the company level. There can be ancillary purposes as well. The United Kingdom does not integrate company and investor taxes completely. The ACT serves in part to ensure some double taxation of income.

tax is collected from the enterprise on distributions. The tax is creditable to the shareholder, but does not further reduce the total tax payable by either the enterprise or the shareholder.

Although all imputation systems have elements in common, within this broad framework, there are also many differences. Common to all systems are the survival of the separate enterprise tax, the attribution to shareholders of at least some enterprise tax paid on distributed profits, and the denial of a credit for enterprise tax paid on retained profits. Differences are manifested, for example, in the accuracy with which imputation systems take account of enterprise tax payments.¹⁴¹ In some systems, the amount of tax credited to the individual shareholder may not reflect the total tax paid by the enterprise. At one extreme, the Canadian system simply increases the amount of any distribution by a constant amount to represent enterprise tax paid and then gives the shareholder a credit for a portion of the grossed-up amount. This grossing up and credit occur whether or not tax has actually been paid at the enterprise level.¹⁴² The United Kingdom's ACT system is slightly more careful to ensure that the tax has been paid, but occasionally at the expense of collecting payments of ACT that exceed the enterprise's own "mainstream" (i.e. enterprise) tax liability.¹⁴³ Of the three systems modeled, the most accurate is that used in Australia and New Zealand. It attempts to track the amount of tax an enterprise actually pays on its profits and attributes only those payments to the profits distributed.

Which system a country chooses to put in place will depend upon many factors, but probably the most important are the desired treatment of enterprise-level tax preferences,¹⁴⁴ the treatment of exempt shareholders, the preferred treatment of nonresident shareholders, the importance of equity concerns, the treatment of foreign source income, and administrative convenience.

¹⁴¹See Avi-Yonah, *supra* note 115.

¹⁴²France and Germany also give a credit to shareholders (for supposed payments of enterprise tax) that is calculated by reference to the enterprise tax rate rather than the enterprise's actual tax payment. See Tirard, *supra* note 115.

¹⁴³The ACT is payable at a flat rate on a distribution regardless of whether the profits out of which the distribution is made have already borne tax and regardless of the actual rate of tax that will be imposed upon the enterprise. The payment of ACT discharges the enterprise's primary tax liability to the extent of the ACT payment, and the individual shareholder is credited with the ACT payment against the shareholder's tax liability on the dividend received. See generally R. Bramwell, et al., *Taxation of Companies and Company Reconstructions* ch. 9 (4th ed. & Supp., 1988).

¹⁴⁴Enterprise-level tax preferences (and credits for tax paid on foreign income) are an issue under an imputation system that traces actual payments of enterprise tax because the value of the preference (or foreign tax credit) will be recaptured if (untaxed) profits are distributed and even, to a lesser extent, for taxed profits if they are retained. The value of the preference under such a system is reduced from a tax exemption to a tax deferral, which may not be consistent with the level of subsidy intended by the government. It would be possible to solve the problem by specific adjustments to the tax credits offered to shareholders: either to gross up the tax the enterprise actually pays by an amount to represent tax not paid but attributable to preference items or foreign income, or to gross up the shareholder's tax credits. See Avi-Yonah, *supra* note 111.

A. AUTOMATIC IMPUTATION MODEL

The first imputation system to be described, which is based on the system used in Canada, appears to be the least accurate. It will be seen, however, that except in some unusual circumstances, the alleged accuracy of some systems may be more apparent than real.¹⁴⁵ This system increases the shareholder's distribution by an amount assumed to represent some of the enterprise's tax payment on the distribution and then gives to the shareholder a credit for a proportion of that assumed enterprise tax. For the purposes of this chapter, the automatic operation of the system is the interesting element of the interaction mechanism.¹⁴⁶

In the Canadian system, the enterprise pays tax on its taxable profits, whether distributed or retained, at the enterprise tax rate.¹⁴⁷ The shareholder must include in income the amount of distributed profits increased by a multiple representing the enterprise tax that is assumed to be paid on the distribution.¹⁴⁸ The factor by which the dividend is increased is set at a constant rate, which is currently 25 percent. The shareholder then pays personal tax on the amount of increased distribution and is given a tax credit against this liability for an amount that is a proportion (currently 66 percent) of the grossed-up amount.¹⁴⁹ Retained earnings are taxed to the enterprise, and the balance after enterprise tax (to the extent reflected in the sales price) is taxable to the shareholder on realization as capital gain.¹⁵⁰ All the steps involved in making the interaction between

See, for example, the adjustment made in Australia to the tax liability on trust distributions where part of the distribution represents untaxed profits, reduced because of the building depreciation deduction. AUS ITAA § 160ZM. This same adjustment is not made to distributions from companies with similar deductions.

Even for retained profits, the value of the tax preference is reduced but in this case by less. The value of the preference will possibly be recaptured when profits on the sale of the shares are taxed as capital gains. The size of the recapture depends on how soon the shares are disposed of, the interest discount factor, and the tax rate applicable to capital gains. In the right circumstances, it is possible for the amount of recapture to approach zero.

¹⁴⁵See U.S. Treasury Report, *supra* note 3, at appendix B2.

¹⁴⁶See Bird, *supra* note 103, at 236 ("as in Belgium, Italy and Denmark, the amount of the dividend tax credit is completely independent of whether any tax was paid at the corporate level at all"); U.S. Treasury Report, *supra* note 3, at 164 ("because the shareholder credit is not dependent on the actual payment of corporate tax, the Canadian system does not require rules allocating credits to dividends").

¹⁴⁷See CAN ITA §123(1).

¹⁴⁸See CAN ITA § 12(1)(j). The section requires an individual shareholder resident in Canada to include in income any "dividend paid by a corporation resident in Canada on a share of its capital stock," and § 82(1) in effect requires the shareholder to include 125 percent of the amount of any dividend in income.

¹⁴⁹CAN ITA § 121 provides a credit against tax on the increased dividend of "two-thirds of any amount that is required by paragraph 82(1)(b) to be included in computing his income for the year."

¹⁵⁰The real possibility that the capital gain may also escape tax under Canada's rather unusual lifetime \$100,000 capital gain exemption introduced in 1985 will not be explored. See CAN ITA § 110.6.

enterprise- and investor-level taxes are effected by the operation of the imputation system at the shareholder level.

1. Resident Individuals

Rather than be distracted by the complexities of the system as it actually operates,¹⁵¹ this section will abstract a little from reality and concentrate on the effect of the automatic interaction mechanism. We therefore treat the imputation process as if the shareholder is given credit under the imputation system at full rates: the gross up occurs at the full enterprise rate, and the tax credit against the personal income tax occurs in the same amount. If the Canadian system is modeled in this way, and the level of the enterprise tax is lower than the investor level tax, the after-tax return to the shareholder becomes

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

This treatment comes about from the following steps. The shareholder includes in income the amount of the dividend received increased by an amount set by reference to the enterprise tax rate:

$$dP(1 - T_c) + [dP(1 - T_c) \times T_c / (1 - T_c)],$$

which can be simplified to dP .

This total is then subject to investor's income tax (dPT_i), and the shareholder is entitled to a credit against the investor income tax liability of the same amount that was

¹⁵¹The following explanation gives a flavor of the actual complications. When the corporation reports all of its profits, the balance available for distribution is $[P(1 - T_c)]$. The net amount distributed $[dP(1 - T_c)]$ is then increased by the gross up amount representing tax that the corporation is assumed to have paid. This step is effected by multiplying the net dividend by a fraction and adding this amount to the net dividend. When all profits are reported, this step becomes: $dP(1 - T_c) + dP(1 - T_c)a = dP(1 - T_c)(1 + a)$, where (a) is a gross-up factor applied to dividends received by a resident. The total amount is then subject to personal income tax $[dP(1 - T_c)(1 + a)T_i]$ and the shareholder is entitled to a credit against the personal income tax liability of a proportion (b) of the amount that was included by the grossing up procedure $[bdP(1 - T_c)a]$. The net tax at the shareholder level on distributed dividends is thus the balance of the liability remaining after subtracting the credit $[dP(1 - T_c)(1 + a)T_i - bdP(1 - T_c)a]$ and the shareholder, after paying tax, retains $dP(1 - T_c)(1 + a)(1 - T_i) + bdP(1 - T_c)a$.

Some of the more important adjustments are the current tax surcharge of 3 percent, the provincial tax credit, the small business tax credit (referred to rather confusingly as the "small business deduction"), and the manufacturing and processing tax credit. See CAN ITA, division E, subdivision b. The basic individual rate is currently 29 percent. CAN ITA § 117(2). Each province then imposes further tax on the federal tax payable—the basic rate in Ontario, for example, is a further 52 percent of the federal tax, giving a combined provincial and federal rate of 44 percent. The federal tax rate is also increased by a 5 percent surtax and a further 3 percent "super surtax" on high-income taxpayers. See CAN ITA § 180(1). Given a current corporate tax rate in Canada of 38 percent with a multitude of further tax adjustments, and personal marginal rates approaching 50 percent, it is clear that something less than full integration of the corporate and personal income tax is achieved by this system. Full relief from double taxation for dividends is almost achieved in practice if the average (and marginal) corporate tax rate is about 20 percent. See Bird, *supra* note 103, at 236.

included by the grossing up procedure. The net tax at the shareholder level is thus $(dPT_i - dPT_c)$. The procedure operates on the assumption that enterprise tax (dPT_c) was collected from the enterprise and gives effect to the goal of taxing distributed profits (dP) ultimately at the investor's income tax rate (T_i) although the tax is collected at two points. No gross up and credit system operates for retained profits and they are taxed as under the classical system.

Several interesting design questions arise under such a system. The first is the question of *surplus credits*—what happens when the assumption that the entity-level tax is lower than the investor level tax is relaxed? That would be the case, for example, with investors who are tax exempt or have carryover losses, and with individuals who are taxed at a low marginal tax rate, most commonly individuals in retirement who are living off the dividend income from their savings. The tax credit is usually conceived as partly satisfying the shareholder's liability for tax on the dividend income, but the shareholder might not have a tax liability on that income. The following example demonstrates the point:

Example

A corporation pays a dividend of \$7,500 to a shareholder who is a resident individual. The shareholder has no other income. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of \$10,000 a year. Income over \$10,000 is subject to a 20 percent rate. The shareholder will report income of \$10,000 and will be entitled to a tax credit of \$2,500, but will still have no tax liability.

Tax credits that exceed the taxpayer's current need for credit can be dealt with in many ways. It would be possible to refund the excess to the investor in cash; deny cash refunds, but allow the taxpayer to carry forward any excess credits to future years; allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer, such as a related corporation in a corporate group; or deny any further benefit.

A second, though slightly different, issue is *spillover*—what would happen if the taxpayer had derived other income? Here, the taxpayer could benefit from the tax credit to reduce or eliminate the tax on the other income.

Example

A corporation pays a dividend of \$7,500 to a shareholder who is a resident individual. The shareholder has other interest income of \$4,000. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of \$10,000 a year. Income over \$10,000 is subject to a 20 percent rate.

The shareholder will report income of \$14,000 and will be entitled to a tax credit of \$2,500. The shareholder's tax liability is \$800 (20 percent of \$4,000), which could be fully satisfied by the tax credit with a surplus of \$1,700. The interest income would be effectively shielded from tax by the credit for corporate tax paid.

While this transaction may seem innocuous, a variation on this example will show how these enterprise tax credits can be used in tax-sheltering activities.

Example

A corporation pays a dividend of \$7,500 to a shareholder who is a resident individual. The taxpayer has a deductible interest expense of \$10,000 incurred for the purchase of the shares (the taxpayer obviously assumes capital growth in the value of the shares, which is presently untaxed). The shareholder has employment income of \$22,500. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of \$10,000 a year. Income over \$10,000 is subject to a 20 percent rate.

The shareholder will report taxable income of \$22,500. The shareholder's tax liability is \$2,500 [20 percent of \$12,500], and the shareholder will be entitled to a tax credit of \$2,500. All the salary income is effectively shielded from tax by the credit for corporate tax paid.

There are several solutions to this problem, assuming it is seen as a problem. One solution, a rule that the tax credits for enterprise tax are quarantined and can be used only to satisfy the tax liability on dividend income, would address both this example and the prior one.¹⁵²

2. *Enterprise-level Tax Preferences*

A second series of issues arises from the automatic nature of the process. An automatic gross up and credit mechanism automatically passes through to shareholders the benefit of preference items offered to enterprises. This is because distributions of untaxed preference income come with tax credits attached; the enterprise pays no tax on this income because of the preference and the investor pays no tax because of the automatic tax credit. The following example demonstrates the outcome:

¹⁵²Another approach would attack the interest deduction claimed by the taxpayer. The United States, for example, has loss limitation rules for passive activities. See USA IRC § 469. Rules of this type would defer the interest cost, driving up the taxpayer's income in the current year and generating a tax liability against which the tax credit would be needed. A third possibility would be a dual income tax system as practiced in Finland, Norway, and Sweden. See Leif Mutén et al., *Towards a Dual Income Tax?* (1996).

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special tax deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent and so the corporation pays \$6,000 in tax. The corporation pays a dividend of \$24,000 to a shareholder who is a resident individual. The personal income tax rate is 25 percent on income up to \$40,000 and 40 percent thereafter.

The shareholder reports as income \$32,000—the sum of the dividend of \$24,000 and the gross-up for assumed corporate tax on a dividend of that size of \$8,000 ($\$24,000 \times 0.25 / 0.75$). The taxpayer has a tax liability of \$8,000 (25 percent of \$32,000) and a tax credit of \$8,000. The total tax paid is \$6,000—one corporate tax payment of \$6,000 and no further shareholder tax payment.

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Nonpreference income	24,000	25	6,000
Preference income	6,000	0	0
Total	30,000		6,000

The same outcome would have occurred if, instead of being a tax incentive, the difference between commercial profit and taxable income had been brought about because the enterprise earned \$6,000 of foreign-source income that was treated as exempt in the residence country. It would also have happened if the \$6,000 of foreign-source income had been taxable but the enterprise was entitled to a tax credit of \$1,500.

If, as is more common in industrial economies at the moment, the investor's rate is higher than the enterprise rate, the outcome changes in this way:

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special tax deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent and so the corporation pays \$6,000 in tax. The corporation pays a dividend of \$24,000 to a shareholder who is a resident individual. The personal income tax rate is 30 percent on income up to \$40,000 and 40 percent thereafter.

Again, the shareholder reports as income \$32,000—the sum of the dividend of \$24,000 and the \$8,000 gross-up for assumed enterprise tax. The taxpayer now has an initial tax liability of \$9,600 (30 percent of \$32,000) but still has a tax credit of \$8,000. The total tax eventually paid is \$7,600—one corporate tax payment of \$6,000 and a further shareholder tax payment of \$1,600.

In this case, the outcome is just as if the investor had faced the following tax rates:

	Income (In units of domestic currency)	Rate (In percent)	Tax (In units of domestic currency)
Non-preference income	24,000	30	7,200
Preference income	6,000	6.66	400
Total	30,000		7,600

The outcome in each case occurs because the computation made at the shareholder level is based not on the amount of enterprise tax paid, but on the enterprise tax rate and occurs automatically. That is, the shareholder must gross up at the rate of

$$T_c / (1 - T_c).$$

There are, of course, other options. One is a nonautomatic tracking system that traces only the amount of tax payments made, a system discussed in more detail below.¹⁵³ Automatic systems do have the advantages of simplifying somewhat compliance and administration. However, tying the imputation process to a stipulated rate can lead to a problem, sometimes referred to as *over integration*. If the gross-up and tax credit are simply a constant proportion of the dividend received, and are not tied to the current enterprise tax rate, the system can become misaligned, for example, when there are multiple enterprise and investor rates:

Example

The corporation has pretax financial profits of \$100,000 but has taxable profits of only \$94,000. The enterprise tax rate is 10 percent up to \$50,000 and 25 percent thereafter. The corporation pays \$19,000 in tax (\$50,000 x 10 percent plus \$44,000 x 25 percent). The corporation pays a dividend of \$81,000 to a shareholder who is a resident individual. The investor's tax rate is 30 percent on all income up to \$40,000 and 40 percent thereafter.

The shareholder reports as income \$108,000—the sum of the dividend of \$81,000 and the gross-up computed as one-third of the amount of the dividend \$27,000 (\$81,000 x 1/3). The taxpayer has an initial tax liability of \$37,200 (\$40,000 x 25 percent plus \$68,000 x 40 percent) and a tax credit of \$27,000, leaving a net liability of \$10,200. The total tax paid is \$29,200—one enterprise

¹⁵³If only the \$6,000 of corporate tax actually paid had been used in the imputation calculations, the value of the incentive would have been recovered at the investor level. In the first example, the shareholder reports as income \$30,000—the sum of the dividend of 24,000 and the enterprise tax paid. The taxpayer has a tax liability of \$7,500 (25 percent of \$30,000) and a tax credit of \$6,000, leaving a net tax payment due of \$1,500 and total tax of \$9,000. In the second example, the shareholder reports as income \$30,000—the sum of the dividend of \$24,000 and the corporate tax paid. The taxpayer has a tax liability of \$9,000 (30 percent of \$30,000) and a tax credit of \$6,000, leaving a net tax payment due of \$3,000 and total tax of \$9,000.

tax payment of \$19,000 and a further shareholder tax payment of \$10,200. This is an average tax rate of 29.2 percent.

The alignment of rates in the example may appear bizarre, but common circumstances and plausible arguments can lead to these kinds of situations. The low rate in the enterprise tax might be intended as an incentive or concession for small business. The marginal rates in the investor tax might be intended to reflect government goals about progressivity and wealth redistribution. The choice of a constant 1/3 ratio to represent the gross-up could have been chosen because it is the right gross-up rate for the higher enterprise rate. The 1/3 ratio is too high a gross-up for the lower enterprise rate — for a 10% enterprise rate, the correct gross-up should be 1/9 — but it might be a deliberate decision intended to ensure that the benefit of the small business rate is permanent, like the tax incentives discussed above, and is not recovered when the small business distributes its profits to its shareholders. But this benefit is itself subject to the proviso that the progressive rate scales in the investor-level tax will be allowed to operate thereafter to recapture some, though not all, of the benefit delivered to high income earners. This juxtaposition of policies, each of which may have some merit in isolation, explains how profit of \$100,000 can become subject to an average rate of 29.2 percent.

3. *The Equalization Tax Variant*

The problem highlighted above in relation to untaxed enterprise income and the potential for over integration can be solved, even within the broad parameters of an automatic tax credit system, with a common European variant of the automatic credit process just described.

Many countries in Western Europe—in particular, France, Germany and Italy—apply an additional withholding amount or “equalization tax” on distributions out of accounting income that have not borne enterprise tax.¹⁵⁴ Called the *précompte mobilier* in France, the *imposta di congrualio* in Italy, and the *Ausschüttungsbelastung* in Germany, its principal point is to collect tax on distributed income not taxed at the enterprise level. However, while these systems do try to recapture some enterprise preferences, they do not attempt to levy a compensatory tax on *all* distributions of economic income. In particular, foreign-source income distributed by a resident enterprise to resident shareholders will typically not trigger the equalization tax.

The system in France is typical of this variant.¹⁵⁵ In France, the *précompte* operates within the framework of the basic automatic imputation system. The enterprise pays tax at 33% percent. Every dividend paid by a enterprise carries a tax credit, the *avoir fiscal*, of 50 percent of the amount of the dividend. The shareholder grosses up the dividend by the amount of the tax credit and is taxed on the total with an automatic credit in the manner described above.¹⁵⁶

¹⁵⁴See generally International Fiscal Association, Corporate Tax on Distributions (Equalization Tax) (1994).

¹⁵⁵See generally Michael P. Devereux, The Integration of Corporate and Personal Taxes in Europe: The Role of Minimum Taxes on Dividend Payments (Working Paper 96–5) (unpublished paper prepared for

Unlike the Canadian variant, however, the automatic process of gross-up and credit is not intended to have the effect of passing enterprise tax preferences through to investors. So, for distributions of untaxed income from domestic sources, and for distributions of profits retained for more than five years, the *précompte* can apply.¹⁵⁷ The rate of *précompte* varies and operates as a supplement to the actual rate of enterprise tax paid, so that the total of enterprise tax and *précompte* equals 33 α percent—in other words, the amount needed to fund the *avoir fiscal*.¹⁵⁸ The automatic process is unaffected and functions in the usual way at the shareholder level, but the imposition of the *précompte* at the enterprise level has been interposed to correct for some of the problems noted above.

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special tax deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 33 α percent and so the corporation pays \$8,000 in enterprise tax. The corporation pays a dividend of \$20,000. The corporation will be liable to *précompte* of \$2,000 (33 α percent of \$6,000).

The automatic process can now resume at the shareholder level. The personal income tax rate is 40 percent. The shareholder reports as income \$30,000—the sum of the dividend of \$20,000 and a further one-half of the dividend—the amount of the *avoir fiscal*. The taxpayer has a tax liability of \$12,000 (40 percent of \$30,000) and has a tax credit of \$10,000. The total tax eventually paid is \$12,000—\$8,000 enterprise tax, *précompte* of \$2,000, and the shareholder pays a further \$2,000.

In order to operate the *précompte*, the French system requires enterprises to keep accounting records to determine whether the income being distributed has borne enterprise tax at the full rate. However, that process of tracing taxed and untaxed profits raises important administrative questions that recur throughout the remainder of this discussion:

Technical Committee on Business Taxation, Canada); Patrick de Fréminet, *Perspective of France, in* International Fiscal Association, Corporate Tax on Distributions (Equalization Tax) 55 (1994).

¹⁵⁶See FRA CGI § 158 *bis*.

¹⁵⁷Foreign-source income is partially excluded from the *précompte* system by the operation of France's foreign income system. Typically, profits from foreign branches or dividends from foreign subsidiaries are exempt from tax in France, but for the purposes of operating the *précompte* system, foreign taxes are also treated as a credit against French tax, in this case, the *précompte* rather than the mainstream French enterprise tax.

¹⁵⁸FRA CGI § 223 *sexies*.

- Since the *précompte* is triggered by payment of a dividend out of untaxed profits, can the corporation avoid the tax by retaining all profits?
- If it does not want to retain all profits, can the corporation choose which profits are being distributed and to whom, allowing a process generally referred to as *streaming*?
- If not, what are the *stacking* rules, that is, what rules determine the order in which various types of profits are distributed?

These questions also arise in the examination of the remaining systems, and are discussed below.

B. ADVANCED CORPORATION TAX MODEL

An advanced corporation tax (ACT) system, modeled on the system used in the United Kingdom, uses a distribution-related tax as both a collection mechanism and the interaction mechanism between the enterprise tax system and the personal income tax.¹⁵⁹ The essence of the ACT mechanism is that a flat-rate tax is imposed on the enterprise making a distribution, and this tax is then credited against both the enterprise's liability for enterprise tax payable on its taxable income and the shareholder's liability for tax on the distribution. While the system used in the United Kingdom is not actually a withholding tax, at least not for the purposes of international tax treaties, an ACT can best be understood as a withholding tax that is credited twice—once for the benefit of the enterprise making the payment and again for the benefit of the investor receiving the payment.

The ACT system described below also abstracts from reality in order to identify more clearly the major policy choices involved. The mechanism of the system operates in these steps. Each dividend distribution made by a enterprise is subject to ACT at a flat rate, and the enterprise subtracts the ACT payment made during the year from its own liability for enterprise tax on its profits.¹⁶⁰ The balance of enterprise tax remaining to be paid after the credit for ACT payment is usually referred to as the mainstream corporation tax (MCT) liability, and it can come about either because the ACT rate on dividends is less than the adjusted corporate tax rate on distributed profits or because the enterprise has elected to retain some profits. Where the corporation retains profits, there is no ACT payment and hence no change to the classical system's consequences for the enterprise and the shareholder. If we assume that the ACT rate (T_a) is less than the enterprise tax rate (T_c), the position of the enterprise after payment of tax is therefore

$$dP[1 - T_a - (T_c - T_a)] + (1 - d)P(1 - T_c) = dP(1 - T_c) + (1 - d)P(1 - T_c).$$

¹⁵⁹See generally S. James & C. Nobes, *The Economics of Taxation* 287 (3d ed., 1988); U.S. Treasury Report, *supra* note 3, at app. B6.

¹⁶⁰GBR ICTA §239(1) provides that “advance corporation tax paid by a company ... in respect of any distribution made by it in an accounting period shall be set against liability to corporation tax on any profits charged to corporation tax for that accounting period and shall accordingly discharge a corresponding amount of that liability.”

1. *Resident Individuals*

The shareholder is treated in respect of distributed profits in the same way as under other imputation systems. The shareholder is taxed on the net distribution increased by the amount of ACT and then receives a credit for the ACT.¹⁶¹ The shareholder includes in income

$$dP[(1 - T_a - (T_c - T_a)] \times [(1 + T_a) / (1 - T_a)].$$

Where (T_a) is set at a lower rate than (T_c), the position for distributions is equal to

$$dP[(1 - T_c)] \times [(1 + T_a) / (1 - T_a)].$$

The shareholder receives a credit equal to the amount of ACT (dPT_a). If the ACT rate (T_a) is set at the same rate as the investor's rate (T_i),¹⁶² and the ACT is lower than the enterprise rate, the after-tax return of the shareholder becomes

$$R = dP(1 - T_c) + (1 - d)P(1 - T_c)(1 - T_g).$$

There is obviously a lot of importance to be attached to the *rate alignments* under such a system; that is, what are to be the relative sizes of the ACT rate, the enterprise rate, and the personal tax rate? At the enterprise level, dividends will effectively be taxed at the higher of the two enterprise rates as the following examples of different rate alignments show:

Example

The corporation has pretax financial profits of \$24,000. The enterprise tax rate is 25 percent, and so the corporation is in principle liable to pay \$6,000 in mainstream corporate tax. The corporation pays a dividend of \$18,000 to a shareholder who is a resident individual. The ACT rate is 15 percent of the amount of dividends paid, and so the corporation is liable to pay \$2,700 in ACT. The personal income tax rate is 15 percent on income up to \$40,000 and 40 percent thereafter.

¹⁶¹GBR ICTA § 20(1), sched. F. The amount taxed is “the aggregate of the amount or value of [any] distribution and the amount of [any] credit.” The credit is provided in GBR ICTA § 231, which states that “where a company resident in the United Kingdom makes a qualifying distribution and the person receiving the distribution is ... a person resident in the United Kingdom..., the recipient of the distribution shall be entitled to a tax credit equal to such proportion of the amount or value of the distribution as corresponds to the rate of advance corporation tax...”

¹⁶²It will be the same rate if T_i is a marginal rate rather than an average rate since income is subject to reliefs, progressive rates, losses, and so on, while T_a is set at a gross rate.

The corporation pays ACT of \$2,700 and MCT of \$3,300 (\$6,000 - \$2,700). The shareholder reports as income \$21,176—the sum of the dividend of \$18,000 and the \$3,176 gross-up for ACT ($18,000 \times 0.15/0.85$). The taxpayer has a tax liability of \$3,176 (15 percent of \$21,176) and has a tax credit of \$3,176. The total tax eventually paid is \$6,000—ACT of \$2,700 and MCT of \$3,300, with no further shareholder tax payment.

Where, as here, the enterprise rate is higher than the ACT rate, it is the higher enterprise rate that is collected on distributed profits, but the gross-up occurs at the shareholder level only at the lower ACT rate. Indeed, in the United Kingdom, the ACT rate is approximately the same as the rate charged on taxable enterprise profits under the enterprise tax to avoid some of these problems.¹⁶³

Where the ACT rate is higher than the enterprise rate, the ACT is the amount that is collected before the dividend leaves enterprise-level solution:

Example

The corporation has pretax financial profits of \$24,000. The enterprise tax rate is 20 percent and so the corporation is in principle liable to pay \$4,800 in mainstream corporate tax. The corporation pays a dividend of \$18,000 to a shareholder who is a resident individual. The ACT rate is 33 percent of the amount of dividends paid, and so the corporation is liable to pay \$6,000 in ACT. The personal income tax rate is 33 percent on income up to \$40,000 and 40 percent thereafter.

The corporation pays ACT of \$6,000 and MCT of 0 ($\$4,800 - \$6,000 = -\$1,200$). The shareholder reports as income \$27,000—the sum of the dividend of \$18,000 and the \$9,000 gross-up for ACT ($\$18,000 \times 0.33/0.66$). The taxpayer has a tax liability of \$9,000 (33 percent of \$27,000) and has a tax credit of \$9,000. The total tax eventually paid is \$6,000—an ACT payment of \$6,000, no MCT payment, and no further shareholder tax payment.

2. *Enterprise-Level Tax Preferences*

Because the tax is imposed upon distributions, it is collected whether or not the source of enterprise profits from which the distribution has been paid has borne tax or is even taxable. Nor, usually, does the reduction in the enterprise's tax liability for payments of ACT generate a refund of enterprise tax if the enterprise distributes more than its taxable profits, or if it is taxable at less than the ACT rate on its profits.¹⁶⁴

¹⁶³The United Kingdom currently imposes tax at 25 percent on corporations with profits less than £150,000 and 35 percent for other corporations.

¹⁶⁴This consequence is dealt with in the variety of provisions dealing with surplus advance corporation tax. If the corporation has insufficient tax liability, it can carry the credit back and recover tax paid in prior

Effectively, tax is collected from the enterprise at the higher of the ACT rate or the enterprise tax rate on distributed profits and at the enterprise tax rate on retentions. An ACT system can thus generate the consequence that all distributions are reduced by an amount of ACT, while some will be reduced by the enterprise tax rate if that is higher. This outcome is especially important for the treatment of tax preferences, which will reduce the enterprise's MCT tax liability by reducing either its taxable income or its tax.¹⁶⁵ Unfortunately, however, under an ACT system fashioned in this way, these items have no effect on the enterprise's ACT liability. This problem is referred to as "surplus ACT"; that is, the enterprise can distribute more profit than its own tax payments would indicate. In such a case, surplus ACT is generated on the difference—the amount by which the ACT on distributions exceeds the enterprise's own MCT liability.

One question that arises is, what should be done with these *surplus ACT credits*? As was discussed above, with all tax credits it is possible to refund them, allow the taxpayer to carry forward any excess credits to future years, allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer such as a related corporation in a corporate group, or simply deny any further benefit. Each option will obviously have different consequences under an ACT system. If the excess credits are lost, it means that tax preferences are effectively recaptured at the enterprise level, but are taxed at the ACT rate, not at the personal or the enterprise rate.

If the enterprise reduces its primary enterprise tax liability, for example, by using domestic tax preferences, the after-tax position of the shareholder remains the same for distributions of declared earnings. But lower enterprise tax means that the enterprise's managers can attribute the ACT payment on distributions of undeclared earnings toward the mainstream enterprise tax liability on declared earnings. The gross-up and credit procedure occurs automatically as in the Canadian system, but on the basis that ACT has actually been collected on distributions. No enterprise tax will be collected on retained earnings where tax has been successfully reduced, and no ACT will be collected because profits have been retained. Consequently, only capital gains tax will be collected on the sale of the shares.

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent, and so the corporation is in principle liable to pay \$6,000 in mainstream tax. The corporation, which could pay a dividend of up to \$24,000, decides to pay a dividend of \$18,000 to a shareholder who is a resident individual. The ACT rate is 33½ percent of the

years or forward to use against the tax liability of future years, the liability of other companies in the group or controlled foreign corporations. See GBR ICTA §§ 239, 240. This complication will be ignored.

¹⁶⁵It also used to be a major problem for the taxation of distributions from foreign income. This issue was resolved in 1994 by the introduction of a special regime, the Foreign Income Dividends system. Under this system, ACT on dividends paid from foreign income, where there is no MCT liability to offset, can be refunded to the corporation. GBR ICTA §§ 246A–246Y.

amount of dividends paid, and so the corporation is liable to pay \$6,000 in ACT. The personal income tax rate is 33% percent.

The corporation pays ACT of \$6,000 and MCT of 0 (\$6,000 - \$6,000 = 0). The shareholder reports as income \$27,000—the sum of the dividend of \$18,000 and the \$9,000 gross-up for ACT (\$18,000 x 0.33/0.66). The taxpayer has a tax liability of \$9,000 (33% percent of \$27,000) and has a tax credit of \$9,000. The total tax eventually paid is \$6,000—an ACT payment of \$6,000, no MCT payment and no further shareholder tax payment. The shareholder’s shares will have grown in value by an amount related to the \$6,000 retained profits.

	Amount (In units of domestic currency)	Rate (In percent)	Tax (In units of domestic currency)
Nonpreference income	24,000	25	6,000
Preference income	6,000	0	0
Total	30,000		6,000

Under an ACT system, there is no problem with allocating tax credits to particular shareholders or groups of shareholders. There is, however, a different allocation question—about the “spillover” of ACT credits to preference income—which this example demonstrates. ACT is collected on distributions, but can ACT payments be used to offset all MCT liabilities, even the MCT on retained earnings? Or are ACT payments to be quarantined, so that they can be used to reduce the MCT only on distributed earnings?

The example above shows how, by retaining the \$6,000 in preference income, the corporation paid ACT only up to the point where the MCT liability was completely eliminated. Thus, the ACT in this case does not ensure that the correct enterprise tax is actually paid when the enterprise enjoys tax preferences but makes distributions. Rather, the ACT simply permits the enterprise’s managers to reduce the amount of any final MCT to be paid on declared profits. More enterprise tax will be paid under the ACT mechanism when the enterprise proposes to report less taxable profit than the amount of profit (both taxed and untaxed) that it proposes to distribute. But in the reverse situation—when the enterprise’s managers propose to retain the untaxed profits—the ACT system does not recapture preferences.

At the shareholder level, the rate alignment question involves the relationship between the ACT rate and the shareholder’s personal rate. Where the amount of ACT is less than the individual shareholder’s tax liability, the shareholder can be made to report the deficiency and make a top-up payment, as was shown in prior examples. Where the amount of ACT exceeds an individual shareholder’s tax liability, there is a further question about the treatment of the excess ACT paid, as far as the shareholder is concerned. In the United Kingdom, the ACT rate is set at a level equal to the basic personal income tax rate so that the ACT is the effective collection mechanism for the

personal tax liability.¹⁶⁶ However, for low-income shareholders who receive dividend income, typically retired individuals, the ACT rate may exceed their own personal income tax rate. When this occurs, there is again the issue of the proper treatment of the surplus credits. It is possible to refund them, allow the taxpayer to carry forward any excess credits to future years, allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer, or simply deny any further benefit. In the United Kingdom, the ACT credit, if it exceeds the shareholder's tax liability, is refundable to the shareholder.¹⁶⁷ When the ACT rate is set equal to the highest personal rate rather than the lowest, and there is no intention of refunding "excess" credits to low-rate shareholders, the gross-up and credit procedure achieves nothing, and it is possible to simply exempt dividends received from further tax.¹⁶⁸

C. TAX-TRACING MODEL

The final imputation system to be modeled is similar to that used in Australia and New Zealand.¹⁶⁹ Of the three imputation systems discussed, it appears to be the most accurate measure of the interaction of the enterprise and personal income tax, at least on distributed income. The Australian system tries to trace tax payments actually made by the enterprise and to attribute tax credits for those payments to individual shareholders only to the extent that verified tax payments have been made by the enterprise. The stylized Canadian system modeled above assumes that enterprise tax has been paid on all distributions; in other words, it disregards the possibility that distributed profits may not have borne tax. The U.K. system forces the payment of a tax on all distributions through the ACT mechanism, even when no MCT is owed. The Australian system traces the tax actually paid by the enterprise on its profits and attributes only tax actually paid to the profits distributed. It does permit untaxed profits to be distributed, but identifies them as such in the hands of the shareholder.

¹⁶⁶GBR ICTA §14(1) provides that, "where a company ... makes a qualifying distribution it shall be liable to pay an amount of corporation tax in accordance with subsection (3)." Section 14(3) formally expresses the ACT rate in the form: $I/(100-I)$, I being "the percentage at which income tax at the basic rate is charged...." Since, at present, the United Kingdom has only two rates of personal income tax (25 percent and 40 percent), this ACT rate is currently $25/75$ or 33α percent. The reference to a "qualifying distribution" is the way that returns of capital and certain other distributions are excluded from tax. Distributions from corporations are not subject to further tax because ACT is collected only on the excess of distributions made over distributions received. GBR ICTA § 241.

¹⁶⁷GBR ICTA § 231(3).

¹⁶⁸This is done in Estonia and Lesotho. EST ITL § 9(2)(6) ("income of a resident taxpayer does not include ... dividends taxable under Article 32 of the present Law"). EST ITL § 32 establishes the ACT system for corporate tax. LSO ITA § 87(6) ("a dividend paid by a resident company shall not be included in the gross income of a resident shareholder").

¹⁶⁹See generally R.J. Vann, *Company Tax Reform* (1988); Richard E. Krever, *Companies, Shareholders and Capital Gains Taxation*, 3 Aust. T. F. 267 (1986); Robert Richards & Ross Doherty, *The Imputation System* (1987); Robert Officer, *supra* note 120; U.S. Treasury Report, *supra* note 3, at app. B1.

As under the previous imputation systems, the enterprise still pays tax on its taxable income, whether distributed or retained (PT_c) and will have a balance available for distribution [$P(1 - T_c)$]. The net amount distributed to the shareholder [$dP(1 - T_c)$] is increased by the gross-up that represents corporate tax, effected by multiplying a fraction of the net dividend¹⁷⁰ by the factor [$T_c / 1 - T_c$] and adding this amount to the net dividend. A resident shareholder pays income tax at marginal rates on the proportion of after-tax profits distributed by the corporation as dividends,¹⁷¹ and a tax credit is given to the shareholder for the amount of the gross up.¹⁷² Retained profits are still taxed as a capital gain when the shares are sold by the shareholder; no explicit credit against capital gains tax is given for enterprise tax already paid on retained profits—the tax paid on reported profits that are retained is effectively lost.¹⁷³ In this respect, the Australian imputation system, like the other imputation systems discussed, operates in a way similar to the classical system for retained profits.

¹⁷⁰AUS ITAA § 160AQT requires the shareholder to include in income the “franked amount” of the dividend increased by this factor.

¹⁷¹See AUS ITAA § 160AQT.

¹⁷²See AUS ITAA § 160AQU.

¹⁷³Generally, no tax credits are attached to retentions. Some minor exceptions to the proposition that tax on retained enterprise profits is not credited to shareholders arise in the case of share buyback arrangements and the attributed income of controlled foreign corporations. See AUS ITAA div.16J of pt. III, § 461. These exceptions will not be discussed further here.

1. *Resident Individuals*

The shareholder reports the portion distributed increased by the gross-up for enterprise tax (dPT_c).¹⁷⁴ However, this gross-up does not occur as a simple increase of the net dividend by a constant rate. Rather, it is calculated on the amount that has been debited to the enterprise's franking account, which may or may not correspond to the net amount of dividend distributed, as will be shown later. Where the full taxable profits have been declared, this step becomes

$$dP(1 - T_c) + [(1 + T_c) / (1 - T_c)] = dP.$$

This amount is then subject to personal income tax (dPT_i) and the shareholder is entitled to a credit against the personal income tax liability of the same amount that was included by the gross-up procedure (dPT_c).¹⁷⁵ The net tax at the shareholder level on distributed dividends is thus ($dPT_i - dPT_c$). The after-tax return to the shareholder is

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

The total tax is paid in two parts: enterprise tax (dPT_c) is collected from the enterprise, and when the enterprise rate is less than the personal income tax rate, the deficit ($dPT_i - dPT_c$) is collected from the shareholder.

Example

The corporation has pretax financial profits of \$24,000. The corporate tax rate is 25 percent and so the corporation pays \$6,000 in enterprise tax. The corporation pays a dividend of \$18,000 to a shareholder who is a resident individual. The payment of \$6,000 in enterprise tax will be recorded as a credit in the corporation's tax-paid account, and the payment of the dividend of \$18,000 will be a debit of \$6,000 to its tax-paid account.

The personal income tax rate is 33 percent. The shareholder reports as income \$24,000—the sum of the dividend of \$18,000 and the \$6,000 debited to the corporation's tax-paid account. The taxpayer has a tax liability of \$8,000 (33 percent of \$24,000) and a tax credit of \$6,000. The total tax eventually paid is \$8,000—corporate tax payment of \$6,000 and a further shareholder tax payment of \$2,000.

When the amount of enterprise tax paid is more than the shareholder's own personal liability—for low-income shareholders who receive dividend income, there is again the issue of the proper treatment of the surplus credits—it is possible to refund them to the shareholder, allow the taxpayer to carry forward any excess credits to future

¹⁷⁴See AUS ITAA § 160AQT.

¹⁷⁵See AUS ITAA § 160AQU.

years or to transfer (or perhaps even sell) the credit to another taxpayer, or simply deny any further benefit.

2. *Enterprise-Level Tax Preference Income*

Even if the two rates are identical, a further shareholder payment also comes about when for some other reason, such as the existence of foreign tax credits or enterprise-level tax preferences, all of the profits distributed by the enterprise's managers have not borne domestic tax at the full enterprise rate.¹⁷⁶

One purpose of the system is to provide tax credits only for enterprise tax actually paid in the country where the corporation is resident.¹⁷⁷ This has the consequence that corporate tax preferences or foreign tax credits are recaptured at the shareholder level.

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent and so the corporation pays \$6,000 in corporate tax. The corporation pays a dividend of \$24,000. The payment of \$6,000 in corporate tax will be recorded as a credit in the corporation's tax-paid account, and the payment of the dividend of \$24,000 will create a debit of \$6,000 to its tax-paid account.

The personal income tax rate is 33 percent. The shareholder reports as income \$30,000—the sum of the dividend of \$24,000 and the \$6,000 debited to the corporation's tax-paid account. The taxpayer has a tax liability of \$9,900 (33 percent of \$30,000) and a tax credit of \$6,000. The total tax eventually paid is \$9,900—a corporate tax payment of \$6,000 and a further shareholder tax payment of \$3,300.

¹⁷⁶Any excess that arises—that is, where dPT_c is greater than dPT_i —can be used as a credit against the shareholder's other tax liabilities, but is not refundable.

¹⁷⁷This is, of course, not consistent with any neutrality principle—either capital-export or capital-import neutrality—and is accordingly open to criticism.—LM

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
<i>Nonpreference income -</i> corporate tax component	24,000		
shareholder tax component		25	6,000
		(33 -25)	1,920
<i>Distributed preference income -</i>	6,000		
shareholder tax		33	1,980
Total	30,000		9,900

This example involves the same problem of the “leakage” of tax benefits that was discussed in relation to the ACT system: is it possible to use tax credits from taxed but retained profits to immunize untaxed distributed profits from tax? If we relax the assumption that the corporation distributes all corporate profits, the treatment of untaxed profits distributed as dividends will depend on how the account is debited and how the tax credits are attached to dividends—an issue similar to that raised both in the ACT system and under the equalization tax variant. It is clear that the balance in the account (PT_c) would be insufficient to permit the corporation’s managers to distribute a dividend with full tax credits greater than $P(1 - T_c)$. But if the corporation’s managers retain a proportion of the profits $[(1 - d)P(1 - T_c)]$, the “unused” credits in the account (representing tax on taxed but retained profits) can be applied against the undeclared but distributed profits. If so, distributed undeclared profits can also be distributed tax free to shareholders under this system, as they are under an ACT system.

Example

The corporation has pretax financial profits of \$30,000. It is entitled to a special deduction of \$6,000 for making an investment and therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent, and so the corporation pays \$6,000 in corporate tax. The corporation, which could pay a dividend of \$24,000, decides to pay a dividend of \$18,000 to a shareholder who is a resident individual. The payment of \$6,000 corporate tax will be recorded as a credit in the corporation’s tax-paid account, and the payment of the dividend of \$18,000 will be create a debit of \$6,000 to its tax-paid account.

The personal income tax rate is 33α percent. The shareholder reports as income \$24,000—the sum of the dividend of \$18,000 and the \$6,000 gross-up for the amount debited to the corporation’s tax-paid account. The shareholder has a tax liability of \$8,000 (33α percent of \$24,000) and a tax credit of \$6,000. The total tax eventually paid is \$8,000—a corporate tax of \$6,000 and a further

shareholder tax payment of \$2,000. The shareholder's shares will have grown in value by an amount related to the \$6,000 retained profits.

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
<i>Nonpreference income - corporate tax component</i>	24,000	25	6,000
<i>shareholder tax component</i>		33 α -25	2,000
<i>Undistributed preference income</i>	6,000	33 α	0
Total	30,000		8,000

3. *Streaming of Taxed and Untaxed Dividends*

The systems in operation actually allow more flexibility than this simple matter of leakage would suggest—hence, the comment above that the accuracy of the crediting mechanism may be more apparent than real. That flexibility raises an issue that is commonly referred to as “streaming”—that is, directing the tax credits to shareholders who can use them most advantageously. The examples above assume that the enterprise's managers will (and must) debit the tax-paid account with its full credit balance if the size of the dividend being paid permits them to do so. But if such a rule does not exist—in other words, if the corporation's managers have discretion about how much of the credit balance in the account to use and when—the possibility of streaming arises. For example, if the enterprise has shareholders in both high and low tax brackets, it might try to direct the credits predominantly to the former group (and not to the latter, where excess credits at the shareholder level might be unusable). Various devices and techniques would be needed, but having shares with differential rights or declaring successive dividends might be feasible tools, especially in closely-held companies.

To reduce this problem, the systems in place try to ensure that all dividends carry the same proportion of credits, where there are insufficient credits to cover all dividends to be declared in a year.¹⁷⁸ But this rule does not apply if the enterprise's managers plan to make distributions from undeclared profits up to the amount of retained declared profits, that is, if the total distribution is less than the balance in the account. This would mean that all dividends, whether out of declared or undeclared profits, up to

¹⁷⁸AUS ITAA § 160AQF provides that all dividends paid under a resolution of the company are taken to be franked to the percentage specified in a declaration made in relation to the dividend. The declaration cannot be varied or revoked. Section 160AQG treats all dividends paid during the year on the same class of shares as being franked to the same percentage declared for the first dividend. The purpose of these sections is to prevent streaming of distributions whereby distributions carrying tax credits are paid to taxpaying entities, while taxable distributions (if any) are directed to tax-exempt bodies. Streaming of this kind would permit the enterprise to increase the after-tax return to both groups of shareholders. The section tries to prevent this practice by insisting on a pro rata attaching of credits rather than a first-in-first-out rule.

that amount could effectively be distributed tax free to shareholders. If, however, the enterprise's managers plan to distribute all of the declared profits and some portion of the undeclared profits, the rule does apply and all dividends will carry only fractional credits.¹⁷⁹ The enterprise's managers can effectively attach tax credits to a distribution up to an amount of taxed profits regardless of whether some portion of the amount distributed has actually borne tax. If there are insufficient credits, the gross-up and credit procedure described above will still operate for taxed profits but not for untaxed profits. If the profits are not taxed, they carry no tax credit and the shareholder simply includes the distributed portion of untaxed profits in income with no gross-up or credit and is taxed in the same way as under a classical system.

4. *Nonresident Shareholders*

The position of nonresident shareholders raises a few novel questions in the context of an account-based imputation system.

One reason for the imputation systems described above is that benefits can be, although they need not be, confined to resident shareholders. But if benefits are so confined, the issue will arise whether the tax-paid account must be debited in the case of dividends paid to non-resident shareholders because the shareholders will derive no benefit from the tax credit. Indeed, this is an area where streaming could be expected to occur—allocating all the credits for enterprise tax paid to resident shareholders where the system does not afford any benefit to nonresident shareholders.

International experience in this area is not uniform, although most, but not all countries choose to confine the benefits of their imputation system to resident shareholders. One interesting exception is Singapore, which levies no additional withholding tax on distributions. In addition, some of the treaties negotiated by France, Ireland, and the United Kingdom levy withholding taxes, but allow partial or full credits to flow to non-residents by refunds in cash.

For example, Australia's tax treaties with France, Ireland, and the United Kingdom allow Australian resident shareholders who are individuals some access to foreign imputation credits. Article 9(6) of the Australia-France treaty provides that an Australian resident who is an individual and receives a dividend from a company resident in France is entitled to a payment from the government of France equal to 85 percent of the tax credit (*avoir fiscal*) that would be attached to the dividend if received by an individual resident of France. Fifteen percent remains in France by way of withholding tax.

6. *Full Integration System*

¹⁷⁹The Act also offers the corporation's managers the choice of franking the distribution of untaxed profits to 100 percent, but the corporation will be obliged at the end of the year to pay additional tax to repay the deficit balance in the franking account. That is, the corporation effectively prepays the next year's corporate tax.

The last option to be explored is a full integration system for enterprise.¹⁸⁰ An integration system operates at the shareholder level and attributes the enterprise's income, whether distributed or not, to the shareholders who are taxable on all the enterprise's profits. There are two varieties of full integration systems. One, usually referred to as the partnership version of the integration system, implies that no tax is imposed on the enterprise's profits, unlike the other systems already discussed. Under the other version, where the enterprise remains taxable, the enterprise's tax is then credited to the shareholders as a credit against their liability on the attributed profits.

Non-single rate schedular integration systems are intended to offset the effect of the enterprise income tax entirely so that all enterprise profits are ultimately taxed at individual marginal rates in the current year, regardless of whether the profits are distributed. This system promises the model treatment to which the other systems aspire, because all profits are taxed at exactly the shareholder's personal income tax rate (although portions of the total tax might be collected from both the enterprise and the shareholder), and there is no gain to the taxpayer from deferring the recognition of income by retaining profits within the enterprise.¹⁸¹

The so-called partnership-style integration achieves this result by eliminating the enterprise tax altogether and taxing the shareholders as if they were in partnership—all enterprise profits are included in the individual's taxable income. The United States permits shareholders to elect this treatment under Subchapter S of Chapter I of the Internal Revenue Code for domestically controlled corporations with few shareholders and little foreign-source or passive income.¹⁸² One consequence of the election is that the benefits of corporate losses and tax preference items are passed through to the shareholders.¹⁸³ For the reasons discussed in section II above, this style of integration is generally considered unfeasible as a model for all corporations and will not be considered further in this chapter.

With this exception and for the reasons referred to earlier, no country has adopted a full integration system for the taxation of domestic enterprise and their resident shareholders, despite the support of many commentators and several government

¹⁸⁰See generally Pechman, *supra* note 103, at 178–81; McLure, Must Corporate Income Be Taxed Twice?, *supra* note 103, at 2–9; Bradford, *supra* note 79, at 54–56; Blueprints, *supra* note 3, at 63–69; Bird, *supra* note 103, at 235. To add to the complexity, there are also partial integration systems. Under a partial integration system, some (or all) of the corporation's profits are attributed to the shareholders and some (or all) of the corporation's tax is credited to the shareholders. McLure, *supra* note 103, at 15–18.

¹⁸¹See Cnossen, *supra* note 108, at 98; Bird, *supra* note 103, at 235.

¹⁸²See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ch. 6 (5th ed., 1987).

¹⁸³USA IRC § 1372(b)(1) (corporation not taxable); § 1373(b) (shareholders taxable on all income); § 1374 (corporate losses deductible to shareholders). In this model, the corporation effectively ceases to exist as either a separate taxable entity or a withholding point.

reports.¹⁸⁴ But, somewhat surprisingly, a second style of integration system is more common for taxing nonresident enterprises controlled by resident shareholders, where the system is usually referred to as a controlled foreign corporation (CFC) tax system. In this context, the system is used not because it approximates the economist's ideal of eliminating the double taxation of enterprise profits, but rather as an antiavoidance mechanism to prevent the accumulation of untaxed passive or tax-sheltered income offshore.¹⁸⁵ This section considers a theoretical CFC-type system, but for domestic enterprises.¹⁸⁶ Such a system is not in use in any domestic tax system, but the one described here would achieve the central element of an integration system, taxing shareholders currently on all declared enterprise profits, but with the innovation of retaining the enterprise tax as a pure withholding mechanism.

A. RESIDENT INDIVIDUALS

For this integration system, it is assumed that the enterprise still pays tax on its profits and that the individual shareholders pay income tax at progressive marginal rates on all the taxable profits of the enterprise, whether or not they are distributed. A tax credit is then given to the shareholders for the entire enterprise tax paid. Again, a decision would have to be made whether the tax credit mechanism traces actual payments of enterprise tax or operates automatically. Any retained profits are taxed to the shareholders at the appropriate personal rate when earned (and appropriate credits are also attributed). The shareholder's cost in the shares is increased by the amount of profit taxed to the shareholder, to avoid double taxation when the shares are disposed of.¹⁸⁷ Any further capital gain beyond the value of retained taxed earnings is taxed in the usual way as capital gain. When the enterprise's managers report and pay tax on the enterprise's full profit, the after-tax position of the shareholder is

¹⁸⁴See *supra* notes 103, 183.

¹⁸⁵See USA IRC subpt. F, AUS ITAA pt. X. CFC regimes exist in Australia, Canada, France, Germany, Japan, New Zealand, Norway, Sweden, the United Kingdom, and the United States. See B. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986). Curiously, while CFC systems were originally developed as a means of eliminating the gain from accumulating lightly taxed income offshore, the substantial income tax rate reductions of the 1980s mean that some taxpayers may now benefit from creating a CFC. See Paul McDaniel & Hugh Ault, *Introduction to United States International Taxation* 118–20 (3d ed. 1989). See also OECD, *Controlled Foreign Company Legislation* (1996).

¹⁸⁶See Pechman, *supra* note 103, at 178–81. It is one of the prototypes suggested by the U.S. Treasury Report, *supra* note 3.

¹⁸⁷The result might be prevented in several ways, including, for example, through a further gross up and credit procedure that increased the basis in the shares by $(T_g/1 - T_g)$ and gave to the shareholder a credit against capital gains tax for the same amount that could be carried forward and used when the shares were sold. Instead, the procedure described here is the one used in the United States to reconcile the capital gains tax and personal income tax on shareholders in S corporations, with appropriate modifications to reflect the fact that the corporate tax has been retained in this discussion. See also Blueprints, *supra* note 3, at 64. An alternative procedure—used in Australia for the attributed profits of CFCs—writes down the proceeds of sale by amounts already attributed, permitting shareholders to sell retentions of previously taxed income without further tax. AUS ITAA § 461.

$$R = P(1 - T_i)$$

This result would be achieved in several steps. First, enterprise tax (PT_c) is collected from the enterprise. The amount of any distribution is included in the shareholder's income together with the usual gross-up for enterprise tax:

$$dP(1 - T_c)[(1 + T_c) / (1 - T_c)] = dP.$$

This approach generates a tax liability at the personal income rate (dPT_i) and the shareholder receives a credit (dPT_c) against this tax liability for the enterprise tax paid. The element that makes this system different from those described earlier is that retained earnings and a further gross-up for enterprise tax on the earnings would also have to be included in the shareholder's current assessable income

$$(1 - d)P(1 - T_c)[(1 + T_c) / (1 - T_c)] = (1 - d)P.$$

This creates a tax liability of $[1 - d)PT_i]$ and a credit of $[(1 - d)PT_c]$ is set off against the tax liability.

The capital gains tax is retained to capture items not taxed on a current basis, such as unrealized enterprise profits, tax preferences, or stock market gains.¹⁸⁸ A further adjustment is necessary to reflect the fact that some of the retained profits reflected in the price of the shares will already have been taxed. The adjustment involves annually increasing the shareholder's cost in the shares by the amount of retained earnings taxed in that year.¹⁸⁹ If the taxpayer realizes only the accumulated value of retained taxed profits, the shareholder's basis equals this amount and no capital gain arises.

¹⁸⁸U.S. Treasury Report, *supra* note 3, at 82 (“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”); Head & Bird, *supra* note 113, at 15 note 22 (“a capital gains tax at the personal level would still be needed to tax ‘goodwill gains’—those arising from such factors as improved market position, technological developments, and natural resource discoveries”).

¹⁸⁹In the United States, this process occurs in two steps. USA IRC § 1367(a)(1)(A) increases the shareholder's basis in the share holding by the “items of income described in subparagraph (A) of section 1366(a)(1).” This is the provision that includes in the shareholder's taxable income “the shareholder's pro rata share of the corporation's items of income (including tax- exempt income).” USA IRC § 1366(a)(1)(A). A subsequent provision states that this increase in basis occurs “only to the extent such amount is included in the shareholder's gross income on his return.” USA IRC § 1367(b)(1). The shareholder's basis is then reduced by “distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368.” USA IRC § 1367(a)(2). Section 1368 exempts distributions by an S corporation up to the lower of the shareholder's basis in the shares or the balance in the “accumulated adjustments account.” The result of these provisions is that the shareholder will increase his or her basis in the shares by the net of the income actually disclosed by the corporation and distributions up to the amount actually disclosed.

The annual increase in the shareholder's cost in the shares comes about through a series of steps.¹⁹⁰ Given that the enterprise's managers have distributed some after-tax profits, the enterprise still retains an amount $[(1 - d)P(1 - T_c)]$ on which enterprise tax has already been paid. The shareholder's cost in the total retained earnings is calculated in the following way. First, the shareholder's cost is increased by the amount of taxable profits remaining after corporate tax $[P(1 - T_c)]$. Then the shareholder's cost is reduced by the amounts already "liberated" from the enterprise for the benefit of the shareholder—the distributed taxed profits and the tax attaching to all profits. Thus the taxpayer's basis in the earnings is increased by $[(1 - d)P(1 - T_c)]$. The system operates in this fashion:

Example

The corporation has pretax financial profits of \$24,000. The corporate tax rate is 25 percent and the corporation is liable to pay \$6,000 in enterprise tax. The corporation pays a dividend of \$15,000 to a shareholder who is a resident individual and retains \$3,000. The personal income tax rate is 30 percent on income up to \$40,000 and 40 percent thereafter.

The corporation pays tax of \$6,000. The shareholder reports as income \$24,000—the sum of the dividend of \$15,000 and a tax credit attached to it of \$5,000 $[(\$15,000 \times 0.25/0.75)]$ and the retained earnings of \$3,000 and the tax credit attached to it of \$1,000 $(\$3,000 \times 0.25/0.75)$. The investor is liable to gross tax of \$7,200 and has a total tax credit of \$6,000. The shareholder's cost is increased by \$3,000.

B. PREFERENCE INCOME

The treatment under such a system of the untaxed enterprise profits, such as enterprise-level tax preferences or foreign income, raises several policy issues. The decision about the crediting mechanism will be the basis for the answer. If the decision is made that preference income is washed out at the shareholder level, then only actual tax payments, rather than an automatic credit, should be used for computing the tax credit. The shareholder's cost is increased by the amount of taxable profits (P) remaining after enterprise tax $[P(1 - T_c)]$ and reduced by the amount of profits distributed without further personal income tax $[dD(1 - T_c) + d(P - D)]$, up to the amount of the taxable profits. Thus, the taxpayer's basis in the earnings is increased by only $[(1 - d)D(1 - T_c) - d(P - D)]$; that is, untaxable but distributed profits effectively reduce the increase in basis by the amount distributed. This means that the capital gains tax calculation becomes

$$\{ (1 - d)D(1 - T_c) + (1 - d)(P - D) - [(1 - d)D(1 - T_c) - d(P - D)] \} (1 - T_g).$$

which becomes $[(P - D)(1 - T_g)]$.

¹⁹⁰These steps have to be modified from those described in note 192 *supra* because the enterprise tax still remains in operation, unlike the position of S corporations in the United States.

The eventual after-tax position of the shareholder becomes

$$R = D(1 - T_i) + (P - D)(1 - T_g).$$

Example

The corporation has pretax financial profits of \$30,000. Because of a special incentive, it is entitled to a special tax deduction of \$6,000. It therefore has taxable profits of \$24,000. The enterprise tax rate is 25 percent, and so the corporation is liable to pay \$6,000 in corporate tax. The corporation pays a dividend of \$15,000 to a shareholder who is a resident individual and retains \$3,000 of its taxable profits. The personal income tax rate is 30 percent on income up to \$40,000 and 40 percent thereafter.

The corporation pays tax of \$6,000. The shareholder reports as income \$24,000—the sum of the dividend of \$15,000 and a tax credit attached to it of \$5,000 ($\$15,000 \times 0.25/0.75$) and the retained earnings of \$3,000 and the tax credit attaching to it of \$1,000 ($\$3,000 \times 0.25/0.75$). The investor is liable to gross tax of \$7,200 and has a total tax credit of \$6,000. The shareholder's cost is increased by only \$3,000.

If the corporation distributes some of the untaxed profits, the deficiency will be recaptured in the taxation of dividends. But because the tax preference income is not taxable income, it is difficult to see how it could be attributed to shareholders and taxed on a current basis. Therefore, it remains to the capital gains tax to collect tax, albeit deferred, on this income.

Example

The corporation has pretax financial profits of \$30,000. Because of a special incentive, it is entitled to a special tax deduction of \$10,000. It therefore has taxable profits of \$20,000. The enterprise tax rate is 20 percent, and the corporation is liable to pay \$4,000 in corporate tax. The corporation pays a dividend of \$24,000 to a shareholder who is a resident individual and retains \$2,000. The personal income tax rate is 30 percent on income up to \$40,000 and 40 percent thereafter.

The corporation pays tax of \$4,000. The shareholder reports as income \$28,000, the amount of the dividend and the tax credit attached to it of \$4,000 (because of the tracing process). The investor is liable to gross tax of \$8,400 and has a tax credit of \$4,000. The shareholder's cost is not increased so that the retained untaxable earnings of \$2,000 will be taxed as capital gain only. Total tax paid is \$8,400, \$4,000 by the corporation and \$4,400 by the investor.

In this case, the outcome is just as if the investor had faced the following tax rates:

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Distributed non-preference income	20,000	30	6,000
Tax on non-preference income	4,000	30	1,200
Distributed preference income	4,000	30	1,200
Retained preference income	2,000	0	0
Total	30,000		8,400

C. NONRESIDENT SHAREHOLDERS

Although on the basis of the discussion in previous sections, it might be thought that a full integration system is eminently desirable, its apparent virtues are subject to one major and probably insuperable impediment—the difficulties presented in taxing of nonresident shareholders.

As has been mentioned already, the general consensus that has developed on the appropriate international allocation for taxing enterprise profits is that the source country is able to tax the enterprise in full and has limited rights to tax dividends paid out of those profits. A system of full integration challenges this consensus by attempting to tax the nonresident shareholder on undistributed profits, an option that tax treaties do not explicitly countenance.¹⁹¹ It is unclear whether the source country has the right to tax this amount prior to distribution, what rate would be applied, and, correspondingly, whether the shareholder could insist that the tax system in its country of residence give relief for the tax so collected.

Taxing undistributed profits is a challenge not only to the existing tax base orthodoxy, but also to a tax administration. The ability to tax resident shareholders on undistributed income is facilitated by having both the enterprise and the shareholder as residents—any top-up tax on undistributed profits can be collected when the resident files a return. For nonresident shareholders, the tax administration would have to collect both the profit tax and the tax on undistributed profits from the enterprise directly because there is no dividend to tax, and the shareholder is not necessarily within the

¹⁹¹This problem already arises when a residence country taxes a resident on the accumulated profits of a foreign controlled corporation under its CFC rules. For a discussion of this problem of the interaction of tax treaties and domestic CFC systems, *see generally* OECD Model Treaty, *supra* note 122, paragraphs 23–26, commentary to article 1. *See also* OECD, *supra* note 188.

jurisdiction of the source country's tax administration. While this result is technically feasible, it is not clear what rate should be applied because there is no real information about the marginal tax rate applicable to the nonresident.

Moreover, as a practical matter, in a world where taxes are an important factor in decisions about locating real investments, no country can afford to be the sole country to tax resident enterprise on such a basis.

VI. Distributions

A. Typology of Distributions

For the purpose of this section distributions are defined as any payment made by a company to its shareholders with respect to the shareholders' capital investment. Distributions can take various forms, the most common of which are amounts paid by companies as dividends and amounts paid to repurchase company shares, or to purchase the shares of a subsidiary of the company. However, inventive finance and tax experts are constantly developing new techniques of making company distributions to shareholders. In addition to assuming various different forms, distributions can have different economic origins. They can be paid out of profits that have been taxed at the company level, out of profits that have not been taxed at the company level, or out of no profits at all (meaning, they constitute a return of capital).

B. Tax Consequences of Distributions from Different Origins

The tax consequences of a distribution arising from one of these three different origins will vary significantly depending on the type of tax system in place. One constant among income tax systems, however, is that shareholders do not include as income distributions that constitute a return of capital. In addition, shareholders whose tax base includes capital gains and losses on sale or transfer of their shares must make a downward adjustment to their share cost in an amount equal to such a distribution.¹⁹² Therefore, all tax systems are concerned with whether a distribution constitutes a return of capital.

In addition, fully integrated tax systems are concerned with techniques that allow enterprises to declare taxable bonus shares or to use other techniques that allow shareholders whose tax base includes capital gains and losses on sale or transfer of their shares to, in effect, increase the cost of their shares by the amount retained. In addition,

¹⁹²From a purely theoretical perspective, it would be possible to require a shareholder who included capital gains and losses on its shares in its tax base to include the return of capital in the tax base, and not require any adjustment of the share's cost. When the shareholder sold or transferred the shares, the shareholder would realize a loss equal to the return of capital previously taxed. If tax rates on income and capital gains and losses were the same, and if the taxpayer could claim the entire loss, the taxpayer would be made whole.

in imputation systems where the enterprise tax is at a higher rate than for some shareholders, these techniques may also allow the shareholder to receive a credit for the difference between the two rates.¹⁹³

The different treatment accorded distributions made from taxed income and from untaxed income will vary depending on a number of factors. The most important is whether there is an integrated enterprise-shareholder tax with the enterprise rate equal to or higher than the shareholder rate. In such system, distributions of income fully taxed at the enterprise level need not be taxed at the shareholder level, although depending on the integration system the shareholder may be entitled to a refund of all or part of the accompanying credit. However, as discussed in the previous section, any distribution from income that was either not taxed at all or not fully taxed at the enterprise level raises the question of whether tax should then be levied.

Obviously, this question can only arise when enterprises are not taxed on a base that closely approximates their economic income, or at a rate less than the top shareholder rate. As was discussed at length in the previous section, the tax system can either not tax distributions from untaxed income, or tax them in some way. Also as discussed at length in the previous section, some of the more common techniques employed to tax distributions from untaxed or partially taxed income include using a compensatory- type tax levied on payment at the enterprise level, levying tax on receipt at the shareholder level, or combining the two techniques into a hybrid system.

In jurisdictions without full imputation, the issue is different still. These jurisdictions impose tax on distributions from both taxed and untaxed income, although typically at the same rate. While the reasoning for imposing double taxation on company income is not particularly compelling, it requires levying a tax on all distributions other than those that constitute returns of capital. Withholding or shareholder level taxes, or a hybrid of both, can be used to levy this additional tax on the distribution.

C. Implications of Different Tax Consequences for Distributions

As can readily be seen, it would benefit an enterprise's shareholders if it could make distributions of untaxed or partially taxed income without drawing additional tax. For this reason, and depending on the rules the particular jurisdiction has in place, enterprises may attempt to disguise distributions that draw additional tax as distributions that do not draw additional tax. For example, in integrated systems, an enterprise may try and make a dividend look as if it were paid from previously taxed income. In both integrated and unintegrated systems, an enterprise may try and make a dividend or a redemption appear as if it constitutes a return of capital.¹⁹⁴ And, as noted earlier,

¹⁹³This issue is discussed in greater length *infra* at .

¹⁹⁴With imputation systems the incentive for the company to find ways to make non-taxable distributions exists only with regard to its untaxed income, while in unintegrated systems the incentive extends to all company income, whether taxed or untaxed at the company level.

inventive finance and tax experts are constantly developing new techniques of making enterprise distributions to shareholders, techniques that may not be adequately addressed by existing rules, or that may not be sufficiently understood by hard-pressed tax administrators.

D. Simplified Systems

Given these incentives for enterprises to avoid tax, and the inventiveness with which they may try to do so, it would greatly simplify the design and implementation of enterprise- shareholder tax systems if it were unnecessary to tax distributions. As discussed in the previous section, if nearly all income were taxed at the enterprise level in a fully integrated system, the question would not arise as to whether any distributions should be taxed, in that all distributions would either be paid out of taxed income, or would represent returns of capital to shareholders. And, if a single-rate schedular tax at the shareholder level equal to and integrated with the tax of the enterprise level were applied, then no distribution would be taxable as income by the shareholder.¹⁹⁵ In such a simplified system, the only tax effect a distribution would have would be on those shareholders subject to capital gains tax, who would have to determine whether the distribution were a return of capital; if so, they would be required to adjust downward the share's cost by the amount of the distribution.

In the case of non-schedular imputation systems it would only be necessary to distinguish between distributions carrying imputation credits (which would be included as income, along with a credit) and those that did not (which would be treated as return of capital).¹⁹⁶

¹⁹⁵This would include non-resident investors, who would be exempt from additional withholding tax.

¹⁹⁶In the former case, distribution plus credit would be added to the shareholder's income, with a credit given against tax due, with only share cost adjustment in the latter case. In these systems there may be instances where shareholders are subject to tax at a rate less than the enterprise rate. While it would be one thing to allow small amounts of profits untaxed at the enterprise level also to go untaxed at the shareholder level, it would be another thing to allow these shareholders to claim credits for enterprise tax that was never actually paid. For this reason, it might be advisable to limit the total amount of credits that can be claimed to total amounts of enterprise tax.

E. Rules for Distinguishing Between Distributions of Income and Returns of Capital

In the absence of a single tax rate schedular system it may sometimes be necessary to determine whether a distribution constitutes a return of capital. In addition, in a system where a fair amount of income can escape enterprise tax, or where there is no integration or incomplete integration, there is an incentive to describe distributions as nontaxable returns of capital. However, in a system where substantially all enterprise income is already fully taxed, and where there is complete integration, there is no such incentive. In fact, if anything, there may in some cases be an incentive to disguise distributions of capital so as to avoid reducing the adjusted cost of the share for capital gains purposes. While the latter incentive would presumably be considerably less of a problem than the former, it would still be helpful to have simple techniques for determining what constituted a return of capital and what did not.

Unfortunately, most jurisdictions have systems where a fair amount of income can escape enterprise tax, or where there is no integration or incomplete integration, and are therefore more concerned with proving distributions to be taxable than not to be taxable. One technique for policing distributions is to rely, in effect, on the operations of corporate law.¹⁹⁷ Corporate law governs the circumstances and manner by which a company may make a distributions to its shareholders. Under the corporate law of many jurisdictions, distributions to shareholders are subject to a number of restrictions designed to protect the rights of creditors. In the most restrictive company law regimes, distributions are restricted to dividends paid out of company profits (as determined by special corporate accounting rules), and to the redemption of certain limited types of stock (usually preferred);¹⁹⁸ other types of stock redemptions, including the purchase of shares in a subsidiary, are prohibited. In these cases, only the price paid for the redemption of preferred stock would be treated as a return of capital.

However, corporate law rules concerning shareholder distributions are, at least in many jurisdictions, being liberalized. The repurchase of nonredeemable shares is now often permitted, as is, in at least some jurisdictions, the payment of dividends out of capital. In these cases it still may be possible to rely on the corporate law rules for purposes of defining for tax purposes what is a return of capital. In particular, the rules would have to determine when a dividend is not made out of company income, and how much of the purchase price of a share buy back would have to be deemed to be a return of capital.

¹⁹⁷Of course, corporate law would not govern enterprises other than corporations. However, most large economic enterprises in most jurisdictions operate in corporate form. In certain cases, it may be possible to apply corporate law to other enterprises that function like corporations.

¹⁹⁸Such a rule would greatly restrict the ability for a company to borrow against appreciated assets and make distributions to shareholder of the proceeds of the borrowing. On the other hand, if a tax rule were adopted which required the taking into income of such proceeds, it should also be treated as income for corporate law purposes.

A helpful modification of this approach may be to combine corporate law rules with special tax rules, particularly with regard to determining a corporation's income. If comprehensive income tax rules are applied, taxable income can, for example, be substituted directly for traditional definitions of corporate "profits."¹⁹⁹ However, the rules concerning what constitutes a repayment of capital in the case of stock redemptions would continue to apply.

In a fully integrated system that effectively taxes nearly all of a company's income, such rules should be relatively easy to apply.

F. Complex Systems

However, it is a different story in systems that do not capture most income through the enterprise tax, or where the shareholder level tax is equal to and integrated with the tax at the enterprise level. Considerable additional care on the part of tax administrations will likely be required if they wish effectively to capture distributions from untaxed income (in imputation systems), or from both untaxed and taxed income (classical systems). This is because the incentives to make otherwise taxable distributions look like nontaxable distributions will be greater. In these cases, corporate law rules may be too easily manipulated, and may require additional tax rules to prevent tax avoidance. For example, if there is untaxed income at the enterprise level, it will always be preferable to make distributions to shareholders through redemptions if those payments are treated as returns of capital and therefore not taxable.

G. Examples

As described in the previous section, France has a partial imputation system.²⁰⁰ It levies a compensatory tax on distributions out of income not fully taxed at the enterprise level. The tax system does so in what is essentially a two step process. It first determines if the distribution is from profits (whether taxed or untaxed). It next determines if the distribution is from income already subject to full tax. If so, the *précompte mobilier* is applied.

Essentially any distribution to shareholders (other than bonus shares that represent capitalization of reserves or earnings) is deemed to be out of profits, unless it qualifies for treatment as a redemption or a liquidation.²⁰¹ The enterprise keeps track of what profits it has retained and which have borne full tax, and a stacking rule provides that distributions come first from after-tax profits, then from untaxed profits.²⁰²

¹⁹⁹See *supra* note 6.

²⁰⁰This discussion is based on Hugh J. Ault et al., *Comparative Income Taxation: A Structural Analysis* 304–05 (1997).

²⁰¹Under French law corporate stock dividends can be received in cash at the choice of the shareholder.

²⁰²Although a time limit is in effect, after which the after-tax profits can no longer be distributed without bearing the *précompte mobilier*.

The French rules on the treatment of redemptions is rather complicated. Where redemptions are permitted, a portion of the distribution may be deemed to be taxable. A number of steps must first be followed to determine what portion. For those shareholders not subject to capital gains tax, the portion of the distribution that exceeds the greater of the shareholder's actual gain or the amount of the share's paid in capital is taxable as a dividend, up to the extent of the enterprise's accounting profits. All amounts paid out of untaxed profits are subject to the *précompte mobilier*. A different, and more complicated rule applies to shareholders subject to capital gains tax.

These tax rules appear to allow enterprises to borrow against appreciated assets, and then use the proceeds of the borrowing to pay exempt dividends or to make exempt redemptions. However, French corporate law mitigates these options substantially. It prohibits companies from making distributions of dividends except out of accounting profits, and severely restricts the ability of companies to make redemptions. However, if corporate law were to change, so too might these conclusions.

As described in the previous section, the United Kingdom has only a partial imputation system, and uses the ACT as its primary technique of capturing distributions from untaxed income. Under this system, it is necessary first to determine which distributions are from income (whether taxed or untaxed), for those distributions will attract ACT. Distributions from capital do not attract ACT. Next, it is necessary to determine whether the distribution is from taxed income. This is done by keeping track of total taxes paid, and by assuming that distributions are made first from taxed income, next from untaxed income. A partial credit for the ACT is then given against the corporate tax paid. If the ACT credit were given in full, the net effect would be that only those distributions from untaxed income would be subject to tax.

The U.K. law defines taxable distribution as including any dividend allowed under corporate law, as well as any other distribution unless defined as repayment of capital.²⁰³ U.K. corporate law allows dividends to be paid from unrealized capital gains; these are taxable. However, a dividend from capital is not permitted. As a general matter, amounts returned to the shareholders in a redemption of capital in excess of the paid-up capital allocable to the shares in question are deemed to be non-capital distributions.²⁰⁴ There is also a rule that where a company repays share capital and at any time thereafter it issues any share capital as paid up otherwise than by the receipt of new consideration, then the amount so paid up will be treated as a distribution.²⁰⁵ A distribution of bonus

²⁰³GBR ICTA § 209.

²⁰⁴See Barry Pinson, *Pinson on Revenue Law* 283 (1981). Generally, the paid-up capital for corporate law purposes is the stated capital of the class of shares in question as shown in the company's financial statement.

²⁰⁵GBR ICTA § 210.

shares is not treated as a distribution, although the bonus shares may be subject to what is in effect a special tax at the shareholder level.²⁰⁶

The U.K. rules do capture borrowings against appreciated assets that are paid out to shareholders as dividends. However, the rules also make it possible for enterprises to turn otherwise taxable distributions into non-taxable returns of capital through share redemptions. While corporate law limits the ability of companies to make redemptions, the opportunities are still greater than under French law.

Canada maintains a partial imputation system without the levying of additional tax on any distributions. This is due in part to the presumption that distributions to shareholders in the form of dividends have already borne enterprise-level tax. Dividends are therefore deemed to have been paid out of taxed income, save for certain instances where the dividend is deemed to be a return of capital.²⁰⁷ Because the imputation system is only partial, additional tax may be due at the shareholder level on dividends. However, if the distribution is deemed to be from capital, there will be no additional tax.

The term “dividend” is not defined by statute, but has been interpreted by the courts and the tax administration as meaning any distribution except as an authorized reduction of capital. In addition, the statute defines dividends to include stock dividends. The statute treats all or a portion of distributions made during share redemption or reduction in capital as non-taxable returns of capital. The amount treated as a dividend is the amount distributed in excess of the paid-up capital allocable to the shares in question.

H. Taxable Bonus Shares and Constructive Dividends

Enterprises may wish to retain earnings rather than to distribute them to their shareholders. These retained earnings will be reflected in an increase in the value of the enterprise’s shares. If these earnings have been subject to tax, the increase in shareholder value will represent already taxed gains. In a fully integrated tax system, there will be a tax disincentive for retaining these earnings unless the shareholder who is subjected to capital gains taxation is not taxed on these gains. Therefore, such systems typically allow enterprises to take measures to ensure that such shareholders are not so taxed. In addition, in imputation systems where the enterprise tax is at a higher rate than for some shareholders, these techniques may also allow the shareholder to receive a credit for the difference between the two rates.

²⁰⁶See Barry Pinson, *supra* note 206, at 284.

²⁰⁷This discussion is based on Brian Arnold et al., *Materials on Canadian Income Tax* 698 (1993).

Two typical methods include allowing enterprises to declare either taxable bonus shares or what has sometimes been termed “constructive dividends.” Taxable bonus shares are typically shares paid as dividends that represent capitalized earnings through the issuing of additional shares of stock,²⁰⁸ although there is no particular tax reason why capitalization under company law should be required. The value of a dividend distributed as a bonus share equals the proportionate amount of capitalized earnings. The result is a decrease in the value of the existing shares equal to the cost of the new shares, which is itself equal to the amount of retained earnings. Systems must ensure only that the bonus share represents after-tax income.²⁰⁹

Another technique is to allow enterprises to declare “constructive dividends.”²¹⁰ These are notional dividends that are declared but not actually paid, and are designed to allow shareholders to increase their share cost by the amount of the retained earnings. This can be effected by an enterprise simply reporting to a shareholder the per share amount of after tax income the enterprise has retained; a shareholder subject to capital gains taxation can then increase cost by this amount.²¹¹

VII. Defining Which Business Enterprises Should be Subject to Separate Corporate Tax

An enterprise tax law must spell out, usually at the beginning of the statute, which entities are subject to tax. As with the individual income tax, a distinction must be drawn between residents and nonresidents, nonresidents typically being taxed only on income sourced in the jurisdiction. The definition of residence is discussed in chapter 18.

One definitional technique that is often used in civil law countries is to rely on an entity’s legal status. Under this approach, if an entity is considered a legal person under the civil code, then it will be subject to enterprise tax. This rule may then be supplemented by listing specific forms of legal persons that are subject to tax, listing as taxpayers certain entities that are not legal persons and excluding certain legal persons from tax. For example, the German corporate income tax law lists the most common types of commercial companies, adds “any other legal persons under private law,” adds certain entities (such as *Stiftungen*) that may not be legal persons, and also includes

²⁰⁸In a number of countries taxable bonus shares can only be issued if the company has capitalized the retained earnings. See the discussion in Hugh J. Ault et al., *Comparative Income Taxation: A Structural Analysis* 314-317 (1997).

²⁰⁹In some imputation systems a shareholder taxed at less than the enterprise rate may qualify for a credit for the difference.

²¹⁰The ALI Integration Report describes them as this way, while the U.S. Treasury Department Report refers to them as reinvested dividends. ALI Integration Report 125-27; U.S. Treasury Report 87-8, 106-7,

²¹¹As noted *supra*, in some imputation systems a shareholder taxed at less than the enterprise rate may qualify for a credit for the difference.

enterprises administered by entities that are legal persons under public law (even when the enterprise may not itself be a legal person).²¹²

The French approach is broadly similar. The law lists certain forms of company and then refers to “any other legal person carrying out an exploitation or operations of a profit making nature.” It then lists certain forms of companies that are subject to corporate tax on an elective basis.²¹³

Although, as illustrated in the above examples, corporate tax laws in civil law countries typically start from the status of entities as legal persons, these countries do not uniformly subject entities to corporate tax if and only if they are legal persons.²¹⁴

Common law countries take different approaches. Canada relies on legal personality, imposing the income tax on any “person.”²¹⁵ The United States imposes the corporate income tax on “every corporation,” but corporation is defined as including “associations.”²¹⁶ In turn, the regulations have adopted a test of corporate resemblance, holding that entities with sufficient corporate characteristics are taxed as associations. Hybrid entities can now elect whether to be treated as a corporation or as a partnership.²¹⁷

In the United Kingdom, corporation tax is imposed on “profits of companies.”²¹⁸ Company “means... any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association.”²¹⁹ This differs from the U.S. approach in that partnerships cannot be recharacterized as associations and therefore treated as corporations. In addition, some non-corporate entities such as unit trusts are taxed in essentially the same manner as companies, only at different rates and with more complete integration.

Some transition countries treat as taxpayers under the corporate tax not just legal persons, but separate divisions of legal persons.²²⁰ This practice arises from the treatment of these divisions as separate enterprises under the former command economy. The fact

²¹²See DEU KStG § 1.

²¹³See FRA CGI § 206.

²¹⁴See *infra* ch. 21, note 18.

²¹⁵CAN ITA § 2.

²¹⁶See USA IRC §§ 11, 7701(a)(3).

²¹⁷See *infra* ch. 21, note 38.

²¹⁸GBR ICTA 1988 § 6.

²¹⁹*Id.* § 832(1).

²²⁰See, e.g., ALB PT § 4; RUS PT § 1(1)(b). Georgia used to tax divisions separately, but has now changed this rule. See GEO TC §§ 12, 44(2).

that these enterprises were not separate legal persons may have been of little importance in the past. However, their treatment as separate taxpayers under the profits tax can be problematic. In particular, how can systems designed to tax dividends operate when the dividends are paid not by each separate division but by the legal person? How are transfers of property among divisions to be accounted for? Although taxing divisions separately may not fit very well with a market economy-type corporate tax, there has in some countries been resistance to changing the system of taxing divisions separately. The divisions may be accustomed to keeping separate accounts, and tax officials may also be accustomed to auditing and dealing with divisions separately (corruption may be involved here). Local governments may be used to receiving their share of the revenues from the divisions located in their jurisdictions (they are often entitled to a share on this basis under laws governing the division of revenues from taxes). Eventually, however, as revenue sharing laws are adjusted, it can be expected that these special rules treating divisions as separate taxpayers will be abandoned.

The opposite issue is consolidation of taxpayers. Consolidation is allowed, for example, in the United States under extremely complicated rules. A few transition countries also allow consolidation.²²¹ Generally, countries whose tax system is not highly developed should steer clear of allowing consolidation.

Some transition countries impose a tax not on legal persons or corporations but on enterprises, which in some cases can include sole proprietorships. For example, in Latvia, taxpayers of the enterprise income tax are defined as enterprises, with a cross reference to the Law on Taxes and Fees.²²² That law in turn defines as resident an entity that is “registered” in accordance with the legislation of Latvia.²²³ The enterprise income tax excludes from the definition of taxpayer individual enterprises that are not required to submit annual reports in accordance with the Law on Annual Reports of Enterprises. Therefore, sole proprietorships that are required to submit such reports are taxed under the enterprise income tax. And in Vietnam, the new Business Income Tax applies generally both to individuals engaged in production and trade and to business entities. The law itself does not provide for flow-through treatment for partnerships, thereby leading to some confusion when business is carried out in partnership form (particularly when the partners themselves are companies). Who is the taxpayer in that case? The partnership, the partners, or both? The enterprise income tax law of China likewise taxes enterprises, which are defined as state-owned enterprises, collective enterprises, private enterprises, joint-venture enterprises, and “any other organizations deriving income from production and business operations and other income.”²²⁴

²²¹*E.g.*, KAZ TC § 6(4), second paragraph (allowing consolidation in limited circumstances upon decision of the government); AZE PT § 1(2)(consolidation for certain taxpayers by government decision).

²²²*See* LVA EIT §§ 1, 2.

²²³*See* LVA LTF § 14.

²²⁴*See* CHN EIT § 2.

Imposing tax on enterprises as described in the preceding paragraph can be faulted for lack of clarity. The basic problem is that “enterprise” is generally not a clear legal concept.²²⁵ It is much better technique for the law to refer to legal persons because it will be clear whether an entity is a legal person.²²⁶ However, one can see the counter argument. If everyone carrying on a business is required to register as an enterprise, it seems an attractive proposition to tax separately each registered enterprise, regardless of its legal status.²²⁷ Again, the same arguments can come up as with corporate divisions. Enterprises may be registered locally. An administrative mechanism may have grown up around the concept of enterprise registration. The basic problems with this approach are that (1) a single legal or physical person may have more than one registered enterprise or branch, and the boundaries around these enterprises may be difficult to draw, and (2) a person may carry on a business without registering it. Using instead the concept of legal person provides for greater certainty because it derives from the legal personality of the taxpayer as defined in the civil code.

The definition of taxpayer also needs to specify exemptions. Government agencies, but not government-owned enterprises, are typically exempt. Also typically exempt are various forms of nonprofit organization, whose definition will differ from country to country. When a system of incorporation and registration of such organizations exists outside the tax law, it may be possible to simply make a cross reference, rather than to put all the necessary qualifications into the tax law. It is necessary to determine which agency (for example, the tax agency or some other licensing agency) will be responsible for ensuring that the entities in question qualify as nonprofit. While some countries completely exempt certain organizations from tax,

²²⁵Particularly problematic are enterprises that are operated as partnerships (with greater or lesser degrees of formality) and sole proprietorships. These are generally not legal persons and may or may not be formalized. In China, sole proprietorships are regulated by the Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the State Council on Aug. 5, 1987.

²²⁶For example, in China, art. 36 of the General Principles of Civil Law of the People’s Republic of China, *reprinted in* Robert Guillaumond & Xie Zhao Hua, *Code chinois du droit des affaires* (Maison Larcier 1995), establishes the concept of a legal person. The Company Law, *reprinted in id.*, establishes two forms of commercial company: limited companies and share companies. Both are legal persons. The law distinguishes between branches of companies, which are not legal persons, and subsidiaries, which are. *See id.* art. 13. Foreign companies are allowed to establish branches in China and must obtain a business license in order for the branch to be allowed to operate in China. *See id.* art. 200. However, such branches are not considered separate legal persons. *See id.* art. 203. The Company Law came into force on July 1, 1994. Companies established before this date are required to take steps to conform to the requirements of this law. *See id.* art. 229. Procedure for registration is governed by the ordinance of June 24, 1994, *reprinted in id.*

²²⁷For example, in China, the ordinance of June 24, 1994, contemplates the registration of branches, even though branches are not separate legal persons. *See* Ordinance of June 24, 1994, art. 39–44, *reprinted in* 2 Guillaumond & Hua, *supra* note 210. There is also a registration procedure for permanent representative offices of foreign companies. *See* Detailed Regulations of the Ministry of Foreign Commerce and Economic Cooperation Concerning the Approval and the Administration of Permanent Representative Offices of Foreign Enterprises, *reprinted in id.* The distinction is that representative offices cannot “directly engage in profit-making activities on the territory of the People’s Republic of China.” *Id.* art. 4.

others tax nonprofit organizations on their business income if they carry on a business that is not related to their nonprofit purpose. The United States has developed quite detailed rules and practices on what is known as “unrelated business taxable income.”²²⁸ A more aggressive approach would be to tax nonprofits not only on their business income but on all their business and investment income. One advantage of such an approach is that it is not necessary to distinguish between business and investment (e.g., how would rental activity be classified?). Whether such an approach is taken is very much a political decision because of possible reluctance to impose tax on entities that are considered to be carrying on good works.

VIII. Concluding Remarks

This chapter began with a discussion as to the merits of an income tax system including a separate enterprise tax, and continued with recommendations as to how such a tax should be structured. It elaborated a number of arguments in support of a system that taxes enterprise income once, at the highest shareholder marginal rate, and that collects such tax to the greatest extent possible at the enterprise level. In addition, it advocated an enterprise level tax that sought to capture, as accurately as possible given practical constraints, all income as it accrued, and at the same tax rate.

The arguments favoring such a system were primarily rooted in economics, that such a system was likely to result in the fewest distortions, and would allow the market to function with greater efficiency. However, an important byproduct would be that the system would be far simpler to administer, and also considerably less prone to tax avoidance. The primary reasons for this are that, with nearly all economic profits taxed at the enterprise level, there is no need for levying dividend taxes, nor for rules to determine what constitutes a distribution. Incentives to make non-equity payments would be greatly reduced.

In addition, where there is little untaxed income at the enterprise level, there is a corresponding reduction in the need to tax capital gains at the shareholder level, in that more of any share’s increase in value due to the enterprise’s economic income will already have been subject to tax at the enterprise level. This reduces the need to administer a capital gains tax at the level of the individual shareholder (including having to provide for the adjustment of cost of shares for amounts of retained earnings or distributions of capital), a difficult undertaking in developed countries, and correspondingly more difficult in developing or transition economies.²²⁹

²²⁸See USA IRC §§ 501(b), 511–515.

²²⁹In addition, gains and losses of non-residents are typically exempt either by statute or through bilateral treaties. Of course, this is not to say that there are not benefits to having capital gains taxes, and this chapter argues for the inclusion of gains and losses at the enterprise level. There may in some cases be unleveraged (and therefore untaxed) gains at the enterprise level, and a capital gains tax at the shareholding level would end deferral of tax on those gains when the shares were sold or transferred. Also, there may be gains reflected in the value of shares that are not also reflected at the enterprise level, such as market expectation that an enterprise will earn profits in the future.

Next, rules providing for the stacking of income or against the streaming of distributions become unnecessary, in that all income bears the same rate of tax. Finally, the chapter argues that if the enterprise tax is final, meaning that the tax on enterprise income is schedular, there is additional improvement in administrative ease and reduction in tax avoidance possibilities because the tax system would not need to tax distributions at the shareholder level.

It may be argued by many income tax designers that implementation of a completely effective enterprise level tax on economic income is impossible. Even if this turns out to be the case, to the extent that preference income can be reduced by ending as many intentional enterprise-level tax preferences as possible (such as investment credits, accelerated depreciation, and the like), and deferred capital gains can be reduced by marking to market as many assets as possible for which objective values can easily be ascertained (such as precious metals, foreign exchange, quoted securities, derivatives and the like) and by including in corporate income total borrowings net of written-down asset value, the need to capture distributions from untaxed economic income will be reduced to the same extent. This would mean, in effect, that some or all of the elaborate mechanisms described in sec. V to capture untaxed income, or to allow shareholders to be taxed at marginal rates might raise so little additional revenue as not to be necessary, or if necessary in occasional cases, unnecessary in most. It would also mean that any of the elaborate rules described in sec. VI to distinguish among different types of distributions would become similarly less necessary or less important. With significant progress having been made toward such a simplified system, the methods described in those sections can be either enacted, applied, or both only on a selective bases, based only on what is required to do the job.

It may also be argued that it is politically difficult to tax enterprises at the highest shareholder rate. But to the extent that enterprise income and shareholder income were taxed at as close to the same rate as possible, any incentive by enterprises to retain earnings or to make non-taxable distributions to take advantage of the lower enterprise rate would be reduced.

Finally, tax designers may also argue that it is unfair to implement a schedular tax on enterprise income. However, to the extent that a non-schedular tax can be limited to the fewest taxpayers as possible, the need to file returns, or for enterprises to shift ownership to those taxed at lower rates, would be reduced.

Therefore, even if complete adherence to a simplified system is impossible for whatever reason, there still is considerable merit in designing a tax system with as many features as described in the above simplified system as possible.

While these arguments apply in varying degrees to all economies, they have particular relevance to developing countries and to economies in transition. Even in these jurisdictions, many enterprises, particularly larger companies or companies with foreign management, may have developed considerable tax planning expertise. The globalization

of sophisticated tax planning ability, and therefore tax avoidance, has been a remarkable, another perhaps unexpected consequence of the general globalization of markets and financial information. The authors have experienced in a number of cases of developing and transition countries with complex systems, and where a surprisingly large amount of tax administration resources were dedicated to attempting to prevent sophisticated income tax avoidance schemes. However, because of inadequacy of resources, these tax administrations were less likely to be able to design and implement the rules necessary to operate their complex systems without diverting administrative resources from other tasks. These other tasks, while perhaps more mundane, were also more likely to be productive in the collection of needed revenue.

Therefore, in these circumstances it is perhaps best to design the most effective simple system as possible, and to direct limited bureaucratic resources not to trying to capture the relatively meager income that will escape through the tax avoidance net, but to more productive, if less intellectually challenging, activities.