

# THE CASE FOR TAX INTEGRATION AND CURRENT-BASE TAXATION

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*If you are truly serious about preparing your children for the future, don't teach them to subtract – teach them to deduct*

– Fran Lebowitz

## *Abstract*

*The U.S. tax system has many distortions, but two triumph them all. The first is debt-over-equity. Under the current corporate double taxation mechanism, C corporations are incentivized to borrow rather than issue equity, because interest is deductible, and dividends are not. The second is foreign-over-domestic investment. Under the current U.S. international tax regime, U.S. multinationals are subject to a reduced tax rate, and in certain occasions are also exempt from U.S. tax on their foreign earnings, while their domestic earnings are subject to full corporate tax rate.*

*In this Article, I call for the adoption of a Dividends-Paid Deduction form of tax integration and for current-base taxation of foreign earnings. The already reduced corporate tax rate (21%), combined with tax integration, will provide a significant relief from the relatively high burden of corporate double taxation, allowing U.S. multinationals to better compete in the global economy. It will eliminate (or substantially reduce) the debt-over-equity bias and the inefficient penalty on business activities carried through C corporations. Current-base taxation will eliminate the current incentive to invest and shift income abroad, while providing a very important source of revenue. It will also obliterate the need to distinguish between domestic and foreign earnings and as such will facilitate the adoption of tax integration, because all distributions of earnings that were previously taxed will give rise to the benefits of tax integration. Finally, in order to avoid a potential revenue loss as a result of this new dividends-paid deduction, a non-refundable full-rate withholding tax, or a new compensatory tax, equal to the rate of the corporate tax, should be introduced and implemented.*

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## I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (2017 Tax Reform) represents the most far reaching reform of the U.S. tax code since President Reagan's 1986 tax reform. The international provisions of the 2017 Tax Reform introduced a significantly new international tax regime based on the premises of participation exemption and minimum tax. The general approach is that foreign income earned by U.S. corporations will be exempt from further U.S. taxation up to a certain amount. Under this approach, a U.S. corporation that owns 10% or more of a foreign corporation will be entitled to a 100% dividends-received deduction for the foreign-source portion of the dividends paid by the foreign corporation. Additionally, a new 10.5%<sup>1</sup> tax on Global Intangible Low Taxed Income (GILTI) was introduced and is aimed to limit the applicability of the tax benefits provided by the participation exemption mechanism. GILTI is intended to capture the excess return—with the main purpose of capturing income attributable to intangibles—above a 10% return on tangible investments. Nonetheless, because GILTI allows a Foreign Tax Credit (FTC) for 80% of foreign taxes attributed to GILTI, foreign income that is subject to a 13.125% (or higher) foreign tax rate should generally be exempt from any additional U.S. tax. The 2017 Tax Reform also introduced an anti-base erosion and income shifting mechanism, the Base Erosion and Anti-abuse Tax (BEAT). BEAT imposes a minimum of 10% corporate tax, based on the taxpayer's income before certain tax deductions and other tax benefits arising from base erosion payments. Finally, the act also introduced a special regime under which foreign-derived intangible income of U.S. corporations is subject to an effective tax rate of 13.125% as well, which resembles a patent box-like regime.<sup>2</sup>

The legislative process of the 2017 Tax Reform was widely covered by the media. But a certain proposal that eventually did not get into the final legislation did not get the attention it deserved. Section 242 of Senate's proposed bill called for the adoption of a Dividends-Paid Deduction (DPD).<sup>3</sup> The DPD is a form of integration favored by Senator Orrin Hatch, Chairman of the Senate Finance Committee. In January 2016, Hatch announced that his team was working on a comprehensive proposal to adopt tax integration in the form of DPD.<sup>4</sup> Under Hatch's proposal, which was never officially published, corporations would be entitled to DPD for their distributions to both domestic and foreign shareholders. The DPD proposal was combined with a 35% (the corporate tax rate at the time) withholding tax (WHT) on all distributions.<sup>5</sup> If income is indeed distributed, DPD will effectively eliminate the current two-tier tax system, or the double taxation mechanism. Generally, Double taxation refers to corporate earnings that are taxed twice – first

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<sup>1</sup> This rate is half of the general corporate tax rate (which is achieved by a 50% deduction).

<sup>2</sup> See Sullivan & Cromwell, *U.S. Tax Reform: Congress Passes Tax Reform*, available at [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_US\\_Tax\\_Reform\\_12\\_20\\_17.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_US_Tax_Reform_12_20_17.pdf) [<https://perma.cc/5W5T-NGDP>].

<sup>3</sup> H.R. 1, 115th Cong. Section 13011 (as proposed by Senate, Dec. 2, 2017).

<sup>4</sup> Bernie Becker, *Hatch to Take a Shot at Corporate Double Tax*, POLITICO (Jan. 21, 2016), <https://www.politico.com/tipsheets/morning-tax/2016/01/hatch-to-take-a-shot-at-corporate-double-tax-brady-tax-staffer-gets-high-marks-yes-the-irs-deleted-another-key-hard-drive-212275> [<https://perma.cc/MKN7-KN4D>].

<sup>5</sup> Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Shareholder Taxes*, 69 NAT'L TAX J. 677, 678 (2016) [hereinafter Graetz & Warren Jr. *Integration of Corporate and Shareholder Taxes*].

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when earned by corporations (currently at a rate of 21%), and second when the earnings are distributed as dividends (currently at a rate of up to 20%). The total burden of the double taxation mechanism is up to 36.8% of the earnings.<sup>6</sup>

A DPD creates the risk of substantial revenue loss in the cross-border context. Since cross-border transactions are subject to tax treaties, foreign taxpayers engaging in such transactions already receive tax benefits such as reduced WHT on dividends.<sup>7</sup> These treaty benefits, combined with a DPD, would potentially result in minimal US taxes collected from foreign shareholders.<sup>8</sup>

Clearly, one major problem that might occur when one country adopts integration and the other does not is a potential revenue loss on outgoing payments (for the first-mentioned country). For example, imagine that under the tax treaty between the United States and the United Kingdom, dividends distributed by a U.S. corporation to a U.K. shareholder are not subject to U.S. WHT. In such a case, if the United States adopted DPD regime, the income earned by the U.S. corporation, and later distributed to the U.K. shareholder would escape U.S. taxation entirely. This is because the U.S. corporation will be entitled to a deduction equal to the dividend distribution, effectively reducing the corporate taxable income on such distribution to zero, and the distribution itself will not be taxed by the United States because of the tax treaty. When the United Kingdom tried to mitigate such effects at the time by implementing tax integration (in the form of imputation), the Court of Justice of the European Union prevented it from doing so, on the grounds that taking preventive steps to mitigate the problem would be discriminatory and would violate E.U. law, a decision that led to the elimination of the imputation regime in the United Kingdom.<sup>9</sup>

As we will see, the main advantages of tax integration primarily address the domestic problems of the U.S. tax code. But the U.S. international tax regime is also in need of a serious reform beyond the 2017 Tax Reform. U.S. multinational enterprises (MNEs) are incentivized to shift income abroad due to the reduced rates under GILTI and the Foreign-Derived Intangible Income (FDII) effectively eroding the U.S. tax base.<sup>10</sup> To prevent this, the general premise of the U.S. tax system should be that domestic and foreign income be taxed at the same rate.<sup>11</sup> This could be achieved by eliminating GILTI and FDII and applying a current-base taxation, under which the foreign earnings of U.S. MNEs are taxed in the same year they were earned and at the same rate

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<sup>6</sup> Assuming an income of 100: First level of tax is of 21%, at the corporate level, for 21 of taxes. This leaves net income of 79, which is then distributed as a dividend and is subject to up to 20% of dividend tax at the shareholder level, for an additional 15.8. The total tax paid is 21+15.8=36.8. Before the 2017 Tax Reform (and with a corporate tax rate of 35%), the total tax burden was 48%. Compare these to the highest individual marginal tax rate of 39.6%.

<sup>7</sup> See CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 13 (1979).

<sup>8</sup> *Id.*

<sup>9</sup> Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1208 - 1211 (2006) [hereinafter Graetz & Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*].

<sup>10</sup> The GILTI will also incentivize U.S. MNEs to keep their earning abroad and reinvest it in foreign tangible property. See Reuven Avi-Yonah, *Guilty as Charged: Reflections on TRA 17*, 157 TAX NOTES 1134 (2017) (arguing that GILTI “creates obvious discrimination between intellectual-property-intensive domestic corporations . . . and other domestic C corporations” and may incentivize shifting income abroad”).

<sup>11</sup> See Reuven S. Avi-Yonah & Nir Fishbien, *Once More, with Feeling: The ‘Tax Cuts and Jobs’ Act and the Original Intent of Subpart F*, 157 TAX NOTES 959, 966 (Nov. 13, 2017).

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as domestic earnings – 21%. This, combined with tax integration, should provide a significant relief from the relatively high double taxation burden on U.S. MNEs, allowing them to better compete in the global economy. Furthermore, it will also eliminate (or substantially reduce) the debt-over-equity bias and the inefficient penalty on business activities carried through C corporations. Current-base taxation will eliminate the current incentive to invest and shift income abroad, while providing an important source of revenue to the U.S. government.

The first part of this Article briefly discusses the history of tax integration in the United States, focusing specifically on DPD and imputation forms of integration. The second part discusses the current domestic and international problems of tax integration. The third part examines the main problems associated with adopting tax integration. The fourth part offers a new comprehensive tax reform proposal, under which U.S. MNEs will be subject to current-base taxation, combined with DPD regime.

### II. THE HISTORY OF TAX INTEGRATION IN THE UNITED STATES

The history of tax integration in the United States is important for two main reasons. First, it illuminates that the decision to tax corporate income twice has remained controversial for over a century. Second, it shows that tax integration has inherent problems that have prevented it from being implemented.<sup>12</sup> It is generally agreed that the best form of integration should comply with the following terms: It must be administratively feasible, it must comply with the realization requirement, it must further the goal of the ability-to-pay principle by imposing tax at the shareholder level, and it must tax corporate earnings only once, whether retained or distributed.<sup>13</sup> It is common to divide the many forms of tax integration into two main groups: full and partial integration. Under *full* integration, the income earned at the corporate level, whether distributed or not, is attributed to the shareholders, just as if they were partners in a partnership, and taxed only at the shareholder level.<sup>14</sup> Most of the proposals for integration, though, are for *partial* integration. Partial integration offers the same treatment as full integration, but only to the extent the income earned at the corporate level is distributed, and not retained at the corporate level.<sup>15</sup>

Under the current double taxation mechanism, dividends are taxed as capital gains at a preferential low rate.<sup>16</sup> In a sense, this reduced rate (compared to the top marginal ordinary tax rate) reflects partial integration, yet it does not eliminate the current distortions of double taxation. The lower dividend tax is aimed to provide relief from the high burden of double taxation. But

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<sup>12</sup> R. Glenn Hubbard, *Economic Effects of the 2003 Partial Integration Proposal in the United States*, 12 INT'L TAX & PUB. FIN. 97, 101–103 (2005). These problems are discussed in Part II, *infra*.

<sup>13</sup> See David B. Clement, *The American Law Institute Reporter's Study of Corporate Tax Integration: A Critique* 19 (Feb. 14, 1994) (unpublished LL.M. thesis, Georgetown University Law Center).

<sup>14</sup> U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 68 (1977).

<sup>15</sup> Graetz & Warren Jr. *Integration of Corporate and Shareholder Taxes*, *supra* note 5, at 687 (“How would integration take account of the fact that some corporate income is distributed to shareholders without bearing a full corporate tax? There are two basic approaches...[Under the second approach,] Instead of requiring a withholding tax on any dividends paid by the corporation, individual taxpayers would be allowed to treat dividends as taxable or nontaxable, based on a statement from each corporation regarding the amount of its dividends that had borne corporate tax.”).

<sup>16</sup> I.R.C. §§ 1(h)(1), (11) (2012).

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Congress only recently (2003) agreed to extend such relief; for many years the traditional full-rate double taxation mechanism prevailed.<sup>17</sup>

A. The Foundation of Corporate Taxation

Corporate income was first taxed under the Revenue Act of 1894 (Wilson-Gorman Tariff of 1894), but the Supreme Court held the act unconstitutional.<sup>18</sup> In 1909, a constitutional amendment was proposed to impose an *excise* tax on corporations.<sup>19</sup> The corporate excise tax provided for a one percent tax on corporate income with the first \$5,000 of income exempt.<sup>20</sup> This tax was upheld by the Supreme Court<sup>21</sup> and was affixed with the income tax in the Revenue Act of 1913, in which the exemption of \$5,000 was repealed.<sup>22</sup> It was the first time that corporations and individuals were subject to separate income taxes. At the time, the risk of double taxation of corporate earnings was addressed by generally excluding dividends from individual taxable income.<sup>23</sup> This was the first phase of integration in the U.S. tax code.<sup>24</sup> In 1936, Congress introduced the bracket rates for corporate income tax.<sup>25</sup> Distributed income was taxed at rates ranging from 8% to 15%. Undistributed income was subject to an additional surtax with rates ranging from 7% to 27%.<sup>26</sup> The main purpose was to eliminate any incentives to accumulate earnings in the corporation and deferring individual tax. Two years later, the surtax was repealed.<sup>27</sup> Ironically, some argue that the double taxation mechanism as we know it today was the result of an intensive lobbying efforts by large corporations that preferred the double taxation mechanism over a higher tax on undistributed corporate profits so that shareholders would be inclined to keep earnings at the corporate level to avoid the additional layer of tax.<sup>28</sup>

<sup>17</sup> See Graetz & Warren Jr. *Integration of Corporate and Shareholder Taxes.*, supra note 5, at 687.

<sup>18</sup> *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895).

<sup>19</sup> Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 478 (2003).

<sup>20</sup> BORIS BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (7th ed. 2000).

<sup>21</sup> *Flint v. Stone Tracy Co.*, 220 U.S. 107, 115–16 (1911).

<sup>22</sup> See Jack Taylor, *Corporate Income Tax Brackets and Rates, 1909–2002*, IRS STAT. INCOME BULL. (2003), available at <https://www.irs.gov/pub/irs-soi/02corate.pdf> [<https://perma.cc/8MW2-ZRFB>].

<sup>23</sup> See Bank, supra note 19, at 489. Dividends could still be subject to a *surtax*.

<sup>24</sup> *Id.* at 489–490. By excluding dividends from the “normal” individual income tax, corporate income was first taxed at corporate rates, and then at surtax rates (at progressive rates up to 6%), if applicable, when received by individuals. On the other hand, noncorporate income was subject to the “normal” individual income tax, and above a certain level, the same additional surtax was applied. Corporate income and individual tax rates were tied and related. Congress thus made the corporate income tax a quasi-withholding provision for individual income tax.

<sup>25</sup> See Bank, supra note 19, at 511.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 515.

<sup>28</sup> Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, in BUSINESS TAX STORIES 159 (Steven A. Bank & Kirk J. Stark eds., 2005). The essay examines the circumstances leading up to repeal of the dividend exemption and the introduction of full double taxation and argues that the main reason behind it was a threat from another proposal—the undistributed profits tax. The main concern was that the undistributed profits tax would put pressure on managers of big corporations to distribute their profits instead of keeping them in the corporate solution and using them for potential expansion. The threat posed to managers by the undistributed profits tax led them to support the retention of the corporate income tax and eventually the repeal of the dividend exemption. This is because double taxation would aid in aligning management-shareholder attitudes toward the retention, and not distribution, of corporate earnings. Double taxation, according to the essay, became a tool in the campaign against the undistributed profits tax.

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B. The 50s and 60s

From 1954 to 1964, individual shareholders were allowed a tax credit for a fixed percentage of dividends received.<sup>29</sup> A partial exclusion was also available from 1954 to 1986.<sup>30</sup> During the 70s, economists began to argue that the corporate double taxation was the main reason for the capital shortage and that integration would help relieve it.<sup>31</sup> In addition, policies in Europe demonstrated that dividend relief proposals were driven by the goals of capital injection and increased corporate returns.<sup>32</sup> As such, proposals to move towards integration in the form of dividend tax relief were often raised in both the United States and Europe.<sup>33</sup> The call for integration included the desire to eliminate the bias in favor of debt over equity,<sup>34</sup> improve capital allocation, make capital markets more competitive, and reduce the difference between ordinary income rates and capital gain rates.<sup>35</sup> Some suggested a partial DPD regime, whereby corporations could deduct only half of the amount of dividends they distribute.<sup>36</sup> In general, under the DPD form of integration, the same rules regarding the deductibility of interest would apply to dividends, and corporations would be able to deduct the full (or partial) amount of dividends they distribute (after recognizing any Section 311(b) gain for the appreciated property distributed). All of these proposals for DPD were eventually dismissed. In 1984, the proposal for a 50% DPD was raised again, this time by the Treasury Department, but it was not adopted mainly because of revenue concerns.<sup>37</sup> In 1985, President Reagan proposed reducing the percentage of the DPD to 10% (instead of 50%), but once again, the proposal was not adopted.<sup>38</sup> One of the main reasons the proposal failed was the potential problem with tax treaties, under which the United States might be obliged to extend any sort of dividend tax relief also to foreign investors. Such a step might result in dividends paid to foreign investors escaping U.S. taxation entirely, which would negatively impact U.S. revenue.

The 60s brought about a profound change in the nature of the underlying principles of the U.S. international tax regime. The focus changed from arguments of equity and fairness to arguments

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<sup>29</sup> *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the H. Comm. on Ways and Means*, 95th Cong. 6230 (1978).

<sup>30</sup> *Id.*

<sup>31</sup> See Graetz & Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, *supra* note 9, at 7.

<sup>32</sup> McLure, *supra* note 7, at 46-49.

<sup>33</sup> Graetz & Warren Jr. *Integration of Corporate and Shareholder Taxes*, *supra* note 5, at 678.

<sup>34</sup> TAX REFORM TASK FORCE, A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA 128 (2016), available at [https://www.novoco.com/sites/default/files/atoms/files/ryan\\_better\\_way\\_poverty\\_policy\\_paper\\_060716.pdf](https://www.novoco.com/sites/default/files/atoms/files/ryan_better_way_poverty_policy_paper_060716.pdf) [https://perma.cc/Q9ZL-MV7F].

<sup>35</sup> *Tax Reform: Public Hearings Before the H. Comm. on Ways and Means*, 94th Cong. 34-35 (1975).

<sup>36</sup> *Id.* at 3857.

<sup>37</sup> U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 124 (1984). STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 131 (2014).

<sup>38</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 37, at 127-128 (discussing the difficulties with the DPD form of integration posed by tax treaties). *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity* 7 (May 29, 1985), available at <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Reform-Proposal-1985.pdf> [https://perma.cc/2PDP-LBSV]. For the final bill that was eventually adopted, see Tax Reform Act of 1986, H.R. 3838, 99th Cong. (1986) (not containing a 10% DPD).

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of economic efficiency and neutrality.<sup>39</sup> It is thus useful to first briefly discuss the relevant neutralities with respect to international tax policy. Capital export neutrality (CEN) refers to the indifference a resident taxpayer should have upon choosing between a domestic and foreign investment.<sup>40</sup> A global residence-based tax system, in which each country's firms are subject to its tax regardless of where their income is earned while foreign firms' income earned within its borders is not taxed, achieves CEN.<sup>41</sup> As such a system taxes a country's firms at the same rate irrespective of where their investments are located, taxes will not distort the choice between domestic and foreign investment.<sup>42</sup> If all countries adopt such a system, there would be no need for a foreign tax credit. By contrast, a worldwide tax system, which taxes a country's nationals on their worldwide income as well as foreign nationals on income earned in the country, may violate CEN. Under a worldwide tax system, foreign income of a country's nationals would be subject to tax in the home country as well as the foreign jurisdiction. This potential for double taxation would skew investors' choices towards investing domestically.<sup>43</sup> The common tool to mitigate the double taxation and achieve CEN with a worldwide taxation system is the FTC, which generally allows taxpayers to credit their foreign tax liability paid on foreign income against any additional U.S. tax liability on that same income. An unlimited FTC equivalates the tax liability on income earned inside and outside of the United States and thus promotes CEN among U.S. investors. The end result is that income, wherever earned, would ultimately be subject to U.S. tax rates.<sup>44</sup>

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<sup>39</sup> Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 324 (2005).

<sup>40</sup> Reuven S. Avi-Yonah & Nicola Sartori, *Foreword*, 65 TAX L. REV. 313, 317 (2012).

<sup>41</sup> Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?* 65 TAX L. REV. 323, 329 (2012).

<sup>42</sup> *Id.*

<sup>43</sup> *See Id.*

<sup>44</sup> Avi-Yonah & Sartori, *supra* note 40, at 317. Before the term CEN came to the world, the Foreign Tax Credit was thought to encourage the competitiveness of American firms abroad and to avoid "double taxation." *See Surrey, supra* note 17, at 817–18. According to Surrey:

The earliest differentiation between foreign and domestic income was the adoption of the foreign tax credit device. Its origins are somewhat obscure. Until 1918 all foreign taxes were treated as deductible expenses, in the same manner as state and local taxes. All these taxes were simply regarded as expenses of operating the business enterprise and therefore to be deducted in determining the net business income on which our federal income tax is based. In 1918 efforts were made to exempt foreign income from the United States tax. The principal grounds advanced for this relief were the alleged competitive disadvantages suffered by American corporations operating branches abroad because the United States taxes were much higher than the taxes to which competing local enterprises in foreign countries were subject. There was also talk of "double taxation," and here the target as respects the "doubling" was the United States tax...Congress thereby reaffirmed its historical decision to tax the United States citizen and corporation on worldwide income. The argument that this approach placed our corporations at a disadvantage in foreign markets because of the United States tax was rejected, but the argument based on the burden of double taxation was persuasive. The United States would retain its jurisdiction to tax on world-wide income, but it would recognize the interests of the country of source in also taxing the income arising therein. This recognition of source jurisdiction would extend as far as giving primary effect to the source jurisdiction to prevent the heavy burden that would otherwise fall on the United States taxpayer having fiscal responsibilities to two national jurisdictions. To provide this protection for



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On the other hand, capital import neutrality (CIN) requires that all investments in a given country are treated the same for tax purposes, regardless of the residence of the taxpayer.<sup>45</sup> Because the United States taxes worldwide income of its nationals, U.S. firms investing in a given foreign country face double taxation (the U.S. and the foreign jurisdiction) while the foreign country's nationals are only taxed once on income earned in the foreign country.<sup>46</sup> To prevent this additional liability that impairs the CIN principle, the United States can exempt foreign income of U.S. MNEs.<sup>47</sup> Exempting (and not just crediting) foreign income, is necessary because it will result in only one layer of taxation on foreign earnings—the foreign tax layer—similarly to the way foreign competitors are taxed.

CEN and CIN usually cannot be achieved at the same time. This is because CEN, to the extent that the U.S. tax rate is higher than the foreign tax rate, would require a credit method, so that the foreign source income would be subject in total to the U.S. tax rate, while in the same scenario, CIN would require an exemption method, so that the foreign source income would be subject solely to the foreign tax rate, which would be the final tax liability. Those neutralities can be simultaneously satisfied only if the tax rates of the United States and the source state are the same, which is not usually the case.<sup>48</sup>

C. The 70s

The late 1970s saw further proposals for integration. In 1977, the Treasury issued a report proposing full integration by a pass-through taxation method.<sup>49</sup> Later that year, the Treasury presented a proposal for integration by imputation.<sup>50</sup> Under imputation, corporations would still pay corporate tax, but shareholders would receive a credit for that tax paid upon the distribution of dividends and the imposition of the dividend tax.<sup>51</sup> In that sense, the corporate tax would function like WHT, on behalf of the shareholders, similar to the tax withheld by an employer on behalf of its employees, and the income itself would be *imputed* to shareholders. When a distribution is made, the shareholders would be taxed at their marginal rate, but they would also be entitled to a credit in the amount of taxes paid by the corporation. It should be noted, of course, that shareholders would include in their taxable income the grossed-up amount of the dividend to reflect the amount of tax withheld. It is also important to note that the recommendation was to

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the United States taxpayer, our Government would consider its own tax claims met to the extent that a tax payment had been made to the country of source.

Gravelle, *supra* note 41, at 332 (a limited FTC, which caps a firm's FTC to the amount of tax paid to the home country either per foreign jurisdiction or in total, does not achieve CEN).

<sup>45</sup> AM. LAW INST., INTEGRATION OF INDIVIDUAL AND CORPORATE INCOME TAXES 172 (1993).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> See David A. Weisbach, *The Use of Neutralities in International Tax Policy* 4 (Coase-Sandor Inst. for L. & Econ., Working Paper No. 697, 2014).

<sup>49</sup> U.S. DEP'T OF THE TREASURY, *supra* note 14, at 68–75.

<sup>50</sup> See *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the H. Comm. on Ways and Means*, 95th Cong. 6250–54 (1978) (statement of Donald C. Lubick, Acting Assistant Sec'y for Tax Policy, Treasury Dep't).

<sup>51</sup> Michael J. Graetz & Alvin C. Warren, Jr., *Unlocking Business Tax Reform*, 145 TAX NOTES 707, 708 (2014).

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adopt a *refundable* credit in order to allow low bracket taxpayers to take advantage of the benefits of tax integration.<sup>52</sup> Ultimately, however, the proposal was never adopted.

The Joint Committee on Taxation also issued a report in 1977 calling for the integration of corporate and individual income taxes as part of the main goal of enhancing and injecting private capital into the financial markets.<sup>53</sup> Three methods of integration were suggested: imputation, pass-through taxation, and DPD.<sup>54</sup> Then, in 1978, the chairman of the House Ways and Means Committee introduced a new integration proposal, calling for a shareholder tax credit equal to a graduated percentage (from 10% up to 20%) of the dividend distribution, up to a certain limitation.<sup>55</sup> None of the proposals were ever adopted.<sup>56</sup>

#### D. The 80s and 90s

In 1982, the American Law Institute (ALI) called for corporate integration in the form of DPD with a statutory limit.<sup>57</sup> In addition, the report called for a flat-rate WHT on non-dividend distributions.<sup>58</sup> In 1989, the ALI issued a supplemental study recommending that the DPD would only be available for equity acquired after the date of enactment. The main reason for this limitation was the assumption that the markets had already discounted the price of pre-enactment equity to reflect the double taxation on corporate earnings, and any deduction for that pre-enactment equity would result in an unjustified windfall to shareholders.<sup>59</sup> In 1993, the ALI issued another important report calling for tax integration, which was authored by Harvard Professor Alvin C. Warren Jr.<sup>60</sup> and based on a 1992 Treasury report. Both these reports will be discussed below.

##### 1. *The 1992 Treasury Report*

In 1992, the Treasury recommended adopting corporate integration in one of four prototypes: (1) a dividend exclusion prototype; (2) a shareholder allocation prototype (pass-through), which is a form of full integration; (3) a comprehensive business income tax prototype (CBIT), in which a tax would be imposed on taxable income, with no deductions for interest or dividends (while the respective holders of bonds or shares would not include interest or dividends in gross income); and, finally, (4) an imputation credit prototype.<sup>61</sup> Another method that was briefly discussed was

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<sup>52</sup> See *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the H. Comm. on Ways and Means*, 95th Cong. 6252 (1978).

<sup>53</sup> See STAFF OF JOINT COMM. ON TAXATION, JCS-14-77, TAX POLICY AND CAPITAL FORMATION 9 (Comm. Print 1977).

<sup>54</sup> *Id.* at 11-15.

<sup>55</sup> STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 129 (2014).

<sup>56</sup> See *id.*

<sup>57</sup> AM. LAW INST., FEDERAL INCOME TAX PROJECT—SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982).

<sup>58</sup> *Id.* at 442.

<sup>59</sup> AM. LAW INST., FEDERAL INCOME TAX PROJECT—SUBCHAPTER C (SUPPLEMENTAL STUDY) [i], REPORTER'S STUDY DRAFT 51 (1989).

<sup>60</sup> See AM. LAW INST., *supra* note 46.

<sup>61</sup> U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEM: TAXING BUSINESS INCOME ONCE viii (1992).

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DPD.<sup>62</sup> To address the problem of retained earnings, a dividend-reinvestment plan was proposed—this proposal will be discussed separately in Part III.

Under CBIT, a uniform tax would be levied at the business level. Corporations would *not* be able to deduct interest (similar to the current treatment of dividends).<sup>63</sup> On the other hand, individual shareholders *would not include interest or dividends in their gross income*.<sup>64</sup> CBIT would eliminate tax distortions on capital structure and related arbitrage opportunities more completely than any of the other methods of partial integration.<sup>65</sup> In that sense, CBIT offered a comprehensive solution for the bias toward debt investment.<sup>66</sup> CBIT would be applicable to almost all businesses, not just corporations.<sup>67</sup> To a certain extent, the CBIT proposal resembled a consumption tax, similar to the flat tax of Hall and Rabushka.<sup>68</sup> The main difference would be that business investment would continue to be depreciated rather than expensed.<sup>69</sup>

Nevertheless, in December of 1992, the Treasury recommended in a supplemental report that Congress adopt a revised dividend-*exclusion* prototype.<sup>70</sup> The main reasons for favoring this dividend-exclusion prototype were fewer transition and administrative costs and less disruption to financial markets.<sup>71</sup> Under the revised version, any distribution out of the corporation's adjusted income after tax (ATI) would be treated as a dividend and excludable from gross income when received by shareholders.<sup>72</sup> Distributions in excess of ATI would be treated as a return of capital to the shareholders (or capital gain to the extent the distribution is in excess of basis).<sup>73</sup> Because distributions in excess of ATI would be treated as a return of capital, no distribution would ever be treated as a taxable dividend. As a result, "Earnings and Profits (E&Ps) accounts would no longer be relevant for determining the character of distributions from U.S. corporations" and "a [DRD] would no longer be necessary."<sup>74</sup> This proposal was also never adopted.

*2. The 1993 ALI Report*

In its 1993 report, the ALI recommended applying an imputation form of integration. The report discussed the international problem of tax integration and suggested imposing a special

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<sup>62</sup> *Id.* at 108.

<sup>63</sup> *Id.* at 121.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 52-53 (arguing that the CBIT, by taking measures such as disallowing a deduction for interest and expanding §265 to apply to taxpayers who receive CBIT interest and dividends, would reduce incentives for thin capitalization and rate arbitrage on the part of corporations).

<sup>66</sup> Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction*, 65 *TAX LAW* 3, 5 (2011).

<sup>67</sup> STAFF OF S. COMM. ON FINANCE, *COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND*, 113<sup>TH</sup> CONG., 129 (2014).

<sup>68</sup> JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAX REFORM* 272 (4th ed. 2008).

<sup>69</sup> *Id.*

<sup>70</sup> U.S. DEP'T OF THE TREASURY, *A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS* (1992).

<sup>71</sup> *Id.* at 1.

<sup>72</sup> *Id.* at 2.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

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compensatory tax<sup>75</sup> or a high-rate WHT on foreign investment.<sup>76</sup> The report justified such an additional tax on the basis that the United States, as a source state in this case, had the legitimate ties to impose tax on such inbound investments.<sup>77</sup> According to the report, this additional tax would preserve CIN and would not violate any nondiscriminatory provisions because “the U.S. would enforce an equivalent claim against domestic investment through a U.S. company owned by U.S. shareholders, by means of an income tax on those shareholders, for which the corporate tax was a withholding device.”<sup>78</sup> Yet such an additional tax might be in a direct conflict with the current tax treaty network, which provides for substantially reduced reciprocity WHT rates imposed on dividends distributions sourced within the United States.<sup>79</sup> In any case, the recommendations were presented to the Senate Finance Committee in 2012<sup>80</sup> after another proposal for imputation was raised in 2010,<sup>81</sup> but neither was ultimately adopted.

E. The New Millennium

A proposal for dividend exclusion was raised again in 2003 by the Bush administration.<sup>82</sup> Under that proposal, shareholders would not be taxed on dividend income. A dividend exemption is an easy, straightforward way to implement integration.<sup>83</sup> Under President Bush’s proposal, a

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<sup>75</sup> See AM. LAW INST., *supra* note 45, at 176.

<sup>76</sup> *Id.* at 176.

<sup>77</sup> *Id.* at 174 - 176.

<sup>78</sup> *Id.* at 174. See also U.S. DEP’T OF THE TREASURY, *supra* note 61, at 218. The report explained:

The following example illustrates the problem in the context of an imputation credit system that refunds imputation credits to foreign shareholders. The issues would be the same in a dividend exclusion system that refunded corporate tax to foreign shareholders. Assume, for example, that two domestic corporations each earn an annual pre-tax profit of \$100. Corporation A has one shareholder, a U.S. resident individual. Corporation B also has one shareholder, a nonresident alien individual who resides in a country that has a tax treaty with the United States. The tax treaty limits the U.S. dividend withholding rate to 15 percent for portfolio investors (including the shareholder of corporation B) and contains a standard prohibition against discrimination based on capital ownership. Assume also a 34 percent corporate tax rate, a 31 percent individual tax rate and that corporate taxes are credited to shareholders at the 31 percent individual rate. If neither corporation distributes earnings, each pays a tax of \$34 on its \$100 profit. No discrimination exists between the two corporations, and the withholding rules are not implicated. If, instead, each corporation distributes one-half of profits, the domestic shareholder receives a cash distribution of \$33, an imputation credit of \$14.83, and a grossed-up dividend, i.e., including credit of \$47.83. The domestic shareholder will have a tax liability with respect to the gross distribution of \$14.83, which will be exactly offset by the imputation credit. Thus, for corporation A both distributed and retained earnings are taxed at a 34 percent rate. There is a significantly different result for corporation B. The foreign shareholder receives a cash dividend of \$33. If he also receives an imputation credit of \$14.83, his gross dividend will be \$47.83. The withholding tax on this distribution will be \$7.17, entitling him to a refund of \$7.66. In this case, undistributed profits are taxed at 34 percent, but distributed profits are taxed at 18.7 percent (\$50 of pre-tax income that bears \$17-\$7.66 of tax).

<sup>79</sup> See Part IV, *infra*.

<sup>80</sup> *Tax Reform: Examining the Taxation of Business Entities: Hearing Before the S. Comm. on Finance*, 112th Cong. (2012).

<sup>81</sup> PRESIDENT’S ECON. RECOVERY ADVISORY BD., *THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION* 76 (2010).

<sup>82</sup> STAFF OF JOINT COMM. ON TAXATION, JCS-7-03, *DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2004 BUDGET PROPOSAL* 18 (2003).

<sup>83</sup> See U.S. DEP’T OF THE TREASURY, *supra* note 61, at 15.

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special account, the excludable dividend account (EDA), would represent the corporate E&Ps that were *fully taxed* at the corporate level. Only dividends distributed out of the EDA would be excluded from the shareholder's gross income. A dividend exemption might have a significant negative effect on U.S. tax revenue, while a reduced dividend rate, instead of an exemption, might mitigate such a problem. Therefore, the original Bush proposal for dividend exemption was eventually rejected in favor of the current partial integration system, under which dividends are taxed at reduced rates (up to 15% at the time it was enacted, and now 20%).<sup>84</sup> This favorable treatment was set to expire at the end of 2008 and was extended for four additional years, until it became permanent.<sup>85</sup> Despite this, the President's Advisory Panel on Tax Reform issued a report in 2005 recommending, once again, two other forms of integration. The first was the dividend exclusion, combined with a proposal to also exclude 75% of capital gain from the sale of corporate stock (limited to the EDA, which was already taxed at the corporate level).<sup>86</sup> The second was the application of a uniform tax on a business's cash flow (excluding deductions for interest or dividends), combined with a flat rate tax on dividends, interest, and capital gains at the shareholder level.<sup>87</sup>

In 2011, the Senate Finance Committee held a comprehensive debate on corporate tax integration. In support of integration, Professor Auerbach argued in his testimony that the current rules, including the tax deductibility of interest, encourage corporate borrowing and skew corporate investment toward riskier, debt financed projects.<sup>88</sup> Though Professor Graetz agreed that the current tax system encouraged corporate borrowing, he argued that corporate income was not always subject to double taxation, because in some instances, income was excluded from taxation at the corporate level (e.g., deductible interest payments to taxable lenders) and sometimes it was excluded at the shareholder level (e.g., dividends to tax-exempt shareholders).<sup>89</sup> Graetz suggested flipping the current rates of the time so that the corporate rate would be significantly lower than the rate at the shareholder level.<sup>90</sup> In addition, he suggested offering tax credits to shareholders and bondholders for a portion of the taxable income of the corporation (similar to the idea of EDA).<sup>91</sup>

*1. Hatch's Tax Proposal and the 2017 Tax Reform*

In 2014, the Senate Finance Committee introduced a new comprehensive report calling for a reform and tax integration in the U.S.<sup>92</sup> The document called for integration by dividend exemption or by DPD, in combination with changing the international tax regime to territoriality.<sup>93</sup> In 2016,

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<sup>84</sup> STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 134 (2014).

<sup>85</sup> See TAX REFORM TASK FORCE, *supra* note 34, at 18 ("The current tax code only partially mitigates ... double taxation [of savings and investment income] by providing a special rate structure for certain types of investment income... [Qualified dividends are subject to] a top statutory tax rate of 20 percent.")

<sup>86</sup> PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM xvii (2005).

<sup>87</sup> *Id.* at 55.

<sup>88</sup> *Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth?: Hearing Before the S. Committee on Finance*, 112th Cong. 46 (2011) (statement of Professor Alan J. Auerbach).

<sup>89</sup> *Id.* at 75 (statement of Professor Michael J. Graetz).

<sup>90</sup> *Id.* at 86 (statement of Professor Michael J. Graetz).

<sup>91</sup> *Id.* at 12.

<sup>92</sup> STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 134 (2014).

<sup>93</sup> *Id.*

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relying on that report, Senator Hatch declared that his team was working on proposal for shareholder-credit integration in the form of DPD, combined with a 35% (the corporate tax rate at the time) WHT.<sup>94</sup> Under the proposal, corporations would be able to deduct dividend distributions from their income, but a special WHT would be imposed on those distributions. Shareholders would include the distributions in their taxable income.<sup>95</sup> It was not clear at the time whether the credit would be refundable, yet some sources indicated that it would not.<sup>96</sup> The main implication of non-refundability is that domestic shareholders would be able to use the credit only up to their tax liability while tax-exempt and foreign shareholders would not be able to monetize or otherwise use the credit in any way. Thus, this proposal would negatively affect low bracket and tax-exempt taxpayers.<sup>97</sup> A non-refundability feature would have reduced the potential negative effects on the U.S. tax revenue. To achieve parity between debt and equity, it was also suggested that interest payments to tax-exempt taxpayers would be subject to the same nonrefundable WHT.<sup>98</sup> Business entities other than C corporations would seemingly not be affected by the proposal.<sup>99</sup>

Surprisingly, the original Senate version of the 2017 Tax Reform appeared to include a DPD mechanism of 0% (which effectively means no DPD).<sup>100</sup> Nonetheless, had the proposal been approved, Congress could have easily amended the section later on by simply increasing the percentage of the DPD without raising any unwanted public attention. Under the legislative language, an *eligible corporation* would be allowed as a deduction an amount equal to zero percent of the aggregate amount of *applicable dividends* paid by the corporation during the taxable year.<sup>101</sup> To be sure, any exempt income would not give rise to an additional deduction; under the proposal

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<sup>94</sup> Kyle Pomerleau, *Senator Hatch to Introduce Corporate Integration Plan*, TAX FOUND. (Jan. 20, 2016), available at <http://taxfoundation.org/blog/senator-hatch-introduce-corporate-integration-plan> [<https://perma.cc/8PAJ-8XUK>].

<sup>95</sup> *Id.*

<sup>96</sup> Andrew Velarde, *Hatch Integration Plan May Have 35 Percent Interest Withholding*, TAX NOTES (Apr. 13, 2016), available at <http://www.taxnotes.com/tax-notes-today/tax-reform/hatch-integration-plan-may-have-35-percent-interest-withholding/2016/04/13/18455691> [<https://perma.cc/9VMM-J9ES>] (referring to the statement of one of the committee aides); see also Stephen K. Cooper & Dylan F. Moroses, *Corporate Integration Plan Drafting 'May Be Done,' Hatch Says*, TAX NOTES (Sept. 9, 2016), available at <http://www.taxnotes.com/editors-pick/corporate-integration-plan-drafting-may-be-done-hatch-says> [<https://perma.cc/GSF3-ZNC6>].

<sup>97</sup> See e.g., AM. LAW INST., *supra* note 46, at 163 (explaining that the credit would be refundable).

<sup>98</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 61, at 105.

<sup>99</sup> See Pomerleau, *supra* note 94. See also Reuven Avi-Yonah, *A Bipartisan Tax Reform*, 151 TAX NOTES 505 (2016) (providing an updated debate about the 2016 presidential campaign tax proposal).

<sup>100</sup> H.R. 1, *supra* note 3.

<sup>101</sup> *Id.* 'Eligible corporation' means any domestic corporation other than a regulated investment company, a real estate investment trust, an S corporation, a corporation which is exempt from tax under section 501 or 521, an organization taxable under subchapter T (relating to cooperative organizations, or a Domestic International Sales Corporations (DISC) or former DISC. 'Applicable dividend' means, with respect to an eligible corporation, any distribution by the eligible corporation during a taxable year which is treated as a dividend and paid out of its 'applicable earnings and profits'. 'Applicable earnings and profits' means, with respect to any corporation for any taxable year, its earnings and profits for the taxable year and its earnings and profits accumulated in prior taxable years beginning after December 31, 2018. The applicable earnings and profits of a corporation shall not include any exempt earnings and profits. 'Exempt earnings and profits' means with respect to any corporation for any taxable year, its earnings and profits for the taxable year and its earnings and profits accumulated in prior taxable years beginning after December 31, 2018, which are properly allocable to exempt amounts received or accrued by the corporation. 'Exempt amounts' means, with respect to any corporation, among others, any dividend that was previously exempt of taxation.

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and as a general rule, dividends would be treated as paid first, out of “exempt earnings and profits” and only second, out of the “applicable earnings and profits,” similarly to an EAD account.<sup>102</sup>

Although the proposal to adopt DPD (even at 0%) was eventually removed from the final bill, the section illustrates a possible mechanism to address one of the most prominent problems of any form of tax integration—the unwanted extension of the benefits of tax integration to exempt earnings, and particularly to foreign earnings. The main concern is clear: if a corporation is allowed to deduct a distribution out of foreign earnings that were not previously taxed by the United States, U.S. tax revenue would be significantly impacted as a result of such “double non-taxation.” The solution offered here, which follows the lines of the EDA mechanism introduced in 2003 by the Bush administration, was to extend the benefit of tax integration only to distributions that are *not* out of exempt E&Ps (E&Ps that were *not* previously taxed in the United States). The assumption here is that as long as the exempt E&Ps are more than zero, any distribution will be out of that account, and thus not entitled to the benefit of tax integration.

### III. THE BENEFITS OF TAX INTEGRATION AND ITS MAIN PROBLEMS

As discussed in Part I, in the early days of the U.S. corporate tax regime, Congress made a conscious decision to treat corporations as separate taxable entities, resulting in a mechanism of double taxation: Corporations are first taxed on their taxable income. Then, once a corporation distributes a dividend out of its E&Ps, an additional tax is imposed, this time at the shareholder level. This is achieved by including the distribution in the shareholder’s taxable income. At some point in history, when the maximum marginal individual tax rate reached 70% and the top corporate tax rate was 46%, this double taxation resulted in a total tax liability of more than 84%.<sup>103</sup> Many economists have argued that such a regime results in an inefficient penalty on business activities carried through corporations,<sup>104</sup> creating a distortion of investment allocation between the business sector and the non-business sector as well as between C corporations and other forms of business entities.<sup>105</sup> In the past, the structure of business activity was relatively simple, with C corporations earning the vast majority of business income. Yet, as discussed previously, this is no longer the case. Empirical research suggest that C corporations now account for less than half of

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<sup>102</sup> *Id.*

<sup>103</sup> STEPHEN SCHWARZ & DANIEL J. LATHROPE, *FUNDAMENTALS OF CORPORATE TAXATION: CASES AND MATERIALS* 8 (8th ed. 2012).

<sup>104</sup> See SLEMROD & BAKIJA, *supra* note 68, at 270

<sup>105</sup> Though some argue that at times where the corporate tax rate is lower than the marginal individual tax rate, investors might prefer to conduct their business through C corporation rather than pass-through entities, like partnerships. This is because, investors were able to use the profits while still in corporate solution, so those profits would be subject only to one level of taxation – corporate tax, at the corporate level. The profits could remain in the corporate solution until the business was sold or liquidated. In the meantime, shareholders found creative ways to use the income for their own benefit, while still in corporate solution. Alternatively, shareholders who were also employees of the corporation were able to use the profits of the corporation in the form of salary and fringe benefits. The salary was deductible to the corporation, resulting only in one level of taxation – at the employee level and at marginal individual tax rate. On the other hand, many of the fringe benefits were excluded from the income of the employee. Shareholders could also loan funds or lease a property to the corporation and withdraw earnings in the forms of tax-deductible interest or rent. *See id.* at 8.

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business income,<sup>106</sup> with “pass-through” businesses (such as S corporations and partnerships) growing rapidly.<sup>107</sup>

Additionally, the preference towards debt encouraged by the current double taxation regime should not be dismissed.<sup>108</sup> The 2008 financial crisis clearly illustrated the potential destructive consequences of corporations being over leveraged. Further, to the extent one would like to avoid a second layer of taxation, double taxation still incentivizes corporations to accumulate income rather than distributing it as dividend, as doing so will effectively defer any shareholder level taxation indefinitely<sup>109</sup> (although some mechanisms, like the accumulated earning tax, are meant to prevent exactly that).<sup>110</sup> Therefore, eliminating the double-taxation mechanism by adopting tax integration will arguably remove these distortions and consequently increase the rate of return for corporate investment, increase the capital available for corporations, and therefore increase economic growth.<sup>111</sup>

As discussed previously, Senator Hatch and the 2014 Republican report proposed to allow a deduction for corporate distributions. To address several tax policy issues and to insure fiscal needs, a WHT, at a rate similar to the corporate tax rate, should be imposed on any distributions out of corporate earnings if DPD were to be implemented. This WHT will also facilitate taxation of income distributed to tax-exempt and foreign shareholders. In essence, a DPD combined with a WHT has the same economic effect as an imputation form of integration.<sup>112</sup> This is because under both forms, shareholders are entitled to a credit for the taxes remitted by the corporation. Nonetheless, the characterization of WHT is different from the characterization of an income tax. By allowing a deduction and imposing WHT, the tax liability is “shifted” from the corporation to its shareholders, because the corporation is acting as a mere conduit and the tax is ultimately owned by the shareholders themselves.<sup>113</sup> Although the corporation will still collect the WHT, this change

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<sup>106</sup> Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 TAX POL’Y & ECON. 91-92, fig. 1 (2016).

<sup>107</sup> See MATTHEW SMITH ET AL., CAPITALISTS IN THE 21ST CENTURY 9 (2017).

<sup>108</sup> The current system encourages corporations to issue debt because interest paid on debt instruments is currently deductible while dividends paid are not. See SLEMRD & BAKIJA, *supra* note 68, at 270 (noting that the current double taxation regime can “put an inefficient penalty on business activity carried out in corporate form, and it distorts corporate financial structure toward debt finance. It also may make investment in corporate stock particularly unattractive relative to nonbusiness investments such as owner-occupied housing, causing too much high-priced housing to be built at the expense of more socially productive corporate investments”).

<sup>109</sup> STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT xii (2010).

<sup>110</sup> I.R.C. § 531 (2012).

<sup>111</sup> It should be noted that the arguments mentioned above are mainly relevant to publicly traded corporations that do not have the choice to incorporate as pass-through entities (like S corporations). By forming a pass-through entity, an investor could avoid double taxation. Recent data shows that investors do indeed choose to avoid double taxation by forming their businesses as pass-through entities. For more information, see *SOI Tax Stat – Integrated Business Data*, IRS (Apr. 15, 2015), available at <https://www.irs.gov/uac/soi-tax-stats-integrated-business-data> [<https://perma.cc/92L9-Q98E>].

<sup>112</sup> Edward D. Kleinbard, *The Trojan Horse of Corporate Integration*, 152 TAX NOTES 957, 960 (2016).

<sup>113</sup> *Id.* See also Senator Orrin Hatch, Keynote Speech at Bloomberg BNA Tax Policy Event, *The Politics of Tax: Making Sense of Uncertainty* (Feb. 24, 2016) available at <https://www.finance.senate.gov/chairmans-news/hatch-offers-keynote-address-at-bloomberg-bna-tax-policy-event> [<https://perma.cc/X8DU-9GVT>].



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of characterization (from income tax to WHT) presumably allows corporations to reduce their tax liability for accounting purposes, resulting in a lower effective tax rate and higher earnings per share. The main problem with this approach is that such a change is an artificial one and will affect only the financial statements of corporations.<sup>114</sup> This issue will be discussed further below.

A. The Main Problems of Tax Integration

Since DPD with WHT and imputation are economically equivalent, both forms bear similar design issues. As will be discussed below, on the domestically side, these issues include the treatment of (1) corporate income that has not been previously taxed by the United States; (2) retained, undistributed, earnings; and (3) distributions to tax-exempt shareholders.<sup>115</sup> All of the above have been substantially addressed in prior work related to tax integration (either in the form of DPD or imputation). In addition to the above, elimination of the double taxation regime might diminish the tax code's ability to regulate or incentivize corporate behavior. These issues related to the current U.S. international tax regime will be discussed in the next part.

1. *Corporate Income Not Previously Taxed by the United States*

The first problem—extending integration benefits to income that was not previously taxed by the United States—is sometimes referred to as “super-integration.”<sup>116</sup> To illustrate, assume a corporation investing in tax-free municipal bonds and then distributing the earnings from the bonds to shareholders in the form of a dividend, without previously bearing corporate tax on those earnings. Under the DPD (with no WHT) form of integration, such income might escape U.S. tax completely. If a deduction is granted, not only will the distribution not bear any corporate tax (because the interest from these bonds is tax-free), but it will also reduce the total corporate tax liability because of the deduction. The result will be a negative tax liability, or a tax shield at the corporate level. The distribution, on the other hand, will be taxed at the shareholder level. Taken together, the revenue will be minimal (or negative) as the saving from the tax shield will offset the tax collected from the shareholder. The general question with respect to this problem is whether tax preference should be passed through the corporation to its shareholders. In other words, the question is whether the shareholders should enjoy the tax benefit of investment in a municipal bond through a corporation.<sup>117</sup>

If the answer is in the affirmative, then we should accept the result of minimal taxation when earnings from tax-free bonds “escape” taxation. One solution to this problem might be to limit the DPD to corporate taxable income, using an EDA, as discussed in Part I. Another possible solution would be to impose a compensatory tax on distributions out of earnings that were not previously taxed.<sup>118</sup> A WHT, applied to all distributions, could function as a compensatory tax, and would help to eliminate any pass-through of corporate preferences. In a study of eight industrialized countries that have adopted integration in the past, most did not allow corporate preferences to

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<sup>114</sup> See Kleinbard, *supra* note 112, at 958; see also SCHWARZ & LATHROPE, *supra* note 103, at 11.

<sup>115</sup> See SCHWARZ & LATHROPE, *supra* note 103, at 17.

<sup>116</sup> See AM. LAW INST., *supra* note 45, at 63.

<sup>117</sup> *Id.* at 61.

<sup>118</sup> AM. LAW INST., *supra* note 45, at 18.

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pass-through to its shareholders.<sup>119</sup> One potential justification for this is that the function of integration is to eliminate the existing tax on distributed corporate earnings, and not to tax shareholders as though they had interests in a pass-through entity.<sup>120</sup>

Another interesting question relates to corporate equity that already benefited from tax preference under the current double taxation regime. Presumably, tax integration will result in a windfall gain to current corporate equity, which was invested under the assumption of double taxation.<sup>121</sup> In theory, there seems to be no compelling tax argument that can justify granting the benefit of tax integration to such equity. Nevertheless, ad-hoc transition rules, such as designated E&P accounts, can help facilitate a mechanism that will distinguish old from new equity, as it was already invested in the market under the assumption of double taxation.

### 2. *Retained Earnings*

The second problem relates to retained earnings. Under a DPD form of integration, the elimination of double taxation is achieved only if the earnings are distributed rather than retained under corporate solution. Moreover, gain from a sale of stock, part of which is the result of retained corporate earnings, will be taxed as capital gain. As corporations will want to avoid capital gains on the retained earnings component of the gain, they will be incentivized to distribute earnings to shareholders rather than using them for the benefit of the corporation.<sup>122</sup> One solution to this problem is the use of constructive-dividend and reinvestment plans. Those plans will allow corporations to extend the benefits of integration to retained earnings by treating those earnings as if they were distributed and reinvested in the corporation. This, in turn, will increase the shareholders' basis in the corporation, reflecting the amount of the deemed dividend and ensuring that the shareholders would not be taxed on appreciation due to retained, fully taxed earnings, when the stock is later sold.<sup>123</sup> Another solution would be to convert the capital gain from the sale of a stock to dividend income (to the extent of available E&Ps), which is eligible for the DPD.<sup>124</sup>

### 3. *Tax-Exempt Shareholders*

The third problem of integration relates to tax-exempt shareholders. Under a DPD form of integration, the tax is imposed at the shareholder level (assuming earnings are distributed). How should tax-exempt shareholders, such as charitable organizations and pension funds, be taxed? If their tax-exempt status is respected, earnings might avoid any U.S. tax.<sup>125</sup> Again, one of the possible solutions to this problem is to impose WHT or a new compensatory tax on distributions

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<sup>119</sup> Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 *TAXLAW* 196, 213 (1990).

<sup>120</sup> Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 *HARV. L. REV.* 719, 777-78 (1981).

<sup>121</sup> *AM. LAW INST.*, *supra* note 45, at 10.

<sup>122</sup> Warren, *supra* note 120, at 750.

<sup>123</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 61, at 87.

<sup>124</sup> A similar mechanism applies to certain sales by a United States person of shares in a foreign corporation. I.R.C. § 1248(a)(2).

<sup>125</sup> *AM. LAW INST.*, *INTEGRATION OF INDIVIDUAL AND CORPORATE INCOME TAXES* 67 (1992).

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to tax-exempt shareholders and to disallow the tax withheld as credit unless the distribution is taxed at the tax-exempt shareholder level (meaning non-refundable credit).<sup>126</sup>

If a DPD form of integration is adopted, a similar nonrefundable WHT or new compensatory tax should also be imposed on interest payments to tax-exempt shareholders. Such an additional tax on interest would achieve parity between debt and equity because the corporation would deduct both interest and dividend payments and would impose the same tax on the distributions. Since tax-exempt shareholders would exclude both dividend and interest payments from their taxable income, it is important to ensure the imposition of WHT on both payments.<sup>127</sup> Such change would negatively impact the total tax liability of tax-exempt shareholders as compared to the liability under current law. Today, interest payments to tax-exempt shareholders are generally deductible at the corporate level and exempt at the tax-exempt shareholder level. The new WHT on interest payments can increase revenue and support a revenue neutral reform.

*4. Regulating Corporate Behavior*

Although raising revenue and redistributing wealth are among the most well-known goals of any tax system, some argue that there is one additional goal to the corporate tax regime—a regulatory goal:

[T]axation has a third goal, which has not been noticed as widely: a regulatory goal. In most developed countries governments use the tax system to change the behavior of actors in the private sector, by incentivizing (subsidizing) activities they wish to promote and by disincentivizing (penalizing) activities they wish to discourage.<sup>128</sup>

As discussed previously, and assuming any system of tax integration would not allow corporate tax preferences to pass-through to its shareholders, tax integration would hinder the ability of the tax code to regulate corporate behavior. Yet there are several problems with justifying the corporate tax on the basis of its ability to regulate corporate behavior. First, history shows that in at least some areas, regulating corporate behavior through the tax code can be ineffective, temporary and perhaps even undesirable.<sup>129</sup> This is especially true when Congress has to face fierce resistance from corporations to any measures that will affect their after-tax earnings.<sup>130</sup> Second, it is not clear who actually bears the burden of the corporate tax (tax incidence). Finally, there are other legal tools to regulate corporate behavior, such as security and antitrust regulations or general criminal and administrative legislation.<sup>131</sup>

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<sup>126</sup> See SCHWARZ & LATHROPE, *supra* note 103, at 21.

<sup>127</sup> AM. LAW INST., *supra* note 125, at 69.

<sup>128</sup> Reuven Avi-Yonah, *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes* 2–3 (U. Mich. Pub. L. Research Paper No. 281, 2010).

<sup>129</sup> See, e.g., Kurt Hartmann, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159 (1993).

<sup>130</sup> See Bank, *supra* note 19, at 3–4.

<sup>131</sup> Hartmann, *supra* note 129, at 198.

*COLUMBIA JOURNAL OF TAXLAW***B. The Problems of DPD with WHT and Territoriality**

Aside from the previously discussed problems of any proposal of tax integration in general, the DPD form of integration has its own unique problems. One of these problems results from the combination of DPD with WHT. The other problem results from the combination of DPD with a territorial system.<sup>132</sup> Both of the problems and their solutions will be discussed in this order below.

*1. The “Trojan Horse” Problem of DPD and WHT*

DPD combined with WHT might artificially reduce the tax liability of U.S. MNEs for financial accounting purposes.<sup>133</sup> This is because the corporate tax liability would be “shifted” to its shareholders and the corporation would function as a conduit, collecting the tax on behalf of the shareholders. Some refer to this as the “Trojan horse” problem, because presumably the main purpose of the proposals to implement a DPD form of integration might actually be to allow MNEs to show better financial results rather than to alleviate the double taxation problem.<sup>134</sup> It is indeed possible that DPD combined with WHT would reduce, *at least temporarily*, the effective tax rate of U.S. corporations in their financial reports, without having any substantial economic change in the way those corporations and the earnings are taxed.<sup>135</sup> This effect may be temporary because it is not clear how the Financial Accounting Standards Board (FASB) would treat the WHT in such a case, and whether it will require U.S. MNEs to consider the WHT as part of their own corporate tax liability, and not as part of the shareholder’s tax liability, which would result in higher effective corporate tax rates.<sup>136</sup>

Under the current FASB guidelines, the WHT paid by a corporation to its shareholders should be considered as part of the corporation’s own tax liability, rather than its shareholders’. According to FASB, WHT will *not* be a part of the tax liability of an entity paying a dividend only if *both* of the following conditions are met: (1) the tax is payable by the entity if and only if a dividend is distributed to shareholders—the tax does not reduce future income taxes the entity would otherwise pay; and (2) shareholders receiving the dividend are entitled to claim the withholding as tax paid by the entity, on their behalf, either as a refund or as a reduction of taxes otherwise due, *regardless of the tax status of the shareholders*.<sup>137</sup> As discussed previously, one of the proposals to deal with the possible problem of tax-exempt taxpayers under a regime of integration is to disallow them the credit for tax withheld by the distributing corporation (unless the distribution will be taxed at the tax-exempt shareholder level).<sup>138</sup> Should such a rule be indeed adopted, the second condition, which requires the refundability of tax withheld *regardless* of the tax status of the shareholder receiving the dividend, would not be met. In addition, the first condition is not

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<sup>132</sup> Martin A. Sullivan, *Economic Analysis: Corporate Integration Would Tilt Investment to the U.S.*, 150 TAX NOTES 739, 739 (2016).

<sup>133</sup> See Kleinbard, *supra* note 112, at 958.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> See S. COMM. ON FINANCE, THE BUSINESS INCOME TAX BIPARTISAN TAX WORKING GROUP REPORT 60 n.32 (2015).

<sup>137</sup> Guide to Accounting for Income Taxes 1.2, PRICEWATERHOUSECOOPERS (2013), *available at* <https://www.pwc.com/us/en/cfdirect/publications/accounting-guides/income-taxes-accounting-guide.html> [https://perma.cc/V3FT-H22S].

<sup>138</sup> See Sullivan, *supra* note 132.

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necessarily met either, because the WHT is linked to the DPD, which in turn reduces the tax liability of the distributing corporation. By this analysis, the tax liability, the corporate effective tax rate, and earnings per share should be the same as under current law (because the WHT will be part of the corporate's, rather than the shareholders', tax liability) and the "Trojan horse" problem vanishes.

Not taking into account financial reporting considerations, "shifting" the tax liability from the corporation to its shareholders might actually be a desirable tax policy for two primary reasons. First, taxation at the individual level would allow the United States to apply graduated, more accurate individual tax rates to reflect the "ability-to-pay" principle.<sup>139</sup> The second is that, unlike corporations, individuals are much less mobile. Imposing the tax liability on individuals, instead of corporations, might also help the United States fight some of the most notorious tax avoidance techniques, such as inversions. For individuals, it is much more costly to change residence in order to escape U.S. taxation. As long as the capital is held by U.S. shareholders, taxation (at a full individual rate) would occur within the United States.<sup>140</sup>

*2. Integration and Territoriality*

Under a territorial system, the entire (or a certain percentage) of any dividend received by a U.S. corporation from its foreign subsidiaries, would be exempt from U.S. taxation,<sup>141</sup> or subject to relatively low U.S. tax due to GILTI (which will result in no more than half of the corporate tax rate).<sup>142</sup> Essentially, territoriality and integration are "pushing" towards opposite directions. While a territorial system provides a tax advantage to foreign over domestic investment, integration provides the opposite advantage by eliminating the benefits with respect to exempt or foreign earnings.

Furthermore, a dividend exemption mechanism, combined with tax integration, might result in a serious revenue loss. In the inbound case, under which a foreign shareholder invests in a U.S. corporation, dividends paid to the foreign shareholder should generally be subject to reduced U.S. WHT if a tax treaty is applicable, and the U.S. corporation would be entitled to DPD. This means that full WHT is needed so the United States will be able to collect tax on corporate earnings that are distributed to foreign shareholders. However, such WHT might constitute a violation of the applicable tax treaty, which most probably provides for reciprocal reduced WHT rates.

In the outbound case, under a territorial tax system together with a DPD form of integration (and with no WHT), U.S. shareholders would be exempt from dividends paid by a foreign corporation. Under such a regime, distributions from a controlled foreign corporation (CFC) would not be subject to U.S. tax (or subject to reduced rates through GILTI). The problem is that if and when those earnings are redistributed by the U.S. parent to its U.S. shareholders, there will be no corporate tax liability. The U.S. parent will be entitled to a deduction, while the foreign earnings were not subject to U.S. tax in the first place. This resembles the problem arising from distributions

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<sup>139</sup> Avi-Yonah & Chenchinski, *supra* note 66, at 7.

<sup>140</sup> Reuven S. Avi-Yonah, *The International Tax Regime: A Centennial Reconsideration* 6-7 (U. Mich. Pub. L. Research Paper No. 462, 2015).

<sup>141</sup> STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 252 (2014).

<sup>142</sup> Sullivan & Cromwell, *supra* note 2 at 6.

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of untaxed interest from municipal bonds or super integration. As such, WHT is needed in this case as well, as will be discussed in Part III.

C. Imputation vs. DPD with WHT

Though DPD with WHT and imputation are economically equivalent, one might be preferable over the other on administrability considerations.<sup>143</sup> One of the main advantages of DPD over imputation is that that DPD is simpler to adopt.<sup>144</sup> Imputation requires a set of complex computations—mainly grossing up dividends. This might be a problem when the underlying earnings are sourced from different kinds of corporate earnings, subject to different amounts of tax.<sup>145</sup> DPD, on the other hand, is easier to administer because its implementation affects only the corporation under a fixed-rate—the corporate tax rate.<sup>146</sup>

It should be noted that tax incidence should also play a part in the determination of which form of integration is most suitable. It is still not clear who actually bears the burden of the corporate tax. While the exact incidence of the corporate tax remains disputed, it seems to be generally agreed upon that at least a portion of the tax is borne by shareholders. Even so, it is not clear whether tax incidence falls equally on upper and lower income shareholders. The corporate tax is also sometimes said to be shifted to all owners of capital in general, and also to consumers, employees and so on.<sup>147</sup> It is also possible that most of the burden of the current U.S. corporate tax is borne by holders of non-corporate capital. If so, they would benefit the most from corporate integration. Although there is no consensus on who actually bears the corporate tax, different theories of tax incidence should help us choose between the several forms of tax integration.<sup>148</sup>

#### IV. TAX INTEGRATION AND THE INTERNATIONAL TAX REGIME

As described in Part II, the international problem of tax integration might result in a revenue loss (unless combined with full-rate WHT), which in turn could result in a direct violation of tax treaties.

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<sup>143</sup> See AM. LAW INST., *supra* note 4546, at 48–49 (arguing that the partnership method is more complex than than distribution related integration because the partnership method would require yearly attribution to a complex set of capital interests); see also James R. Haney, *Integration of the Corporate and Individual Income Taxes*, 30 NAT'L TAX J. 345, 346 (1977).

<sup>144</sup> See Avi-Yonah & Chenchinski, *supra* note 66, at 14; see also Lee A. Sheppard, *Corporate Tax Integration: The Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 644 (1985).

<sup>145</sup> See, e.g., AM. LAW INST., *supra* note 4546, 46at 61-62 (stating that the gross-up fails when preference income is distributed).

<sup>146</sup> Adopting the imputation form of integration would result in much greater complexity. Not only would imputation have the same problems associated with DPD with WHT (in the form of special rules regarding foreign shareholders, tax-exempt entities, and tax preferences), but it is also not clear which tax rate the credit given to the shareholders would be based on. “[Imputation] would be relatively easy to administer only if a fixed-rate credit was used. But if the credit is to be based on the effective tax rate of each separate corporation, it would be more complicated to administer.” See TAX DIV., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, PROPOSED STATEMENT OF TAX POLICY 10: INTEGRATION OF THE CORPORATE AND SHAREHOLDER TAX SYSTEMS 5, 51, 55-56 (1993).

<sup>147</sup> John D. McDonald, *Hatch's Integration Plan: Trojan Horse or Reasonable Alternative?*, page 6 [I can't seem to access tax notes anymore].

<sup>148</sup> RICHARD GOODE, *THE POSTWAR CORPORATION TAX STRUCTURE* 55 (1947).

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A. The International Problem of Tax Integration

Cross-border transactions usually create problems under tax integration, because either the corporation or its shareholders are residents of the United States and subject to full U.S. tax, but not both. The question is whether the benefits of integration should be granted in cases where the income might escape U.S. taxation entirely, as will be shown below. An answer in the affirmative might result in a substantial revenue loss.<sup>149</sup> To better understand the problem, the discussion will be divided into problems associated with *active* income and problems associated with *passive* income.

*1. Active Income*

Under a regime of DPD (and assuming no WHT), active income is subject to tax when earned but is deducted from the corporate taxable income if and when distributed as a dividend. Assume a U.S. MNE operating a branch in a foreign country. The branch has income that might be taxed in the foreign country and not in the United States (due to FTC). The question is whether

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<sup>149</sup> See Graetz & Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, *supra* note 9, at 1209–10. In Europe, the imputation form of integration was abolished mainly because limiting the benefits of integration only to domestic investors (as a step to avoid revenue loss) violated the principles of European Commission Treaty of Freedoms and was therefore forbidden by the court. Graetz and Warren, Jr. explain:

Largely as a result of the ECJ tax decisions, the shareholder credit option has now been abandoned in the EU, in some cases even before the ECJ had decided whether it violated the EC Treaty freedoms . . . [I]nternational income also complicates imputation for both incoming and outgoing investment. The key issue regarding incoming investment is whether the shareholder credit should be available to foreign investors. A source country typically imposes only flat-rate “withholding taxes” on dividends to foreign shareholders, because it has no way of knowing the rest of the shareholder’s income situation. The traditional practice has been to reduce these withholding taxes to identical low levels in bilateral tax treaties. Corporate income would therefore be subject to primary taxation in the source country (due to the exemption or foreign tax credit in the residence country), while dividends then paid to the foreign investors would be subject to primary taxation in the residence country (due to reduction of withholding taxes in the source country). In this situation, imputation would achieve integration for domestic investors, while leaving for treaty negotiation the question of whether shareholder credits would be extended to foreign investors. Countries have differed in their willingness to enter into treaties that extend credits to foreign shareholders. The most common decision—not to extend such credits to foreign investors—creates the possibility of source-country favoritism of domestic investors, because the corporate tax on domestic income would be integrated when distributed to domestic, but not foreign, shareholders. Regarding outgoing investment, the key issue is whether foreign taxes paid on corporate income earned abroad should reduce shareholder taxes when that income is distributed as a dividend. The tendency has been to ignore corporate-level foreign taxes when computing individual shareholder taxes on dividends out of foreign income. Distribution of foreign income to shareholders could therefore trigger a compensatory tax, leading to the possibility of residence-country bias against investment abroad. Domestic corporate income is taxed only once by the residence country when distributed to domestic shareholders under full imputation. Foreign corporate income is taxed in the source country and typically benefits from either an exemption or a foreign tax credit in the residence country, but such income typically is taxed again when distributed to shareholders as a dividend. The potential for favoring domestic investors and domestic investment under imputation has long been known, and various solutions have been proposed in Commission studies over the years.” The unanimity requirement, however, always precluded adoption of any particular solution, and member states began to fear that their imputation systems would be found by the ECJ to violate the EC Treaty freedoms.

*Id.*

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distributions out of those earnings should be deductible from the taxable income of the U.S. MNE. This essentially turns on whether foreign taxes paid by a U.S. corporation should be treated the same as taxes paid to the United States. If so, the corporation and its shareholders should be entitled to the benefits of integration.<sup>150</sup> If the corporation would be entitled to the FTC and a DPD would be allowed, such scenario might lead to a “negative” U.S. tax liability. This is because the earnings, if distributed, will result in a reduction of U.S. tax liability at the corporate level (due to the deduction), while the FTC would have already reduced the U.S. corporate tax liability on those earnings. In other words, the foreign source earnings will not be subject any additional U.S. tax liability, but nonetheless would generate a DPD upon distribution. A U.S. tax will be imposed only at the shareholder level, so the total U.S. tax liability (if at all) would be minimal. The 1992 Treasury report discussed this question and concluded that the United States should not adopt integration unilaterally, mainly because of the potential revenue loss as discussed above.<sup>151</sup> Imposing a WHT or introducing a new compensatory tax might solve this problem because the FTC will offset the corporate level tax or the WHT/compensatory tax, but not both.

In the opposite scenario, consider a foreign corporation operating a branch in the United States. Under current law, entities engaged in a U.S. trade or business are generally subject to the U.S. corporate tax rates on their effectively connected income. If a treaty is applicable, the foreign corporation would be subject to U.S. tax only if its business constitutes a “permanent establishment” within the United States.<sup>152</sup> In such cases, the U.S. source income would generally be taxed similarly to income earned by a U.S. corporation. As such, it should presumably be entitled to DPD for its distributions. The DPD will reduce the U.S. tax liability of the branch to zero (to the extent earnings are later fully distributed). Yet the branch is not an entity by itself. If and when a distribution is made, it would be made by the foreign entity to its shareholders, which are probably both foreign and U.S. shareholders, or only foreign shareholders. Even if the foreign entity would be required to establish an account tracking the income that is earned through the permanent establishment, it might be hard to follow all distributions made to determine which shareholders received them. Such determination is required since distributions to foreign shareholders should not give rise to DPD or no additional U.S. tax will be collected (assuming the foreign shareholders are not subject to U.S. tax). In this scenario as well, the earnings might escape U.S. taxation altogether. A possible solution would be to disallow the deduction entirely. Yet such disallowance might violate the non-discriminatory provision of the applicable tax treaty. This provision provides that “taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other Contracting State than the taxation levied on enterprises of that other Contracting State carrying on the same activities.”<sup>153</sup> Imposing WHT might be problematic as well because the distributing entity is a foreign, and not a U.S., entity, and thus is not subject to U.S. tax jurisdiction.

## 2. *Passive Income*

When a U.S. shareholder holds interest in a foreign corporation, the question would be whether the United States should grant any kind of relief to the shareholder or the foreign corporation upon

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<sup>150</sup> AM. LAW INST., *supra* note 45, at 180-181.

<sup>151</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 61, at 77.

<sup>152</sup> U.S. MODEL TAX CONVENTION art. 7(1) (2016).

<sup>153</sup> U.S. MODEL TAX CONVENTION art. 24(2) (2016).



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distributions to the U.S. shareholders. Granting a relief might result in a revenue loss.<sup>154</sup> Under DPD, the relief would be granted at the corporate level. Here, the foreign corporation would not automatically be entitled to DPD. At first, this result might seem desirable, yet this might lead to burdensome taxation of foreign income held by U.S. shareholders and a potential violation of the CIN principle. Another possibility is to grant the U.S. shareholders a relief in the form of credit for taxes paid by the foreign corporation to the foreign country, but since the foreign entity is not subject to U.S. law, the U.S. shareholders might have difficulties obtaining the necessary documentation on the taxes the foreign corporation paid.<sup>155</sup>

In the opposite case, consider a U.S. corporation that has foreign shareholders. Should the U.S. corporation be allowed a DPD on dividends that were distributed to the foreign shareholders? If so, the income might escape U.S. taxation entirely since the foreign shareholders are not subject to U.S. tax. In addition, unlike tax-exempt shareholders, foreign shareholders are entitled to the benefits of tax treaties.<sup>156</sup> Those benefits include a substantially reduced WHT rate on dividends sourced within the United States; presumably, the United States cannot unilaterally impose a high WHT on such distributions, but this WHT would be the only tax collected by the United States.<sup>157</sup>

As discussed above, one solution could be to impose a full-rate WHT, or a special new compensatory tax. This WHT would be imposed on earnings distributed to foreign shareholders and would replace the low WHT rate the treaty provides. To prevent revenue loss, the U.S. should disallow the tax withheld as a credit to the foreign shareholders. However, this solution still violates the tax treaties in two ways. First, it may violate the reduced WHT rates provided by the applicable treaty. Second, it would disallow a credit to foreign shareholders for the tax withheld, which might violate the non-discrimination provision of the applicable tax treaty.<sup>158</sup> A potential

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<sup>154</sup> George N. Carlson, *International Aspects of Corporate-Shareholder Tax Integration*, 11 CASE W. RES. J. INT'L L. 535, 557 (1979).

<sup>155</sup> The CIN principle might be also impacted if the U.S. tax rate is higher than the foreign tax rate, but this is not related to DPD or imputation.

<sup>156</sup> See Avi-Yonah & Chenchinski, *supra* note 66 at 11.

<sup>157</sup> See REUVEN AVI-YONAH ET AL., U.S. INTERNATIONAL TAXATION 132 (3d ed. 2010).

<sup>158</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 61, at 79. However, note that while it is not clear whether a disallowance of a credit will constitute a violation of the applicable non-discrimination provision, many of the countries that adopted integration in the past have concluded that refusing to extend integration benefits by statute to foreign shareholders residing in other contracting countries would not violate that provision. The argument was that under imputation, all profits are taxed at the corporate level at the same rate, without regard to capital ownership and allowing or denying the imputation credit to the shareholders is an issue of how to tax shareholders, not corporations. It follows that no treaty requires foreign shareholders to receive the same tax credits as domestic shareholders. According to this analysis, there is no treaty violation. Consider *Biddle v. Commissioner*, in which a U.S. taxpayer had U.S. and U.K. income. Under U.K. law at the time, shareholders of U.K. corporations were required to report as income, in addition to the amount of dividends actually received, amounts that reflected their respective proportions of the tax paid by the corporation on the distributions. The taxpayer argued that those amounts should be credited against their U.S. income tax. The court rejected the taxpayer's argument, stating, at *Biddle v. Comm'r*, 302 U.S. 573, 581 (1938):

Our revenue laws give no recognition to that conception. Although the tax burden of the corporation is passed on to its stockholders with substantially the same results to them as under the British system, our statutes take no account of that fact in establishing the rights and obligations of taxpayers... they have never treated the stockholder for any purpose as paying the tax collected from

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response would be that the WHT, or the compensatory tax, is not a “covered tax” and as such should not be subject to tax treaties (mainly because it is a new tax and not an income tax).<sup>159</sup> If the United States were to entirely reform its domestic and international tax regimes, any *new* taxes that are similar to income taxes should not be subject to, and are not covered by, current tax treaties.<sup>160</sup>

As evident from the above examples, full-rate WHT, or a new compensatory tax, is a necessary mechanism that would prevent substantial revenue loss in case a DPD form of integration were to be implemented. Such a WHT (or new compensatory tax) does not necessarily violate the current U.S. tax treaty network (with respect to the reduced WHT rates those treaties provide or the non-discrimination provisions).

B. The Current Problems with the U.S. International Tax Regime

The 2017 Tax Reform essentially adopts a dividend exemption system (to the extent the income is not subject to GILTI), which allows U.S. MNEs to repatriate future foreign earnings tax free or under a reduced rate (while past earnings were also subject to substantially reduced tax rates).<sup>161</sup> This will presumably help achieve parity between U.S. companies and their foreign competitors and will increase the competitiveness of U.S. MNEs vis-à-vis foreign competitors that are based in countries with territorial tax systems.<sup>162</sup> A dividend exemption system is currently in place in twenty-eight out of the thirty-four OECD countries.<sup>163</sup> Territoriality, as its supporters claim, would stimulate greater economic activity and greater labor demand in the United States, would allow U.S. MNEs to better compete with their foreign competitors, and would prevent U.S. MNEs from accumulating earnings abroad in order to avoid tax liability resulting from repatriation.<sup>164</sup> However, some question why the United States should permit taxpayers to borrow in the United States (and deduct their interest expenses), and then invest the proceeds abroad, effectively earning tax-exempt income under a territorial system. Others answer that the added domestic investment, due to the expansion of U.S. MNEs, will compensate for any U.S. revenue loss “so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were

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the corporation. Nor have they treated as taxpayers those upon whom no legal duty to pay the tax is laid. Measured by these standards our statutes afford no scope for saying that the stockholder of a British corporation pays the tax which is laid upon and collected from the corporation.

<sup>159</sup> U.S. MODEL TAX CONVENTION art. 2(4) (2016). The United Kingdom has taken a similar approach with its “Diverted Profits Tax”, see Reuven S. Avi-Yonah, *Three Steps Forward, One Step Back? Reflections on ‘Google Taxes’, BEPS, and the DBCT 2* (U. Mich. Pub. L. Research Paper No. 516, 2016).

<sup>160</sup> Bret Wells, *International Tax Reform by Means of Corporate Integration*, 20 FLA. TAX REV. 70, 107 (2016) (“A recent example of a major US trading partner taking this same position with respect to new legislation is provided by the United Kingdom. In this regard, the United Kingdom has taken the position that its new diverted profits regime is a new tax that is not ‘identical or substantially similar’ to any earlier UK income tax, and accordingly the UK has taken the position that its new diverted profits tax regime can be applied in preference to any treaty provision without violating its treaty obligations.”).

<sup>161</sup> Tax Cuts and Jobs Act, 26 I.R.C. § 245A (2017).

<sup>162</sup> See TAX REFORM TASK FORCE, *supra* note 30, at 28.

<sup>163</sup> STAFF OF S. COMM. ON FINANCE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, 113<sup>TH</sup> CONG., 252 (2014).

<sup>164</sup> *Id.* at 241.

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invested domestically by the same entity that does the borrowing.”<sup>165</sup> However, this answer assumes that U.S. MNEs will indeed stop shifting profits abroad, which may not be realistic due to the incentives to shift income abroad to attain lower tax rates.<sup>166</sup> Given the current dysfunctional Transfer Pricing system, this assumption might prove itself risky.<sup>167</sup>

Regardless of revenue considerations, allowing U.S. MNEs to exclude their foreign earnings from their taxable income would be a direct contradiction to the basic tax principle of fairness, as embedded in the principle of CEN.<sup>168</sup> Assume there are two companies, both earning \$100 a year. For the first company, all earnings are foreign sourced, but for the second company, all earnings are domestic sourced. On paper, those corporations should be taxed the same. This is due to basic quality considerations.<sup>169</sup> As Professor Surrey wrote in 1956:

Our immediate concern is with United States corporations receiving income from foreign sources. Here the concept of United States income taxation on worldwide income equally applies. Consequently, an American corporation receiving income from a foreign source has always been subject to the United States income tax. An American corporation operating a branch in Illinois and a branch in France is therefore subject to income tax on the profits of the French branch just as it is subject to tax on the profits of the Illinois branch.<sup>170</sup>

Surrey conceded several potential reasons for treating foreign income in a favorable manner, such as giving incentives to foreign trade and investment, enhancing the competitiveness of U.S. MNEs, and furthering national security and foreign policy interests.<sup>171</sup> However, those justifications did not stop him from raising a somewhat obvious question:

[I]f these arguments of incentive and competition and national security are regarded as pertinent to a consideration of the rate of corporate income tax to be applied to profits from foreign activities, they can be made equally persuasive as to domestic activities. Able publicists could take arguments of this nature and with a

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<sup>165</sup> *Tax Reform Options: International Issues: Hearing Before the S. Comm. on Finance*, 112th Cong. 10 (2011) (statement of Professor James R. Hines, Jr.), available at <https://www.finance.senate.gov/imo/media/doc/Testimony%20of%20James%20Hines.pdf> [<https://perma.cc/L723-SKNF>].

<sup>166</sup> McDonald, *supra* note 147, at 4.

<sup>167</sup> *Tax Reform Options: International Issues: Before the S. Comm. on Finance*, 112th Cong. 3 (2011) (testimony of Professor Reuven S. Avi-Yonah), available at <https://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Reuven%20Avi-Yonah.pdf> [<https://perma.cc/FY6D-GV63>].

<sup>168</sup> See SLEMRD & BAKIJA, *supra* note 68, at 89 (defining horizontal equity as tax liability being equal for “those of equal wellbeing.”).

<sup>169</sup> Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 817-818 (1956).

<sup>170</sup> *Id.* at 815.

<sup>171</sup> *Id.* at 816.

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few twists here and there urge them to rationalize a lower rate of tax for one domestic industry as against another.<sup>172</sup>

Furthermore, U.S. MNEs might already be subject to a lower effective tax rate on their foreign earnings, compared to their foreign competitors,<sup>173</sup> and those competitors are also usually subject to much tougher anti-deferral rules in their home countries.<sup>174</sup> While Congress might justifiably want to level the playing field and help U.S. MNEs in their efforts to expand, it should also ensure these MNEs are paying their “fair share” of taxes. It might just be that some of those who lobbied for territoriality care less for the U.S. economy and the competitiveness of U.S. MNEs, and more for reducing their clients’ U.S. tax liability. As Surrey puts so precisely, “[t]he loftier the principles involved, the less apt are the spectators to remember that the reduction achieved will in the first instance go to the marching crusaders.”<sup>175</sup>

The conclusion of all of the above is two-fold. First, a DPD form of integration should be adopted, such that the current debt-vs-equity distortion would be eliminated or substantially reduced. The DPD should be adopted in conjunction with a full rate WHT to protect the U.S. revenue. Second, foreign earnings should be subject to the same tax rates as domestic income to preserve horizontal equity and CEN principles. A tax reform that would archive all of the above will be discussed in the next part.

### C. A Proposal for a Comprehensive Tax Reform

#### 1. *DPD and Current-Base Taxation*

Until the 2017 Tax Reform, tax deferral was the largest corporate expenditure.<sup>176</sup> It accounted for 42% of corporate tax expenditures for the fiscal year of 2014.<sup>177</sup> A territorial system, which will permanently exempt foreign earnings (and not just defer their U.S. taxation until repatriation) will cost even more. Therefore, I call for a current-base taxation regime, under which foreign earnings will be taxed on a current basis, when earned, and at the full corporate tax rate. This can be achieved by including foreign earnings of a CFC, in its U.S. parent’s taxable income, when those earnings are earned, as originally intended by Subpart-F.<sup>178</sup> Besides the obvious revenue considerations, this will also prevent the current incentive to shift income abroad. As discussed above, the current system results in a distortion in favor of foreign investment. Subjecting foreign income to the same rate as domestic income will remove such distortion. In addition, I call for the adoption of a DPD form of tax integration. Taxing all income, wherever earned, to the same tax rate, will obliterate the need to distinguish between domestic and foreign earnings and will

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<sup>172</sup> *Id.*

<sup>173</sup> Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rate of the Largest US and EU Multinationals* 383–84 (U. Mich. L. & Econ, Empirical Legal Studies Ctr. Working Paper No. 11-015, 2011).

<sup>174</sup> Reuven S. Avi-Yonah & Haiyan Xu, *Global Taxation after the Crisis: Why BEPS and MAATM Are Inadequate Responses, and What Can Be Done About It* 3 (U. Mich. Pub. L. Research Paper No. 494, 2016).

<sup>175</sup> See Surrey, *supra* note 169, at 840.

<sup>176</sup> JANE G. GRAVELLE, CONG. RESEARCH SERV., R44220, ISSUES IN A TAX REFORM LIMITED TO CORPORATIONS AND BUSINESSES (2015).

<sup>177</sup> *Id.*

<sup>178</sup> See Nir Fishbien, *From Switzerland with Love: Surrey’s Papers and the Original Intent(s) of Subpart-F*, 38 Va. Tax Rev. 1 (2018).

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facilitate the adoption of tax integration, because all distributions of earnings that were previously taxed will give rise to the benefits of tax integration. The already reduced corporate tax rate (currently 21%), combined with tax integration, will provide a significant relief from the relatively high burden of corporate double taxation, allowing U.S. MNEs to better compete in the global economy. It will eliminate (or substantially reduce) the debt-over-equity bias and the inefficient penalty on business activities carried through C corporations. The DPD form of integration is also relatively easy to administer.

D. The Problem of Potential Tax Treaty Violation

As discussed in Part III, in order to avoid a potential revenue loss, a full-rate WHT, or a new compensatory tax, equal to the rate of the corporate tax rate (currently 21%) should be introduced. This tax would also be imposed on distributions to foreign entities claiming treaty benefits. To avoid revenue loss, full-rate WHT would be imposed on any distributions by a U.S. corporation to its shareholders. Imposing such full-rate WHT on foreign shareholders would achieve equal tax treatment and would not necessarily discriminate against foreign entities.

One problem remains, however, in cases where the residence country of the foreign entity would not credit this WHT. Since domestic investors investing in the United States will benefit from the DPD, foreign investors will be worse-off because both the U.S. and the foreign country will deny them the benefits of tax integration. This, in turn, might discourage investment in the United States. Accordingly, any adoption of tax integration will require the United States to negotiate with foreign countries that relief will be provided to foreign investors under tax integration. A new set of transition rules that will grant a temporary relief until such negotiations are concluded must also be introduced.

V. CONCLUSIONS

The U.S. tax system has many distortions, but two are particularly prevalent. The first is that the current rules skew corporations' preferences towards raising capital through debt rather than equity. Under the current corporate double taxation mechanism, C corporations are incentivized to borrow because interest is deductible while dividends are not. The second that the rules incentivize foreign-over-domestic investment. Under the current U.S. international tax regime, U.S. MNEs are subject to a reduced tax rate, and in certain occasions are also exempt from U.S. tax on their foreign earnings; however, their domestic earnings are subject to the full corporate tax rate.

In this Article, I call for the adoption of a DPD form of tax integration and for current-base taxation of foreign earnings. The already reduced corporate tax rate (21%), combined with tax integration, will provide significant relief from the relatively high burden of corporate double taxation, allowing U.S. MNEs to better compete in the global economy. It will eliminate (or substantially reduce) the debt-over-equity bias and the inefficient penalty on business activities carried through C corporations. Current-base taxation will eliminate the current incentive to invest and shift income abroad, while providing a very important source of revenue. It will also obliterate the need to distinguish between domestic and foreign earnings and as such will facilitate the adoption of tax integration, because all distributions of earnings that were previously taxed will

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give rise to the benefits of tax integration. Finally, in order to avoid a potential revenue loss as a result of this new DPD, a full-rate WHT or a new compensatory tax, equal to the rate of the corporate tax, should be introduced and implemented. The WHT (or the compensatory tax) should be non-refundable, even to foreign and tax-exempt taxpayers.