# PART IV: THE ROADS NOT TAKEN

## INTRODUCTION

Under an imputation credit system, a shareholder would be taxed on the gross amount of a dividend, including both the cash dividend and the associated tax paid at the corporate level. The shareholder would receive a credit equal to the amount of corporate tax associated with the gross dividend. From an individual shareholder's viewpoint, this system would mean that the corporate tax on earnings distributed as dividends would generally resemble the current withholding tax on wages and salaries. An employee includes gross wages in his taxable income and receives a credit against tax liability equal to the amount of tax withheld by the employer. Because of the prevalence of imputation credit systems abroad, such a system would facilitate international coordination of corporate tax regimes, especially in the context of bilateral treaty negotiations.[1] We therefore had expected to recommend an imputation credit system as our preferred form of distribution-related integration.

After a close examination of the imputation credit system, reflected in Chapter 11, we determined that its principal advantage is its flexibility to respond to different policy judgments on the most important issues of integration. For example, an imputation credit can extend the benefits of integration to tax-exempt and foreign shareholders by allowing refundability of imputation credits or it can deny such benefits by denying refunds. Its major drawback is its complexity in creating an entirely new regime for taxing corporate dividends. On balance, we concluded that the dividend exclusion prototype set forth in Chapter 2 was the preferable distribution-related integration alternative because it would implement our policy recommendations, including such issues as the treatment of preferences and tax-exempt and foreign shareholders, in a substantially simpler manner.

An imputation credit system may not be the most straightforward distribution-related integration alternative even if policymakers were to choose policy goals different from ours. A dividend deduction system, described in Chapter 12, also would be simpler than an imputation credit system if policymakers chose to extend the benefits of integration to tax-exempt and foreign shareholders.[2]

# CHAPTER 11: IMPUTATION CREDIT SYSTEM

## 11.A OVERVIEW OF IMPUTATION CREDIT PROTOTYPE

In producing this Report, we looked carefully at the integration systems of other countries. See Appendix B. The imputation credit prototype set forth in this chapter is the one we consider to be most consistent with our policy recommendations. It closely resembles the system that New Zealand adopted in 1988.

Mechanics. Corporations would continue to determine income under current law rule and pay tax at a 34 percent rate. Shareholders receiving a distribution treated as a dividend would include the grossed-up amount of the dividend in income—including both the amount of cash distributed and the imputation credit allocated to the dividend—and could use the credit to offset their tax liability. The credit would be non-refundable; it could reduce tax liability to zero, but would not produce a refund. Credits would be allowed only for taxes paid after the effective date of the proposal.

Allowing a credit for the full amount of corporate tax paid with respect to distributed earnings would eliminate the corporate level tax if the shareholder's tax rate at least equals the corporate rate. Even if the shareholder rate were less than the corporate rate, the corporate tax could be eliminated if the credit were allowed against tax on other income or as a refund. Currently, the maximum statutory rate for individual shareholders (31 percent) is less than the corporate rate of 34 percent. Thus, if the credit were computed at the full corporate rate, most shareholders could shelter other income from tax or claim refunds. This need not be permitted, however, if the goal of the imputation credit prototype is simply to ensure that distributed earnings that are taxed at the corporate level are not taxed again to shareholders. Accordingly, rather than allowing a credit for the full amount of corporate tax paid on a distribution, the prototype computes the amount of the credit at the 31 percent maximum shareholder rate. This approach does not eliminate the corporate level tax. However, it would generally permit shareholders to pay no additional tax on distributions of corporate earnings that have already been taxed fully at the corporate level, while ensuring that shareholders taxable at the maximum individual rate do not use excess credits to shelter other income from tax or to claim refunds.[1] Section 11.B explains how taxes paid at the corporate rate are converted into imputation credits at the shareholder rate.

A corporation would maintain an account of its cumulative Federal income taxes paid, computed as though its taxable income had been subject to tax at a rate of 31 percent (the shareholder credit account or SCA). A corporation could elect to attach a credit to a dividend (frank the dividend) in any amount, provided it does not exceed the lesser of (1) the adjusted corporate level tax (computed at the 31 percent rate) on the pre-tax earnings that generated the dividend (the grossed-up dividend),[2] or (2) the balance in the SCA.[3] The corporation would reduce its SCA balance by the amount of credits used to frank dividends and by refunds of corporate tax. It would increase its SCA by payments of corporate tax and by credits attached to dividends received from other corporations.

Tax-Exempt Shareholders. The prototype would effectively retain the current level of taxation of income earned on corporate equity supplied by tax-exempt shareholders. The credit would be nonrefundable, and fully-taxed income distributed to tax-exempt shareholders would continue to bear one level of tax: the corporate tax. Preference income distributed to tax-exempt shareholders generally would continue to be untaxed both at the corporate and shareholder level.

Corporate Shareholders. The dividends received deduction would be increased to 100 percent for all intercorporate dividends, and any imputation credits attached to a dividend would be added to the recipient corporation's SCA.

Tax Preferences and Foreign Source Income. By adding only U.S. taxes to the SCA and requiring that imputation credits be paid out of the SCA, the prototype ensures that the credit is allowed only to the extent of U.S. corporate tax payments. By generally allowing corporations to decide how much credit to attach to a particular distribution, the prototype allows a corporation to treat distributions as coming first from fully-taxed income and then from preference income and foreign source income shielded from U.S. tax by foreign tax credits. The prototype does not impose a compensatory tax on distributions out of preference or shielded foreign source income. Therefore, the prototype permits a corporation to make distributions out of preference or shielded foreign source income without incurring additional corporate level tax liability. However, shareholders may not claim credits with respect to such distributions. This results in distributed preference income and shielded foreign source income continuing to be subject to the same level of taxation as under present law.

Foreign Shareholders. The prototype also retains the current law treatment of foreign shareholders. The credit would be nonrefundable to foreign shareholders, absent treaty provisions to the contrary, and dividends would be subject to U.S. withholding tax to the same extent as under current law.

Anti-abuse Rules. The imputation credit prototype generally permits a corporation to frank dividends in any amount (subject to a maximum), even if they have a remaining SCA balance. This treatment is more liberal than the dividend exclusion prototype, which requires corporations to pay fully excludable dividends (equivalent to fully franked dividends) until their EDA is exhausted. Permitting this additional flexibility in the imputation credit prototype may require additional anti-abuse rules to prevent corporations from attaching credits to distributions to taxable shareholders and not attaching credits to distributions to shareholders with low or zero U.S. tax liability, such as tax-exempt and foreign shareholders. See Section 11.F.[4]

Capital Gains and Share Repurchases. Chapter 8 discusses the treatment of capital gains on sales of corporate stock and the treatment of share repurchases.

Structural Issues. The prototype generally maintains current law rules for corporate acquisitions, although new rules would be needed to govern the carryover or separation of corporations' SCA balanceasin acquisitive and divisive reorganizations.

Impact on tax distortions. Table 11.1 illustrates the impact of the imputation credit prototype on the three distortions integration seeks to address: the current law biases in favor of corporate debt over equity finance, corporate retentions over distributions, and the noncorporate over the corporate form. The only difference between the current law treatment of nonpreference, U.S. source business income and its treatment under the imputation credit prototype is on corporate equity income distributed to individual investors. The prototype would reduce the tax rate on such income to $t_c$ (when $t_i=t_i^m$) or a lower rate (when $t_i<t_m$), but as long as $t_c>t_i^m$, the rate will be greater than $t_i$. Thus, while the rate on corporate equity income distributed to individuals would be reduced, it would still be higher than the rate ($t_i$) imposed on noncorporate equity income and on interest. It would be lower, however, than the rate on undistributed corporate equity income. Some bias toward debt finance and the noncorporate form would remain, while the bias toward corporate retentions would tend to be reversed, in the absence of a DRIP. See Chapter 9 and Section 11.I. For tax-exempt and foreign investors, there would be no change in the tax treatment of nonpreference, U.S. source income.

## 11.B CHOICE BETWEEN A CREDIT LIMITATION SYSTEM AND A COMPENSATORY TAX SYSTEM

### Introduction

As set forth in Chapter 5, this Report recommends that integration not become an occasion for extending the benefit of corporate tax preferences to shareholders. In implementing this decision in an imputation credit system, the most significant choice is between a shareholder credit limitation system (in which tax is collected only at the shareholder level on distributed preference income) or a compensatory tax system (in which a tax, creditable by shareholders, is collected at the corporate level on distributed preference income). The choice between a credit limitation system and a compensatory tax system also is influenced by the policy recommendations set forth in Chapters 6 and 7 not to eliminate the corporate level tax on earnings distributed to tax-exempt and foreign shareholders and not to treat identically U.S. corporate level taxes paid and foreign taxes on corporations' foreign source income. These policy recommendations imply that imputation credits should not be refundable to tax-exempt or foreign shareholders and that foreign corporate level taxes should not be creditable by shareholders.

**Table 11.1**
**Total U.S. Tax Rate on a Dollar of NonPreference, U.S. Source Income from a U.S. Business Under Current Law and an Imputation Credit Prototype**

| Type of Income | Current Law | Imputation Credit Prototype |
|---|---|---|
| **I. Individual Investor is Income Recipient** | | |
| Corporate Equity: | | |
| Distributed | $t_c+(1-t_c)t_i$ | $[(1-t_i)t_c+t_i-t_i^m]/(1-t_i^m)$ |
| Undistributed | $t_c+(1-t_c)t_g$ | $t_c+(1-t_c)t_g$ |
| Noncorporate Equity | $t_i$ | $t_i$ |
| Interest | $t_i$ | $t_i$ |
| Rents and Royalties | $t_i$ | $t_i$ |
| **II. Tax Exempt Entity is Income Recipient** | | |
| Corporate Equity: | | |
| Distributed | $t_c$ | $t_c$ |
| Undistributed | $t_c$ | $t_c$ |
| Noncorporate Equity | $t_c$ | $t_c$ |
| Interest | 0 | 0 |
| Rents and Royalties | 0 | 0 |
| **III. Foreign Investor is Income Recipient** | | |
| Corporate Equity: | | |
| Distributed | $t_c+(1-t_c)t_{WD}$ | $t_c+(1-t_c)t_{WD}$ |
| Undistributed | $t_c$ | $t_c$ |
| Noncorporate Equity | $t_{WN}$ | $t_{WN}$ |
| Interest | $t_{WI}$ | $t_{WI}$ |
| Rents and Royalties | $t_{WR}$ | $t_{WR}$ |

Department of the Treasury
Office of Tax Policy

$t_c$ = U.S. corporate income tax rate.
$t_i$ = U.S. individual income tax rate.
$t_i^m$ = Maximum U.S. individual income tax rate.
$t_g$ = U.S. effective individual tax rate on capital gains.
$t_{WD}$, $t_{WN}$, $t_{WI}$, $t_{WR}$ = U.S. withholding rates on payments to foreigners of dividends, noncorporate equity income, business interest, and rents and royalties, respectively. Generally varies by recipient, type of income, and eligibility for treaty benefits, and may be zero.

The choice between a credit limitation system and a compensatory tax system may differ depending upon the kind of integration mechanism adopted. For example, in the dividend exclusion prototype, we chose to follow a credit limitation-type approach and to tax distributed preference income only at the shareholder level. This allows adoption of the dividend exclusion prototype with minimal changes from current law and would continue current law treatment of dividends paid out of preference or foreign source income. In addition, because the dividend exclusion prototype applies only to corporate equity, a compensatory tax would tend to increase the incentive for corporations with preference income to issue debt rather than equity to tax-exempt and foreign investors. For similar reasons, we adopt a credit limitation approach in the imputation credit prototype.

Experience in other countries makes clear that an imputation credit system can accommodate either a credit limitation or a compensatory tax, however. Australia and New Zealand, for example, adopted credit limitation systems, while France, Germany, and the United Kingdom adopted compensatory tax systems.[5]

## Comparison of a Compensatory Tax and Credit Limitation

Under current law, preference income distributed to tax-exempt shareholders is not subject to tax at either the corporate or the shareholder level. If a compensatory tax were imposed on preference income at the corporate level and not made refundable to tax-exempt shareholders, a compensatory tax would impose an additional tax on such income.[6] Similarly, under current law, preference income distributed to foreign shareholders is subject only to the 30 percent withholding tax (often reduced to as little as 5 percent by treaty). If distributed preference income were subject to a compensatory tax at the corporate level and the imputation credits could not be used against the foreign shareholders' withholding tax, the net tax burden on that income would increase.

A similar problem arises with distributions of foreign source income earned by a U.S. corporation and taxed abroad. As discussed in Chapter 7, this Report recommends that foreign taxes remain creditable at the corporate level, but that foreign taxes not be treated the same as U.S. taxes paid in determining imputation credits. Under such a rule, distribution of foreign source income that has not borne any residual U.S. tax would be fully taxable at the shareholder level, as under current law. A nonrefundable compensatory tax on distribution of foreign source income shielded from U.S. corporate tax by foreign tax credits would increase the tax burden on distributions of such income to foreign and tax-exempt shareholders relative to the burden on such income under current law.

Because of the additional corporate level tax imposed by a nonrefundable compensatory tax on preference and foreign source income distributed to tax-exempt or foreign shareholders, the compensatory tax and credit limitation systems have very different implications for corporations that currently pay little U.S. tax, due either to substantial use of tax preferences or to foreign tax credits. Under current law these corporations incur little or no United States corporate level tax, but the dividends paid do bear a shareholder level tax (except in the case of tax-exempt shareholders).

A credit limitation system allows corporations to continue to pay dividends out of preference or foreign source income without incurring any additional corporate level tax. In contrast, a compensatory tax system would require such corporations to pay an extra corporate level tax in order to maintain their current level of dividend payments. In practical terms, a compensatory tax may create an extra tax cost for corporations engaged in tax-favored activities, such as research and experimentation and oil and gas exploration[7] and may affect large multinational corporations doing business in high-tax foreign jurisdictions, such as certain European countries. In addition, U.K. experience with a nonrefundable compensatory tax suggests that corporations that would be subject to such taxes will engage in tax planning behavior to avoid its burdens. Nevertheless, a compensatory tax does promote simpler administration, since it collects tax on distributed corporate preference or foreign source income at the corporate level.[8]

The extent to which additional tax burdens would be created by a compensatory tax system depends on the method for determining when a distribution is made out of income that has not borne U.S. tax.[9] A stacking rule that treats all distributions as having borne tax at the full corporate rate (to the extent possible based on total corporate tax paid) may mitigate the imposition of a compensatory tax. If distributions do not exceed fully-taxed income, no compensatory tax is due. Choice of a particular stacking rule also affects both the revenue effects of distribution-related integration and corporate incentives to pay dividends. In this and other prototypes, we have consistently rejected a stacking rule that would treat dividends as made first from preference income, and we have been unable to discover any country that stacks preferences first in its distribution-related integration system. Although that rule would reduce the revenue loss from adoption of distribution-related integration, it also would discourage payment of dividends.[10] Most foreign systems stack preferences last. See Appendix B.

A credit limitation system may be somewhat more complex to administer than a compensatory tax system, because it requires shareholders to apply a different rate of gross-up and credit for each distribution from each corporation. In contrast, under a compensatory tax, all distributions from all corporations are subject to gross up and credit at the same rate. From the shareholder's point of view, however, a credit limitation system may not be significantly more complicated. Under either system, the shareholder must compute tax using two pieces of information—the amount of the cash dividend and the associated credit (also used to compute the grossed-up dividend). The only necessary difference between the two systems is that under a compensatory tax system the credit rate can be provided by instructions to the tax form, while under a credit limitation system it would have to be provided by information returns, which may reflect differing amounts of credit for different corporations and in different years.

Both compensatory tax systems and credit limitation systems have posed problems for countries that have adopted them. For example, the United Kingdom imposes a compensatory tax by collecting Advance Corporation Tax (ACT) on all distributed earnings at the time of distribution. ACT is then creditable against regular tax.[11] The United Kingdom has found that many corporations with a large amount of preference or foreign source income have built up substantial excess ACT accounts rather than reduce their dividend payments. The likelihood of excess ACT accounts has led to tax planning efforts to avoid imposition of compensatory taxes and the existence of excess ACT accounts promotes efforts at trafficking in tax attributes. However, credit limitation systems have had problems in creating and enforcing effective antistreaming rules. Both the Australian and New Zealand systems contain an extensive network of such rules.

On balance, we believe that a credit limitation system is preferable to a compensatory tax in both the imputation credit prototype and the dividend exclusion prototype. In both cases, a credit limitation system would permit corporations to maintain their current dividend policy without the imposition of additional corporate level tax.

## Mechanics of a Shareholder Credit Limitation System

Under the imputation credit prototype, corporations would keep track of cumulative taxes paid by maintaining a Shareholder Credit Account (SCA)—an account of cumulative creditable taxes paid. A corporation would be allowed to attach a credit to a dividend (frank the dividend) in any amount, up to a limit. The credit attached could not exceed the lesser of (1) an amount equal to the product of (a) the distribution and (b) the ratio of the current maximum shareholder tax rate to 1 minus the current maximum shareholder tax rate, or (2) the balance in the SCA. The corporation would reduce the balance in the SCA by the amount of credits used to frank dividends and refunds of corporate tax and increase the SCA by payments of corporate tax (including estimated tax) and imputation credits attached to dividends received.

For example, consider a corporation with taxable income of \$100. Assuming a 34 percent corporate tax rate and a 31 percent shareholder rate, it would pay a tax of \$34 and have \$66 available for distribution. The corporation would add \$29.65 to its SCA account. The amount added to the SCA is determined using the following formula:

Annual additions to SCA =

$$\left[\frac{1}{.69}-1\right]\left[\frac{\text{U.S. tax paid for taxable year}}{.34}-\text{U.S. tax paid for taxable year}\right]$$

+ imputation credits on dividends received

This is the amount of tax that would fully frank, at the 31 percent shareholder rate, the corporation's actual after-tax income of \$66 (\$100 − \$34).[12]

If the corporation distributed a cash dividend of $33, the corporation could elect to frank the dividend in any amount up to $14.83 (determined by multiplying the amount of the distribution by .4493 (the shareholder rate divided by one minus the shareholder rate). The corporation would reduce the SCA by the amount of the credit. Thus, if the corporation chose to fully frank the dividend, the shareholder would report as income the gross dividend of $47.83 ($33 plus $14.83) and claim a credit of $14.83 against the individual tax. If the $14.83 credit exceeded the shareholder level tax imposed on the $47.83 gross dividend, a low-bracket shareholder could use the excess credit to offset tax imposed on other income. For example, a shareholder in the 31 percent bracket would incur tax liability on the gross dividend of $14.83 (.31×$47.83) and would receive a credit of $14.83, exactly offsetting the tax due. A shareholder in the 15 percent bracket would incur tax liability on the gross dividend of $7.17 ($47.83×15 percent) and would receive a credit of $14.83, leaving an excess credit of $7.66 to offset other tax liability.[13]

The imputation credit prototype requires corporations to report annually to each shareholder and to the IRS the amount of dividend distributions to shareholders and the associated imputation credits. The imputation credit prototype also requires corporations annually to report to the IRS the adjustments to and balance in the SCA. This would permit the IRS to verify aggregate allowable credits to a corporation based on the amount of taxes paid and to compare the allowable amount with credits reported by shareholders.

A liquidating corporation would distribute the remaining balance in its SCA among shareholders in proportion to the amount of other assets distributed to them. As with any other distributions for which imputation credits are allowed, the amount of the shareholder credit would be included in income and could be used to offset gain on the liquidation or, in the case of excess credits, other income.

The imputation credit prototype, like the dividend exclusion prototype, treats adjustments to prior years' tax liability as adjustments made in the current year.[14] Thus, an increase in corporate tax liability for a prior year would result in an increase in the SCA for the year of the audit adjustment. A decrease in a prior year tax liability could give rise to a refund, but only to the extent of the current balance in the SCA. Any excess amount would be carried forward to be applied against future corporate taxes.[15]

This method ensures that an adjustment that affects a corporation's prior year tax liability would not affect shareholders' individual tax positions for the prior year. Shareholders may thus claim the credits reported to them as allowable by the corporation, without concern that subsequent corporate level adjustments might require them to file amended returns.[16]

The imputation credit prototype allows corporations to carry back losses to claim refunds only to the extent of any balance in their SCA, with the SCA being reduced by the amount of the refund. This limitation prevents corporations from carrying back losses in order to obtain a refund of taxes that already have served to reduce shareholders' taxes through imputation credits attached to dividends.[17] Any unused losses can be carried forward as under present law.[18]

The prototype generally permits corporations to choose the extent to which dividends are franked, with the consequence that there is no need for a mandatory stacking rule. This flexibility allows a corporation with preference or foreign source income to continue to determine its dividend policy by weighing the business reasons for maintaining a particular level of cash distributions against the possible detriment to shareholders of receiving unfranked dividends. In contrast, the dividend exclusion prototype requires excludable dividends to be paid until the EDA balance is exhausted. This is equivalent to an imputation credit system that requires corporations to pay fully franked dividends to the extent of the SCA. Permitting the additional flexibility to pay partially franked dividends requires anti-abuse rules in addition to those adopted in the dividend exclusion prototype to prevent corporations from paying franked dividends to taxable shareholders and unfranked dividends to tax-exempt shareholders. See Section 11.F.

## Corporate Shareholders

The imputation credit prototype allows a corporate shareholder a 100 percent dividends received deduction (DRD) for both franked and unfranked dividends, regardless of the degree of affiliation.[19] Moving to a single level of tax under integration does not require increasing the DRD to 100 percent for unfranked and partially franked dividends. The dividend exclusion prototype, for example, retains current law for taxable dividends. See Section 2.B. The imputation credit prototype contains a 100 percent DRD for all dividends, however, because retaining current law for partially franked dividends would create unwarranted complexity.[20]

As under current law, the DRD would be available for dividends from domestic corporations and for a portion of dividends from certain foreign corporations engaged in business in the United States. Any imputation credit associated with a dividend would be added to the corporation's SCA. Adding the credit to the corporate shareholder's SCA preserves imputation credits for individual shareholders when the earnings are ultimately distributed out of corporate solution.

Because the 100 percent DRD would be equally available for fully franked and unfranked dividends, distributions of corporate preference income would be taxed only when ultimately distributed to individual shareholders. Mechanically, this result occurs because unfranked dividends do not increase the recipient's SCA.[21] Retaining the DRD for preference income is consistent with the rationale for a credit limitation system discussed above. Requiring immediate taxation in full of preference income received by corporate shareholders would represent a significant departure from current law and would increase the cost of intercorporate dividends. Preserving the DRD means that the ultimate taxability of preference income is determined at the individual level.[22]

Other countries adopting distribution-related integration have dealt with the issues presented by affiliated groups in a variety of ways. In most cases, these countries have permitted the extension of preferences while the income remains in corporate solution, as we suggest here. For example, New Zealand generally exempts intercorporate dividends from taxation and corporate shareholders are permitted to add credits from franked dividends to their own SCA. Similar rules apply in Australia for dividends received by public corporations and for franked dividends received by private corporations from within the same closely held group. In the United Kingdom, although the intercorporate dividends are generally subject to ACT, a "group dividend election" can be made to avoid the ACT and the imputation of credits with respect to distributions between closely affiliated corporations. See Appendix B.

## 11.C ROLE OF THE CORPORATE ALTERNATIVE MINIMUM TAX

Under current law, the corporate alternative minimum tax (AMT) seeks to ensure that, in each taxable year, corporations pay a minimum amount of tax on their economic income. A corporation must pay the higher of the AMT or the regular tax liability on its alternative minimum taxable income (AMTI) for the taxable year. Congress adopted the corporate AMT system in 1986 partly in response to widely publicized reports of major companies not paying taxes in years in which they reported substantial earnings and, in some cases, paid substantial dividends to shareholders.[23]

The imputation credit prototype retains the corporate AMT.[24] Because the imputation credit prototype described here does not substantially alter the current treatment of either retained or distributed preference income, the AMT would continue to serve its current function of limiting corporate tax preferences and ensuring that corporations continue to pay some minimum amount of tax on retained income.[25]

Since some corporations are subject only to the AMT and pay no regular corporate tax for long periods, the question whether the AMT should be considered taxes paid and added to the SCA is important. For these taxpayers, the corporate AMT is the only tax paid, and, despite the current law provisions that allow the AMT to be credited against regular corporate tax in subsequent years, it would not be realistic to view the AMT simply as an advance deposit against ultimate corporate tax liability. We therefore treat the AMT in the same manner as regular corporate taxes paid. Thus, each dollar of AMT is converted into an SCA balance using the formula set forth in Section 11.B.[26] At the corporate level, any AMT paid would continue to be carried forward and credited against regular corporate tax in subsequent years, but regular corporate tax that is not paid by reason of the credit allowed for AMT previously paid would not be treated as tax paid. Accordingly, under the prototype, both regular taxes paid and AMT paid would be added to the SCA, and regular tax that is offset by the AMT credit would not be added to the SCA. If the AMT were not treated as taxes paid, distributions attributable to earnings that have been subject to AMT would be taxed twice, and a higher rate of tax would be imposed on preference activities. However, if distributions are made with shareholder credits arising from payments of AMT, such reductions in the SCA will reduce the corporation's ability to pay franked dividends when the AMT reverses and the corporate tax is reduced by AMT credits.

## 11.D FOREIGN SOURCE INCOME

In general, the prototype permits a U.S. corporation to claim foreign tax credits against corporate tax to the same extent as under current law. A U.S. corporation, however, would increase its SCA only by the amount of the residual U.S. tax (if any) imposed on its foreign source income. Distributions out of foreign source income shielded from U.S. corporate tax by foreign tax credits generally would be unfranked and, therefore, would be taxed at the shareholder level as under present law.

Thus, U.S. corporate shareholders owning less than 10 percent of a foreign corporation's voting stock (the threshold requirement for claiming an indirect foreign tax credit under IRC § 902) would include in income, as under current law, dividends from the foreign corporation and claim a foreign tax credit for foreign withholding taxes. The corporate shareholder, however, would not add foreign income taxes paid by the foreign corporation or foreign withholding taxes on dividends to its SCA.

U.S. corporate shareholders owning at least 10 percent of a foreign corporation's voting stock would continue to include in income dividends from the foreign corporation and to claim a foreign tax credit for foreign withholding taxes on the dividend as well as foreign taxes paid by the foreign corporation. The corporate shareholder would add to its SCA only the U.S. residual tax, if any, paid on the dividend.[27]

U.S. corporations with foreign branch operations would continue to be subject currently to U.S. tax on their worldwide income with a credit for foreign income taxes imposed thereon.[28] As with earnings of foreign subsidiaries, the U.S. corporation would increase its SCA only by the amount of any residual U.S. tax imposed on the foreign source income.

The imputation credit prototype does not change the treatment of individuals owning stock in foreign corporations. U.S. individual shareholders would continue to include in income dividends received and claim a foreign tax credit for any foreign withholding taxes imposed on the dividend. Individual shareholders would not receive an imputation credit for any income taxes paid by the foreign corporation.

In connection with treaty negotiations with countries that have imputation credit systems, the United States may wish to consider whether imputation credits for foreign taxes paid could be extended on a bilateral basis. Serious complexities would arise, however, in applying at the individual shareholder level the foreign tax credit limitations that are designed to ensure that foreign taxes paid are not credited against U.S. taxes at tax rates in excess of the applicable domestic tax rate.

On the other hand, ignoring the foreign tax credit limitation would reduce or eliminate U.S. taxes on U.S. source income, in effect transferring domestic revenues to foreign treasuries. A possible approach might be to extend the benefits of foreign corporate taxes paid to individual U.S. shareholders in the form of a shareholder level exclusion of foreign source corporate income. Even in this event, care would need to be taken to avoid inappropriate results.[29]

## 11.E CHOICES REQUIRED BECAUSE OF SHAREHOLDERS WITH DIFFERENT RATES

### Tax-Exempt Shareholders

As discussed in Chapter 6, this Report recommends that integration retain the current treatment of corporate income distributed to tax-exempt shareholders.[30] Corporate taxable income would continue to bear one level of tax. Corporate preference income and foreign source income shielded from U.S. corporate tax by foreign tax credits would continue to be exempt from U.S. tax at both the corporate and shareholder level to the extent distributed to tax-exempt shareholders. Imputation credits could not be used against UBIT liability.[31]

### Foreign Shareholders

Chapter 7 of this Report recommends that foreign shareholders making inbound investments should not by statute receive the benefits of integration available to U.S. shareholders, and that any such extension of the benefits of integration should occur only through treaties. Accordingly, the imputation credit prototype does not permit foreign shareholders to claim a refund of the imputation credit or to use the credit to offset withholding tax imposed on dividends. The 30 percent statutory withholding tax would continue to apply to the amount of the dividend without gross up, subject to applicable treaty reductions. The branch profits tax would continue to apply to U.S. branches of foreign corporations. Thus, a U.S. branch of a foreign corporation would be taxable on its income effectively connected with a U.S. business (subject to any available treaty exemptions), and the branch's earnings withdrawn from the U.S. business (the dividend equivalent amount) would be subject to the branch profits tax under IRC § 884(a) (as modified by any applicable treaty), without credit for U.S. taxes paid on effectively connected income.

Denying imputation credits to foreign shareholders follows the approach generally adopted by our trading partners that have integrated corporate tax systems. Although the imputation credit would not be available to foreign shareholders as a statutory matter, a dividend to a foreign shareholder would reduce the distributing corporation's SCA by the same amount as if the distribution had been to a taxable domestic shareholder.[32]

### Low-Bracket Shareholders

The imputation credit prototype uses a rate of 31 percent to compute the shareholder credit. Consequently, taxpayers subject to maximum tax rates below 31 percent would receive imputation credits on dividends received that may exceed the shareholder level tax that would otherwise apply to dividends received. Unlike the dividend exclusion or CBIT prototypes, no additional mechanism (such as addition of a credit) is required to adjust the tax burden to the shareholder's rate because the franking process provides the shareholder with the data necessary to compute shareholder level tax (the grossed-up income and credit amounts). The prototype allows these taxpayers to use excess imputation credits to offset tax that would otherwise apply to unfranked dividends or other sources of income. This feature of the imputation credit system produces an additional revenue loss in comparison to the dividend exclusion prototype. Taxpayers who could not fully use such credits against other income could not claim a refund of the excess credits.[33]

## 11.F ANTI-ABUSE RULES

Adopting an imputation credit system in which imputation credits are not refundable to tax-exempt and foreign shareholders may create incentives for taxpayers to "stream" fully franked dividends to taxable shareholders and unfranked dividends to tax-exempt shareholders.[34] Similar incentives arise under the dividend exclusion prototype, in which corporations would prefer to pay excludable dividends to taxable shareholders and taxable dividends to tax-exempt shareholders. Section 2.B discusses the anti-abuse rules we consider appropriate to limit streaming in the dividend exclusion prototype, and we would adopt similar rules in the imputation credit prototype. Thus, for example, a holding period requirement would have to be met for a taxpayer to claim an imputation credit.

In general, opportunities for streaming would be reduced if the imputation credit prototype required corporations to pay fully franked dividends until their SCA balance were exhausted. In that case, the imputation credit system would be substantially similar to the dividend exclusion system, which requires corporations to pay excludable dividends to the extent of their SCA balances.[35]

Application of this rule in an imputation credit context, however, could interfere with corporate dividend practices by making the franking level (and hence shareholder tax consequences) of dividend distributions dependent on taxable income. To permit corporations to smooth the pattern of dividends, including the pattern of associated credits, the prototype permits corporations to pay partially franked dividends. Using this flexibility, a corporation could reserve a portion of its SCA balance to pay future franked dividends.

Because the imputation credit prototype permits corporations to pay partially franked or unfranked dividends even when they have an SCA balance sufficient to frank the dividend fully, two additional anti-abuse rules would be required. First, to prevent excessive franking of dividends, the prototype limits the amount of credit that can be attached to a dividend. The imputation credits attached to any dividend should not exceed the maximum creditable tax on the pre-tax earnings that generated the dividend. See Section 11.B. Second, the prototype requires corporations to frank all dividends paid during a year to the same extent. This rule prevents corporations from paying unfranked dividends on one class of stock held by taxable shareholders and unfranked dividends on another class of stock held by tax-exempt shareholders. This rule is essentially the same as that adopted by New Zealand.[36] This latter rule, while necessary to avoid distortion of corporate dividend payment practices, could give rise to significant complications for a corporation with multiple classes of dividend paying stock.

## 11.G STRUCTURAL ISSUES

### Corporate Acquisitions

The imputation credit prototype retains the basic rules of current law governing the treatment of taxable and tax-free corporate asset and stock acquisitions. Adopting the imputation credit prototype would permit taxable asset acquisitions to be made with only a single level of tax. Corporate tax paid on gain recognized on the sale of assets would be added to the SCA and would create imputation credits to offset shareholder tax when the corporation liquidates and distributes the proceeds from the sale. Stock acquisitions may face a higher tax burden than asset acquisitions under distribution-related integration if capital gains on corporate stock that are attributable to retained earnings are taxed in full at shareholder rates. See Section 8.A. This problem could be mitigated by a dividend reinvestment option. See Chapter 9.

Nothing in the movement to distribution-related integration would require a fundamental change in the basic pattern of taxing qualifying corporate reorganizations. Current law treats a qualifying corporate reorganization as tax-free at the corporate level (with the target's tax attributes, including its asset basis, carrying over to the acquiror) and at the shareholder level. The policy underlying the reorganization provisions is that imposition of tax is inappropriate where a corporate reorganization merely effects a readjustment of shareholders' continuing interests in corporate property under modified corporate forms. This policy applies equally under distribution-relation integration, because it reflects a judgment about when income should be recognized under a realization-based tax system that does not require corporate assets or stock to be marked to market, not a judgment about whether two levels of tax should be imposed on recognized corporate income.[37]

Rules would be needed to divide a corporation's SCA when it engages in a divisive reorganization. Rules are needed to discourage the use of divisive reorganizations to isolate amounts in the SCA in one corporation for the benefit of one group of shareholders.[38] Current law rules generally provide that earnings and profits of the distributing corporation in a divisive reorganization that qualifies as a D reorganization under IRC § 368(a)(1)(D) are divided between the distributing corporation and the controlled corporation based on the relative fair market value of their assets. A similar rule could be adopted to govern the allocation of SCA balances in divisive reorganizations.

For the reasons set forth in Chapter 2, we do not urge any rules limiting the use of SCA balances following an ownership change. See "Anti-abuse Rules" in Section 2.B.

## Earnings and Profits

The imputation credit prototype, like the dividend exclusion prototype, retains the current earnings and profits rules for determining when a distribution is treated as a dividend rather than a return of capital. See Section 2.F.

## 11.H EXTENDING THE IMPUTATION CREDIT PROTOTYPE TO DEBT

Adopting any of the methods of integrating the corporate and individual income taxes discussed in this Report would narrow significantly the differences in taxation of debt and equity. Under integration, only one level of tax generally would be imposed on corporate earnings distributed as dividends. Retaining the interest deduction also ensures that no more than one level of tax is collected on corporate earnings distributed as interest. Accordingly, the introduction of integration, without any change in the rules for taxing debt, would create greater parity in the taxation of debt and equity.

Because the dividend exclusion and imputation credit prototypes are designed to retain the existing level of corporate taxes on equity capital supplied by foreigners and tax-exempt entities, however, some disparities will remain in the treatment of debt and equity capital supplied by those investors. Retaining the interest deduction in an integrated system would permit earnings that are used to pay interest to tax-exempt and certain foreign bondholders to continue to escape U.S. tax entirely.

Thus, for tax-exempt and foreign investors at least, the dividend exclusion and imputation credit prototypes generally maintain current law's bias in favor of debt financing. Eliminating this bias is a principal argument for CBIT, which represents a natural extension of the dividend exclusion prototype to debt and imposes tax once at the entity level. Equating the treatment of debt and equity in an imputation credit prototype would require a different approach—a bondholder imputation credit system.

Under a bondholder credit system with no corporate level deduction for interest, the mechanics would generally follow the rules applicable to dividends. Corporate tax paid on earnings used to pay interest or dividends would be passed through to bondholders and shareholders as imputation credits. Bondholders and shareholders would include in income the amount of the cash interest or dividend payments plus the imputation credits and could use the credits to offset tax on interest income.[39] Tax-exempt and foreign shareholders would not be entitled to claim refunds of imputation credits, and taxable shareholders could use excess credits to offset tax on other income but not to claim refunds.[40]

A bondholder credit system differs in certain ways from CBIT, which equates the treatment of debt and equity at the business, rather than at the individual, level. An imputation credit system would tend to impose taxation on the supplier of business financial capital rather than on the entity. The two approaches are similar when the business and its suppliers of capital would be taxed at the same rates but will diverge if the tax rate of the supplier of capital is different from the CBIT rate.[41] Thus, for example, if both borrower and lender are taxable, but the lender's rate is less than the borrower's rate, CBIT will tax the interest income at the CBIT rate, while the bondholder credit system will generally tax the income at the lender's rate.[42]

Although the bondholder credit system would generally mirror the imputation credit prototype detailed in this chapter, addition of a bondholder credit may require reexamination of the treatment of foreign investors. The issues would be similar to those posed in moving from the dividend exclusion prototype to CBIT. Retaining current law would require collecting two levels of tax on dividends and zero or one level of tax on interest. Such treatment would, however, violate the equality between debt and equity that is the goal of adopting a bondholder credit system. Accordingly, to maintain parity between debt and equity, imputation credits should not be refundable to foreign investors, but the 30 percent withholding tax now applicable to dividends and nonportfolio interest (and the branch profits tax) should be repealed.[43]

## 11.I DIVIDEND REINVESTMENT PLANS (DRIPs)

Chapter 9 discusses how a corporation might use an elective DRIP in the dividend exclusion and CBIT prototypes to allow shareholders to increase share basis to reflect earnings that have been taxed at the corporate level. A DRIP minimizes the extent to which taxing capital gains on sales of corporate stock imposes a second level of tax on such earnings. See Chapter 8.

An elective DRIP could be made a part of an imputation credit prototype as well. A corporation would be permitted to declare deemed dividends up to the amount that can be fully franked by the balance in its SCA.[44] Shareholders would include in income the amount of the deemed dividend plus the associated imputation credit and could use the credit to offset tax due.[45] Share basis would increase by the amount of the deemed dividend.[46]

Permitting a DRIP in the imputation credit prototype requires one additional rule to limit streaming of credits. As discussed in Section 11.F, the prototype limits streaming through cash dividends by requiring each corporation to frank all cash dividends paid during a year in the same proportion (the consistency rule).[47] The consistency rule is necessary because the imputation credit prototype, unlike the dividend exclusion and CBIT prototypes, permits corporations to determine the extent to which dividends (and interest payments, if a bondholder credit were adopted) are franked.

Absent additional restrictions, a corporation could use a DRIP to stream by paying unfranked cash dividends on classes of stock held by tax-exempt shareholders and fully franked deemed dividends on classes of stock held by taxable shareholders. To limit this practice, the prototype permits corporations to use an elective DRIP only if all cash dividends paid during some defined period before and after the deemed dividend are fully franked. This rule effectively extends the consistency rule to deemed dividends and limits the benefits of a DRIP to corporations that pay insufficient cash dividends to carry out its SCA balance—not those that underfrank cash dividends and distribute the remainder of the SCA through the DRIP.[48]

# CHAPTER 12: OTHER PROPOSALS TO REDUCE THE BIAS AGAINST CORPORATE EQUITY

## 12.A DIVIDEND DEDUCTION

We have not developed a dividend deduction prototype in this Report. However, the 1984 Department of the Treasury Report on tax reform recommended a 50 percent dividends paid deduction and the President's 1985 tax proposals included a 10 percent deduction.[1] A dividend deduction system produces results contrary to our general recommendations that integration not be the occasion for eliminating the corporate level tax imposed under current law on distributions to tax-exempt and foreign shareholders.[2] We view these general recommendations as important in ensuring that corporate income distributed to such shareholders continues to bear tax similar to that under current law. In addition, a dividend deduction proposal would be substantially more expensive than either a dividend exclusion or imputation credit system.[3]

The primary arguments for a dividend deduction approach are that it results in equivalent treatment for debt and equity and that it taxes distributions at the shareholder rate. The first claim is not strictly accurate to the extent that interest is deductible as it accrues while dividends are deductible only when paid.[4] The second claim is correct but will exacerbate the bias toward distribution of earnings inherent in any distribution-based system, particularly when, as under current law, the corporate rate exceeds individual rates.

If policymakers were to select a dividend deduction system, it would be important to incorporate a mechanism analogous to the EDA of the dividend exclusion prototype to limit the amount of deductible dividends to the amount on which U.S. corporate tax has been paid.[5] Absent such a restriction, a dividend deduction system would allow a deduction for dividends paid out of preference income and foreign source income sheltered from U.S. tax by foreign tax credits. Allowing such deductions would not simply eliminate corporate taxes paid on that income (because, by definition no U.S. corporate taxes have been paid) but instead would permit the corporation to shelter earnings on which U.S. corporate tax would otherwise be imposed.[6]

It is not altogether clear how a dividend deduction system would treat foreign shareholders. Presumably, the deduction would be allowed for dividends paid to foreign shareholders, and the 30 percent withholding tax on dividends would be retained, although treaty provisions reduce the withholding tax to as low as 5 percent. Similarly, the branch profits tax on domestic branches of foreign corporations presumably would be retained with a modification to provide parity with the dividend deduction for domestic corporations.

Since dividends would be taxable only to the recipient in a dividend deduction proposal, there would be no dividends received deduction for corporations.[7] A DRIP probably would not be appropriate in a dividend deduction approach because it could result in allocation of taxable income to shareholders without receipt of cash sufficient to satisfy the shareholder's resulting tax liability.[8]

While we have not developed a dividend deduction prototype in this Report, we review below two proposals for dividend deduction systems, one made in 1991 by the Capital Taxes Group of the Institute for Fiscal Studies in the United Kingdom and one made in 1989 by the Reporter for the American Law Institute's Federal Income Tax Project (Subchapter C). These proposals are not presented here as fully as other integration prototypes but are included as related proposals intended to improve the neutrality of the tax treatment of debt and equity finance for corporations.

## 12.B INSTITUTE FOR FISCAL STUDIES PROPOSAL

The Capital Taxes Group of the British Institute for Fiscal Studies (IFS) proposed the introduction of an "Allowance for Corporate Equity" (AFCE).[9] Under this approach, a corporation would be allowed to deduct in its calculation of taxable income an allowance based on shareholders' equity employed in the business. The intent of this proposal is to enhance neutrality by treating equity finance like debt finance.[10]

The deductible AFCE allowance would be equal to the product of "shareholders' funds" (generally the corporation's total equity capital)[11] and an "appropriate nominal interest rate." The interest rate used for calculating the AFCE would be set by the government for all corporations and, in general, should reflect a normal market rate of return. The IFS recommends that the rate be established each month equal to the rate for a medium-term government security. Because firms with risky opportunities or facing informational imperfections in capital markets would have costs of funds significantly higher than the allowable rate for deduction, mature, less risky firms would receive a greater relative benefit from the AFCE system.

The AFCE system prevents double counting of intercorporate investments by reducing shareholders' funds by the amount of funds invested in other firms. It also prevents allowance of both an interest deduction and an AFCE allowance with respect to intercorporate equity investments funded by debt by imputing a negative AFCE adjustment to the borrower.[12]

The AFCE proposal is designed to operate in a classical corporate tax system to reduce the tax bias against equity finance. The IFS proposal is not a true integration proposal. Corporate equity income in excess of the AFCE allowance would remain subject to a second level of tax when such income is distributed or when shareholders are taxed on capital gains attributable to such income. As a consequence, the IFS proposal would not eliminate the bias against the corporate form and the incentive to retain rather than distribute corporate equity income in excess of the AFCE allowance.

## 12.C AMERICAN LAW INSTITUTE REPORTER'S STUDY DRAFT

In 1989, the Reporter for the American Law Institute (ALI) Federal Income Tax Project (Subchapter C) outlined a set of four proposals for reform of the corporate tax.[13] The Reporter's Study Draft proposals are not integration proposals. They are intended to revise the classical corporate tax system to reduce the tax bias against new equity finance and to eliminate the tax bias against dividend distributions relative to nondividend distributions, e.g., share repurchases. The latter goal would be accomplished by increasing tax rates applied to nondividend distributions rather than by decreasing tax rates applied to dividend distributions.

The Reporter's Study Draft advances two proposals to reduce the tax bias against new equity finance. First, corporations would receive a deduction for dividends paid on new equity capital (Qualified Contributed Capital or QCC).[14] The deduction would be equal to a prescribed interest rate multiplied by net contributed capital less extraordinary dividends and nondividend distributions. The prescribed interest rate for deductions would be limited to the long-term borrowing rate specified under IRC § 1274, plus 2 percent.

Second, the Reporter's Study Draft would limit corporate interest deductions to the net amount of debt capital raised. In particular, no deduction would be allowed for interest on "converted equity," including debt incurred to finance an extraordinary dividend or stock acquisition, share repurchase, or any other nondividend distribution. The deduction allowed for interest on any other type of debt also would be limited to the long-term borrowing rate specified under IRC § 1274 plus 2 percent.

Taken together, these two proposals are designed to reduce the tax bias against new equity finance.[15]

The concern over the tax bias against dividend distributions relative to nondividend distributions motivates the other two proposals in the Reporter's Study Draft. First, the ALI Reporter proposes a "minimum tax on distributions" (MTD) equivalent to 28 percent of the gross amount of any extraordinary dividend or nondividend distribution, including distributions in redemption and liquidation and any purchase of shares. The tax would be collected by the distributing corporation, and would be creditable against a shareholder's tax on the distribution (but not against other income).[16]

Second, in the case of direct investments in a corporation by another corporation, the Reporter's Study Draft would treat a purchase of shares in a corporation by another corporation that owns at least 20 percent of the shares as a nondividend distribution subject to the MTD and other applicable rules. However, intercorporate dividends would not be subject to tax, and basis adjustments similar to those provided under the current consolidated return regulations would be made. For portfolio investments, on the other hand, the investor corporation would be taxed in full like any other investor and no dividends received deduction would be allowed.[17]

The Reporter's Study Draft proposals would reduce the tax bias against new equity finance, while maintaining the tax bias against dividend payments from accumulated equity. The economic assumptions underpinning the ALI proposals seem to be those of the "new view" of dividend taxation, in which the taxes on dividends from accumulated equity are capitalized into share values and do not affect dividend decisions. As a result, extending dividend relief to accumulated equity is perceived as conferring a windfall gain to "old" equity, since under the assumptions of the new view, dividend distributions are unavoidable. As discussed in Chapter 13, we accept the "traditional view," in which reducing the tax burden on dividends generally increases dividend payouts and economic efficiency.[18]