INTERNATIONAL ASPECTS OF CORPORATE-SHAREHOLDER TAX INTEGRATION

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TABLE OF CONTENTS

		Page
I.	INTRODUCTION	1
II.	PRESENT LAW	3
III.	PRINCIPLES OF U.S. INTERNATIONAL TAX POLICY	7
IV.	ANALYSIS	10
V.	CONCLUSION	22
	REFERENCES	25

ABSTRACT

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George N. Carlson

The integration of corporate and shareholder taxes has received considerable attention in recent years. Several major trading partners of the United States, including Canada, France, Germany, Japan, and the United Kingdom, have integrated their tax structures by giving individual shareholders a credit for taxes paid at the corporate level on distributed corporate earnings. Periodically, in response to a perceived inadequacy of capital formation, integration also has aroused the interest of policy makers in the United States.

Most of the countries that have integrated their tax systems allow individual shareholders a credit for taxes paid at the corporate level on distributed earnings. In effect, some of the taxes paid by the corporation are "imputed to," or treated as paid by, the shareholder.

This form of integration, coupled with the flow of capital across international borders, gives rise to two important international taxation issues:

1. Whether nonresident shareholders are entitled to the credit for corporate taxes.

2. Whether a resident taxpayer is entitled to the credit for foreign corporate taxes paid.

The first issue pertains to whether the country adopting the integrated system will extend the credit to nonresident shareholders in domestic corporations. The second relates to whether a foreign corporate tax will be creditable against the domestic income tax in the shareholder's country of residence.

This paper analyzes these issues with respect to three of the basic objectives of U.S. international tax policy: "capital export neutrality," nondiscrimination in the taxation of residents and nonresidents, and an equitable division of tax revenues between the source and residence jurisdictions. It suggests a mechanism for simultaneously achieving these objectives within the context of an integrated system.

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INTERNATIONAL ASPECTS OF CORPORATE-SHAREHOLDER TAX INTEGRATION *

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I. INTRODUCTION

The integration of corporate and shareholder taxes has received considerable attention in recent years. Several major trading partners of the United States, including Canada, France, Germany, Japan, and the United Kingdom, have integrated their tax structures by giving individual shareholders a credit for taxes paid at the corporate level on distributed corporate earnings. In response to a perceived inadequacy of capital formation, integration also has aroused the interest of policy makers in the United States.

The Ford administration, for example, proposed dividend integration as part of its 1975 tax reform recommendations. 1/ The Task Force on Capital Formation of the House Committee on Ways and Means examined integration as part of its 1976 study of investment needs and incentives. 2/ The Treasury Department, in response to one of President Carter's campaign pledges, looked closely at several methods for integrating the corporate and individual income taxes in developing the Administration's 1978

1/ Tax Reform, statement of William E. Simon, Secretary of the Treasury, Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Congress, 1st Session, Part 5, pp. 3843-3863.

2/ Tax Policy and Capital Formation, committee print, prepared for Task Force on Capital Formation of the Committee on Ways and Means by the Joint Committee on Taxation, April 4, 1977, pp. 9-17.

* This article appeared in substantially the same form in the Case Western Reserve Journal of International Law, Vol. 11, no. 3, Summer 1979.

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tax reform proposals. Because of the complexity of the issues and the need for an immediate economic stimulus, the Administration decided not to propose an integration plan, but to rely on other forms of tax relief for business. 3/ Chairman Ullman of the Committee on Ways and Means proposed a partial integration plan as an "important start toward making corporate finance more efficient and more responsive to the country's need for increased capital formation." 4/ The Congress, however, in passing the Revenue Act of 1978, opted for lower corporate rates and a more generous investment tax credit as the vehicle for reduced taxation of capital.

While there are a variety of methods (see, for example, Ault, 1978; Chown, 1971; McLure, 1979) most of the countries that have integrated their tax systems allow individual shareholders a credit for taxes paid at the corporate level on distributed earnings. In effect, some of the taxes paid by the corporation are "imputed to", or treated as paid by, the shareholder.

This form of integration, coupled with the flow of capital across international borders, gives rise to two important international taxation issues:

1. Whether nonresident shareholders are entitled to the credit for corporate taxes.

2. Whether a resident taxpayer is entitled to the credit for foreign corporate taxes paid.

The first issue pertains to whether the country adopting the integrated system will extend the credit to nonresident shareholders in domestic corporations. The second relates to whether a foreign corporate tax will be creditable against the domestic income tax in the shareholder's country of residence.

In Section IV of this paper these issues are analyzed with respect to three of the basic principles of U.S. international tax policy: "capital export neutrality," nondiscrimination in the

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3/ See statement of Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy, "Integration of the Corporate and Individual Income Tax," before the Committee on Ways and Means of the House of Representatives, April 7, 1978, Treasury Department News Release, B-818.

4/ Congressional Record, February 2, 1978, pp. H640-H642.

taxation of residents and nonresidents, and an equitable division of tax revenues between the source and residence jurisdictions. Section III describes these principles. Section II reviews the taxation of corporations and shareholders under separate entity and integrated tax systems. Conclusions are presented in Section V.

II. PRESENT LAW

Separate Entity System. With limited exceptions, the United States has a "classical" or separate entity system of taxation. 5/ A corporation is taxed on its earnings (as a separate entity) and its shareholders are taxed again on distributed earnings. Double taxation is reduced at the corporate level by allowing a U.S. corporation to deduct 85 percent or 100 percent, depending on the degree of affiliation, of dividends received from other U.S. corporations. 6/ Generally, earnings distributed to individual shareholders are fully taxable. 7/

The present U.S. corporate tax rates are 17 percent on the first $25,000 of taxable income, 20 percent on all income in excess of $25,000 up to $50,000, 30 percent on all income in excess of $50,000 up to $75,000, 40 percent on all income in excess of $75,000 up to $100,000, and 46 percent on all income in excess of $100,000. 8/ Resident individuals are subject to tax on dividends at rates ranging from 14 percent to 70 percent. 9/

5/ Subchapter S of the Internal Revenue Code is a notable exception. It permits a corporation with 15 or fewer shareholders to elect not to pay corporate tax on its income and instead have the shareholders pay taxes on the income, whether distributed or not.

6/ Internal Revenue Code, Section 243.

7/ Under the Internal Revenue Code Section 116, a shareholder is allowed to exclude $100 of dividends from taxable domestic corporations from his taxable income. Prior to 1964, the law provided for an exclusion from income of the first $50 of dividends received from domestic corporations as well as a 4 percent credit against tax of dividends in excess of $50.

8/ Internal Revenue Code, Section 11.

9/ Internal Revenue Code, Section 1.

Nonresident alien individuals and foreign corporations are subject to a statutory withholding tax of 30 percent on dividend income not effectively connected with a U.S. trade or business. 10/

The separate entity principle extends to U.S. shareholders in a foreign corporation. U.S. citizens, residents, and corporations are subject to U.S. taxation on their worldwide income. U.S. shareholders in a foreign corporation, however, generally are taxable only on income received as dividends, not on income retained by the foreign corporation. Because the U.S. tax is deferred until the earnings of a foreign corporation are distributed to the U.S. shareholders, this consequence of a separate entity system is known as "deferral".

Integration Systems. There are a variety of methods for integrating corporate and individual income taxes. Under full integration, which no country has adopted, all of a corporation's income, whether distributed or not, would be taxable only to the shareholders. The corporation would be taxable as a partnership. To guard against the shareholder being unable to pay the tax, the corporation tax would probably be kept as a withholding device to be creditable against the shareholders' individual tax liability. 11/

The countries that have integrated their tax structures have done so only with respect to distributed earnings. This is known as partial integration and can be accomplished by either (1) the split-rate or dividend deduction method or (2) an imputation or shareholder credit system. The former provides relief at the corporate level by taxing dividends at either a reduced or zero rate. Prior to 1976, for example, the German split-rate system provided for a 51 percent tax on retained earnings and a 15 percent tax on distributed earnings.

The imputation or shareholder credit method of integration has been adopted by Canada, France, and the United Kingdom. In contrast to the split-rate system, tax relief is provided at the

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10/ Internal Revenue Code, Sections 871 and 881. An income tax treaty between the United States and another country usually provides a withholding rate on dividends reduced to 15 percent or less.

11/ This was one of the recommendations of the Canadian Royal Commission on Taxation, also known as the Carter Commission. See Canadian Royal Commission (1965) and Bucovetsky and Bird (1972).

shareholder level by allowing the shareholder a credit for part (partial imputation) or all (full imputation) of the corporate taxes paid on distributed earnings. Some countries, such as Germany and Japan, have adopted a "hybrid" system with both a split-rate and shareholder credit. 12/

The dividend deduction and imputation systems are illustrated in examples 1 and 2.

Example 1

Dividend Deduction System

Corporation			Individual shareholder	Tax rate 20%	Tax rate 60%
Income		$100			
Dividend		40			
Dividend deduction (50%)		20	Cash dividend	$40	$40
Taxable income		$ 80	Tax	8	24
Tax (50%)		40	After-tax cash flow	32	16
After-tax income		60	Total (corporate plus shareholder) tax	48	64
Retained earnings	$20				
Dividend	40				

In example 1, the corporation is allowed to deduct 50 percent of dividends paid. Assuming a tax rate of 50 percent, it has a tax liability of $40 and retained earnings of $20 after paying a dividend of $40. The shareholder's after-tax cash flow is $32 and $16, assuming individual income tax rates of 20 percent and 60 percent, respectively.

12/ For a detailed description of foreign integration systems see Ault and Radler (1976), Chown (1971), Gourevitch (1977), NTA-TIA Symposium (1975), and Sato and Bird (1974).

Example 2

Shareholder Imputation System

Corporation			Individual shareholder	Tax rate 20%	Tax rate 60%
Income		$100	Cash dividend	$30	$30
Corporate tax		50	Gross up (1/3)	10	10
After-tax income		$ 50	Gross dividend	$40	$40
Retained earnings	$20		Tax	8	24
Dividend	30		Tax credit	10	10
			After-tax cash flow	32	16
			Total (corporate plus shareholder) tax	48	64

This system allows the shareholder a credit, equal to one-third of the dividend, for taxes paid at the corporate level. The shareholder "grosses up" or increases the $30 cash dividend by the $10 in corporate tax claimed as a credit at the shareholder level. 13/ The shareholder is taxed on the "grossed up" dividend, but is entitled to a credit of $10 for corporate taxes paid. The corporation's retained earnings and the individual shareholder's cash flow are the same as in Example 1.

Thus, while the split-rate system nominally provides relief at the corporate level and the imputation system at the shareholder level, the two systems can be made equivalent, provided the cash dividend is reduced under the imputation system. The lower cash dividend leaves the shareholder in the same after-tax position because he receives a tax credit with the dividend. After-tax corporate profits (dividends plus retained earnings) are higher under the dividend deduction system.

13/ It may seem odd to require the shareholder to include corporate taxes in his taxable income. This is necessary because the imputation system treats taxes paid at the corporate level as paid by the shareholder, i.e., imputes them to the shareholder. This part of the corporate tax can be thought of as a withholding tax, similar to wage withholding, against the shareholder's individual tax liability. It is included in the shareholder's income, just as is the withholding tax on wages.

III. PRINCIPLES OF U.S. INTERNATIONAL TAX POLICY

Under either a separate entity or integrated tax system, the movement of capital across national boundaries gives rise to competing tax claims. The two basic jurisdictional standards for asserting tax liability are source and residence. 14/ Under the source standard, a country asserts tax jurisdiction over income earned within its geographical area. It makes no difference who receives the income; residents and nonresidents are both taxed on income derived from within the source jurisdiction. 15/

The residence of the taxpayer, rather than the source of income, is the relevant criterion under the residence principle. Residence is usually defined in terms of domicile for individuals and place of incorporation or management for corporations. Worldwide taxation is closely related to the residence principle since a resident may be subject to taxation on income from all sources, foreign as well as domestic.

Most countries have a combination of source and residence rules. U.S. citizens and residents, for example, are subject to U.S. taxation on their worldwide income, while nonresident foreign taxpayers are generally subject to U.S. taxation only on their U.S.-source income. 16/ The same income may be taxed twice if it is subject to taxation in both the source and residence jurisdictions. A foreign subsidiary of a U.S. corporation, for

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14/ The United States also taxes on the basis of citizenship.

15/ Residents and nonresidents are not necessarily taxed the same. Sections 871 and 881 of the Internal Revenue Code, for example, impose a flat-rate tax of 30 percent on U.S.-source dividends, not effectively connected with a U.S. trade or business, received by nonresident alien individuals and foreign corporations. Although known as a "withholding" tax, the 30 percent tax does not represent a prepayment of domestic income tax, but a final tax payment that is a substitute for being taxed at the regular rates applied to resident individuals and corporations.

16/ Nonresident foreign taxpayers are subject to U.S. taxation at the normal rates on income "effectively connected" with a U.S. trade or business and to the basic 30 percent withholding tax on U.S.-source investment income, such as dividends, interest, and royalties. The 30 percent rate frequently is reduced by a tax treaty.

example, normally will be subject to foreign tax on its earnings in the source jurisdiction, and the subsidiary's dividends will be subject to U.S. taxation when received by the U.S. parent.

The need to resolve this "international double taxation" has given rise to the following basic principles of U.S. international tax policy: capital export neutrality, nondiscrimination between residents and nonresidents, and a reasonable division of revenue between the source and residence countries.

Capital Export Neutrality. This principle requires that an enterprise pay the same total taxation on its foreign as on its domestic profits. If, for example, a foreign subsidiary of a U.S. corporation is taxed in the foreign country at 40 percent, capital export neutrality would require a current U.S. tax of 6 percent on those profits. 17/ Capital export neutrality tends to maximize world output or efficiency by permitting investment decisions to be made independent of tax considerations on the basis of the most favorable before-tax rates of return. 18/ Capital is allocated optimally in that it is invested where, adjusted for risk, its return is greatest.

The foreign tax credit is the cornerstone of the U.S. policy of capital export neutrality. 19/ Foreign and domestic profits of a U.S. corporation tend to be taxed the same because taxes paid to a foreign country can be subtracted from the taxpayer's U.S. tax liability. The credit is available for income taxes paid on foreign branch earnings, withholding taxes on dividends from a

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17/ This assumes a U.S. corporate tax rate of 46 percent. The effective U.S. rate on domestic profits is, however, less than this because of the investment tax credit and asset depreciation range, which are not available for foreign investment. Equal investment incentives relate, of course, to effective, not nominal, rates.

18/ An alternative criterion is the maximization of national, rather than world, income. This would be accomplished by allowing a deduction, rather than a credit, for foreign taxes. Still another concept is captial import neutrality, achieved when both foreign and domestic firms pay the same ultimate tax in the country in which they are operating. For a discussion and evaluation of these concepts, see Hufbauer (1975, pp. 1-6), and Musgrave (1972, pp. 176-219).

19/ The policy is more properly characterized as "modified" capital export neutrality, in that foreign taxes are creditable only up to the U.S. level and earnings of a foreign subsidiary are not taxed until repatriated as dividends.

foreign corporation, 20/ and the corporate tax on the underlying earnings out of which the dividends are paid, provided the U.S. taxpayer is a corporation that owns at least 10 percent of the foreign corporation. 21/

The credit is limited to the U.S. tax liability on the taxpayer's foreign source income. 22/ A taxpayer therefore pays the higher of the U.S. or foreign rate. If, for example, the U.S. rate is 46 percent and the foreign rate is 44 percent, the U.S. Treasury will collect 2 percent from the U.S. taxpayer. If, however, the foreign rate is 52 percent, the U.S. Treasury will neither collect revenue nor refund the 6 percent excess to the U.S. taxpayer. 23/ The purpose of the limit is to prevent foreign taxes from reducing U.S. taxation of domestic source income.

Nondiscrimination. This principle, which requires equal treatment for residents and nonresidents, is another tenet of U.S. international tax policy. A foreign branch or subsidiary of a U.S. corporation, for example, should not be subject to heavier taxation in the foreign country than a branch or subsidiary of a domestic corporation is taxed in that country. U.S. treaty policy is aimed at assuring that U.S. investors are not subject to discriminatory tax treatment by a foreign country. U.S. statutory policy aims at nondiscriminatory U.S. taxation of

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20/ Unlike a withholding tax on the wages of a resident, a dividend withholding tax is levied at a flat rate and is a final rather than provisional tax payment. Withholding taxes on dividends paid to nonresidents frequently are reduced to 10 to 15 percent by treaty.

21/ Internal Revenue Code, Sections 901 and 902.

22/ Internal Revenue Code, Section 904.

23/ Prior to the Tax Reform Act of 1976, the foreign tax credit limitation could be determined on either a per-country or overall basis. The Act repealed the per-country limitation and requires all taxpayers to use the overall method. This method combines income from various sources, effectively enabling an "averaging" of high and low foreign tax rates. If a taxpayer has foreign income that has been subject to a relatively low tax, it is possible the entire the 52 percent foreign tax in the example would be creditable against the U.S. tax liability.

foreigners. While dividends from a foreign subsidiary are usually subject to a withholding tax in the foreign country, this is acknowledged to be an acceptable alternative to the inability of the source country to subject a nonresident's entire income to its individual income tax system.

Tax Revenue Division. The United States is also interested in an "equitable" or reasonable division of tax revenue between the source and residence countries. The foreign tax credit cedes the first slice of tax revenue to the source jurisdiction, leaving the residence jurisdiction with only residual taxing rights. The United States feels this is reasonable in that it is appropriate for the source jurisdiction to receive the major share of the revenue.

IV. ANALYSIS

Most of the countries that have integrated their tax systems have chosen the shareholder imputation rather than the dividend deduction system. This reflects a desire to explicitly exclude nonresident shareholders from the benefits of integration by not extending the imputation credit to them. These countries are aware that the split-rate or dividend deduction system automatically extends the benefits of integration to nonresident shareholders through the reduced or zero rate applied to all dividend distributions. It would be possible to effectively deny the benefits of integration by levying an increased withholding tax on distributions to nonresidents, but existing treaties with provisions for reciprocal withholding rates generally would prohibit this.

Imputation Credit to Nonresidents: Portfolio Investment. Largely because of revenue considerations, imputation countries are reluctant to extend the integration tax credit to nonresident shareholders in domestic corporations. 24/ Separate entity countries, like the United States, argue that the principle of nondiscrimination demands its extension. Table 1, which assumes a separate entity system in the United States and a shareholder imputation or gross up and credit system in the foreign country,

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24/ It has been extended by treaty. Under the January 1, 1970, protocol to the United States - France income tax treaty, France extends the same shareholder credit to U.S. individuals and corporate portfolio investors in a French corporation that it provides French investors. A U.S. corporation that owns 10 percent or more of the shares of a French corporation, and is thus a direct, rather than portfolio, investor, is excluded from the scope of the protocol.

Table 1

Cash Flow and Tax Liability Consequences for Resident and Nonresident Portfolio Shareholders under Separate Entity and Foreign Imputation Systems 1/

	Shareholder's income and tax	Resident shareholder in U.S. corporation (1)	Resident shareholder in foreign corporation (2)	Nonresident shareholder in foreign corporation: No credit (3)	Nonresident shareholder in foreign corporation: Full credit extended (4)
1.	Cash dividend	$100	$100	$100	$100
2.	Gross up	--	50	--	50
3.	Taxable income (1 + 2)	100	150	--	150
4.	Tentative tax liability 2/	33.33	50	33.33	50
4a.	U.S. 3/	33.33	--	18.33	27.50
4b.	Foreign 4/	--	50	15	22.50
5.	Shareholder imputation credit (2 = 5)	--	50	--	50
6.	Net tax liability (4 - 5)	33.33	0	33.33	0
6a.	U.S.	33.33	--	18.33	27.50
6b.	Foreign	--	0	15	(27.50) 5/
7.	After-tax cash flow (1 - 6)	66.67	100	66.67	100

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1/ The hypothetical foreign imputation system provides for a gross up and credit equal to one-half the cash dividend. Assuming a corporate tax rate of 50 percent, this would integrate one-half the corporate tax with the individual income tax.
2/ Assumes an individual tax rate of one-third in the shareholder's country of residence.
3/ Assumes shareholder receives credit for foreign taxes against U.S. tax liability.
4/ Assumes nonresident shareholder subject to withholding tax of 15 percent on taxable income.
5/ Withholding tax of $22.50 less credit of $50, for a refund of $27.50.

provides a basis for evaluating these claims with respect to an individual shareholder's portfolio, or less than 10 percent ownership, investment.

Column 1 shows that a resident individual shareholder receiving a $100 dividend from a U.S. corporation and subject to an individual tax rate of one-third would have an after-tax cash flow of $66.67. A similarly situated resident individual in the imputation country would receive $100 according to column 2. The integration of the corporate and shareholder taxes in the foreign country accounts for the difference.

Column 3 shows that a nonresident shareholder who does not receive the imputation credit also would receive an after-tax payment of $66.67. This would appear to fulfill the criterion of capital export neutrality and the revenue split (roughly $18 U.S. and $15 foreign) would seem to be reasonable. Denying the credit to a nonresident shareholder, however, violates the principle of nondiscrimination. The nonresident shareholder is subject to heavier taxation in the foreign country than is the resident shareholder because he receives a net dividend of only $85 ($100 cash less $15 withholding tax) whereas the resident shareholder receives a net dividend of $100. An important practical consequence is that the switch from a classical to an integrated system will probably mean a reduced after-tax cash flow for the foreign investor. In order to share in the benefits of integration, most corporations would probably reduce their cash dividends in response to the imputation system. Resident shareholders would still be likely to have an increased after-tax cash flow because of their entitlement to a tax credit. The nonresident shareholders, however, will be left with only the smaller cash dividend.

Extending the credit to the nonresident shareholder, as shown in column 4, eliminates this discrimination. Both residents and nonresidents are taxable on a cash dividend of $100 plus a $50 shareholder credit. 25/ This may, however, be inconsistent with

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25/ It is true that the nonresident shareholder is taxed at only a 15 percent withholding rate on a grossed-up dividend of $150 while the resident shareholder is taxed at an individual tax rate of 33-1/3 percent. A withholding tax on nonresidents, however, is the internationally accepted alternative to the taxation of resident individuals at the regular rates. It is not intended as a full or final tax, since only the country of residence can determine the "appropriate" tax burden by giving consideration to the taxpayer's total income, deductions, and exemptions. The withholding tax concept is not considered a departure from the nondiscrimination principle.

capital export neutrality, since the nonresident shareholder in a foreign corporation now receives an after-tax payment of $100, while the resident shareholder in a U.S. corporation receives only $66.67. One might respond that foreign and domestic profits bear the same total individual tax rate (one-third), but the total foreign dividend (cash plus tax credit) is larger because of the reduction in corporate tax inherent in the imputation system. Still, for a given cash dividend ($100), the investor in the foreign corporation receives a larger after-tax cash flow than the investor in a U.S. corporation.

The revenue division is altered greatly if the source country extends the imputation credit to nonresidents, since it will be giving up all of the integrated portion of its corporate income tax with respect to dividends paid to non-residents. The source country is left with only the revenue from the unintegrated portion of its corporate income tax. A country, such as Germany, that has integrated its entire corporate tax on distributed earnings (full imputation, but not full integration) would, except for a withholding tax, collect no tax on dividends paid to nonresidents. This result might be reasonable if one views the German system, which gives a resident shareholder full credit against his individual tax liability for corporate taxes paid on dividend income, as totally eliminating the corporate tax on distributed earnings.

Imputation Credit to Nonresidents: Direct Investment. The imputation countries are even more reluctant to extend the shareholder credit to nonresident direct investors. 26/ In addition to the obvious revenue considerations, they point out that the theory of an imputation system is to provide relief for corporate taxes with respect to distributions taxed at the individual level. Since a direct investor (at least 10 percent ownership) normally will be a corporation, these countries feel there is little reason for providing corporate tax relief for distributions still in corporate solution. Moreover, as explained below, because of the operation of the indirect or deemed paid foreign tax credit, 27/ the benefits of extending the credit to direct investors frequently will go to the treasury of the residence country rather than to the shareholder.

26/ The recent U.S.-U.K. income tax treaty is a notable exception. That treaty would extend one-half of the U.K. imputation credit to U.S. direct investors in U.K. corporations.

27/ The credit for foreign taxes paid on the corporate earnings out of which the distributions are paid.

From the viewpoint of separate entity countries, such as the United States, it is discriminatory to deny the credit to nonresidents. They observe that the imputation country has decided to reduce its level of corporate taxation on distributed earnings. Whether this is done through an imputation credit or a reduced rate on distributed earnings is immaterial; to tax residents and nonresidents differently violates the principle of nondiscrimination. Suppose, to illustrate the point, that a corporation wholly owned by residents paid no corporate tax, but a corporation wholly owned by nonresidents paid a 50 percent corporate tax. The separate entity countries argue that this clearly would be discriminatory and that denying the imputation credit to nonresidents is also discriminatory.

Table 2 provides a basis for evaluating these views. It assumes that the United States has a separate entity system of taxation and that the foreign country has partially integrated its taxes via the imputation method.

Column 1 shows that a U.S. resident individual receiving a $100 dividend from a U.S. corporation and subject to an individual tax rate of one-third would have an after-tax cash flow of $66.67. The United States, of course, would collect the entire $133.33 in tax on the $200 in income earned at the corporate level. According to column 2, a foreign resident individual investing in a foreign corporation would receive after-tax income of $80. Although the corporate tax rate is assumed to be higher in the foreign country, the individual shareholder receives a higher after-tax payment because of integration.

Columns 3 through 5 illustrate the position of a nonresident shareholder in a foreign corporation under differing treatment of the imputation credit. Since the foreign direct investor is assumed to be a corporation, a U.S. corporation is interposed between the foreign corporation and the U.S. resident individual shareholder.

If the imputation country does not extend the credit, the U.S. corporate shareholder receives a dividend of $80. Since the corporation's U.S. tax liability is offset by its foreign tax

Table 2

Cash Flow and Tax Liability Consequences for Resident and Nonresident Direct Investors under U.S. Separate Entity and Foreign Imputation Systems 1/

	U.S. corporation (1)	Foreign corporation (2)	Foreign corporation (3)	Foreign corporation (4)	Foreign corporation (5)
Corporate level income					
1. Taxable income	$200	$200	$200	$200	$200
2. Corporate tax 2/	100	120	120	120	120
3. Net income (1 - 2)	100	80	80	80	80
4. Cash dividend	100	80	80	80	80
Dividend received by:	Resident	Resident	Nonresident No credit	Nonresident 50% credit	Nonresident 60% credit
U.S. corporation					
5. Cash dividend			$ 80	$ 80	$ 80
6. Shareholder imputation credit 3/			--	20	24
7. Gross up 4/			120	100	96
8. Taxable income (5 + 6 + 7)			200	200	200
9. Tentative tax liability 2/			100	100	100
10. Foreign tax credit 5/			100	100	96
11. Net U.S. tax (9 - 10)			0	0	4
12. Cash dividend to individual shareholder (5 + 6 - 11)			80	100	100

Table 2 (continued)

	U.S. corporation (1)	Foreign corporation (2)	Foreign corporation (3)	Foreign corporation (4)	Foreign corporation (5)
Individual shareholder					
13. Cash dividend	$100	$ 80	$ 80	$100	$100
14. Gross up	--	40	--	--	--
15. Taxable income (13 + 14)	100	120	80	100	100
16. Tentative tax liability 6/	33.33	40	26.67	33.33	33.33
17. Shareholder imputation credit (17 = 14)	--	40	--	--	--
18. Net tax liability (16 - 14)	33.33	0	26.67	33.33	33.33
19. After tax cash flow (13 - 18)	66.67	80	53.33	66.67	66.67
Total tax liability	$133.33	$120	$146.67	$133.33	$133.33
20. United States	133.33 (2 + 18)	0	26.67 (18)	33.33 (18)	37.33 (11 + 18)
21. Foreign	0	120 (2 + 18)	120 (2)	100 (2 - 6)	96 (2 - 6)

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1/ The hypothetical foreign imputation system provides resident shareholders with a gross up and credit equal to one-half the cash dividend. Assuming a corporate tax rate of 60 percent, this would integrate one-third of the corporate with the individual income tax.
2/ Assumes a corporate tax rate of 50 percent in the United States, 60 percent in the foreign country.
3/ In the two cases where the credit is extended, it is equal to 50 percent and 60 percent, respectively, of the credit available to resident shareholders.
4/ For purposes of claiming the foreign tax credit under the U.S. Internal Revenue Code, dividends from a foreign corporation are increased or "grossed up" by the amount of foreign taxes deemed paid with respect to the dividends received. The allowable foreign tax credit is then based on the foreign taxes paid on these grossed up earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.
5/ Limited to lesser of U.S. or foreign taxes.
6/ Assumes an individual tax rate of one-third in the shareholder's country of residence.

credit, 28/ the individual shareholder receives a dividend of $80 on which he pays tax of $26.67, leaving an after tax income of $53.33. This may appear inconsistent with capital export neutrality, since the U.S. resident individual investing in a U.S. corporation receives $66.67. The $13.34 difference, however, is attributable to the fact that the foreign corporate tax in excess of the U.S. corporate tax is not creditable for U.S. tax purposes. Nevertheless, if the credit were extended to nonresidents, this would facilitate capital export neutrality by effectively lowering the foreign corporate tax rate.

Although the resident and nonresident individuals receive the same before-tax cash dividend of $80, the after-tax cash flow of $53.33 received by the nonresident individual appears to be

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28/ The U.S. tax liability is more than offset. The indirect or deemed paid foreign tax credit is equal to:

$$\frac{\text{dividend received}}{\text{net earnings}} \times \text{foreign tax paid}$$

or

$$\frac{80}{80} \times 120 = \$120$$

Assuming a U.S. corporate tax rate of 50 percent, the tentative U.S. tax liability on the $200 in grossed-up foreign earnings is $100. The foreign tax credit is limited, however, to:

$$\frac{\text{foreign taxable income}}{\text{worldwide taxable income}} \times \text{tentative U.S. tax on worldwide income}$$

or

$$\frac{200}{200} \times 100 = \$100$$

The purpose of this limit is to prevent foreign taxes from reducing the U.S. tax otherwise due on domestic source income. The $20 excess credit is available, however, to offset U.S. taxes on foreign income that has been subject to relatively low taxation in a foreign country.

discriminatory. The difference is that one country has integrated its tax system and the other country has not. Those arguing discriminatory tax treatment contend that this misses the point. The resident shareholder, they say, receives an imputation credit of $40 in addition to an $80 cash dividend, while the nonresident receives only an $80 cash dividend.

Finally, there is the issue of revenue division. Through the foreign tax credit, the United States cedes the first slice of tax revenue to the source jurisdiction. This slice becomes the entire pie when foreign rates equal or exceed U.S. rates. The United States is left with only the tax collected from individual shareholders. Denying the credit to nonresidents preserves this arrangement, but it does so arguably by taxing nonresidents more heavily than residents. In effect, nonresidents are asked to finance part of the revenue cost of integration by bearing a heavier corporate tax in the imputation country.

Columns 4 and 5 illustrate cases in which the imputation country extends 50 percent and 60 percent, respectively, of the credit to nonresident direct investors. A rationale for this limited extension, in addition to source country revenue considerations, might be that roughly one-half of corporate earnings are distributed to individual shareholders. Since the "theory" of integration is to provide relief for only those earnings that pass out of corporate solution, one can argue it is appropriate to extend about one-half the credit to nonresident direct investors.

If one-half the credit is extended, the U.S. corporation receives an $80 cash dividend from the foreign corporation and a $20 imputation credit from the foreign treasury. The credit is equivalent to a reduction in foreign corporate tax. Accordingly, the U.S. corporation's tentative U.S. tax liability of $100 is exactly offset by the foreign tax credit, and it distributes $100 to its individual shareholders. A shareholder taxed at an individual rate of one-third would have $66.67 in after-tax income.

Capital export neutrality is achieved because all foreign taxes are now creditable. There is still room for debate as to whether the nonresident shareholder is taxed more heavily than the resident shareholder in the imputation country. The arguments are the same as recited above and need not be reiterated except to note that since the position of the shareholder has improved, any discrimination has been reduced. Because of the effective reduction in foreign taxes, the revenue division is slightly more favorable to the United States. Still, the United States collects no corporate tax on foreign earnings.

The case in which the nonresident's share of the credit is increased to 60 percent of the resident credit deserves special mention. The effective foreign corporate rate, allowing for the imputation credit, now falls below the U.S. corporate rate. The dividend to the individual shareholder, however, cannot be more than $100 because the United States will always collect the residual corporate tax. 29/ The imputation countries tend to focus on this point. The combined impact in the residence country, they note, of residual corporate taxation and no relief at the shareholder level, means that a nonresident can never be made "whole" with a resident.

Separate entity countries respond that how they tax their residents is not the proper concern of the source country. Nondiscrimination means equal tax treatment of residents and nonresidents in the source country. Accordingly, nonresidents should receive the same imputation credit as residents. The fact that it may end up in the coffers of the other country's treasury, rather than in the shareholder's pocket, is a choice properly left to the residence country.

The 60 percent credit also allows all foreign taxes to be credited and thus comports with capital export neutrality. The full benefit of the larger credit, however, goes to the U.S. Treasury. The shareholder receives the same after-tax income. Under these conditions, it is understandable why imputation countries are reluctant to extend the credit to nonresidents. While a capital-importing country may be willing to extend the credit to nonresidents in anticipation of attracting more investment, that anticipation will be frustrated if the benefits of extending the credit go to the foreign treasury, rather than the foreign shareholder.

Integration of Foreign Corporate and Domestic Individual Taxes. In addition to deciding whether nonresidents will receive the shareholder credit, imputation countries must decide whether foreign corporate taxes will be integrated with the domestic individual income tax in the shareholder's country of residence. Will a resident portfolio shareholder in a foreign corporation, for example, be entitled to a credit for foreign corporate taxes in the same way the individual investing in a domestic corporation receives a credit for domestic corporate taxes? Or, will an individual receive a credit for domestic

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29/ The excess, if any, of the U.S. over the foreign rate.