A Taxing History
Why U.S. Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer

by

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What are corporations? They are aggregations of individuals. Who are the officers of corporations? They are your fellow-citizens, your peers, and your equals. Why do corporations exist? Not for the purpose of the intangible, invisible, and artificial being that the law contemplates for certain purposes. They exist for their stockholders, for the men and the women, the widows and the orphans, who have the right to participate in that mode of human enterprise and in that mode of carrying on the business of life. Why should these aggregations of individuals be attacked in their property or in their rights by a method of taxation that we do not dare to apply to the individual when separated from these artificial existences?

- Senator George Gray (1894)¹

We know nothing about the stockholder. We deal with the corporation as an entity, and that is the whole of the argument, whether good or bad.

- Senator George Vest (1894)²

We learn from history that people learn nothing from History.

- G.W.F. Hegel (1830)

I. CONGRESS SHOULD ONLY TAX SHAREHOLDERS ON CORPORATE PROFITS

Corporations are subject to an entity level tax.³ Partnerships are not. Two levels of tax are imposed on corporate profits. Only one level of tax is imposed on partnership profits. The passage of time has converted the foregoing principles into dogma that most tax professionals simply accept without questioning.

Yet, it was not always thus. When the concept of an entity level tax on corporate profits was first considered, it was hotly debated, as evidenced by the first two quotes referenced above. It took another forty-two years before the U.S. started subjecting corporate dividends to two levels of tax in 1936 and double-taxation of all corporate profits was not fully established until 1986.⁴ Yet, over the same time

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³ Unless otherwise noted, all Code, section and Treas. Reg. § references are to the United States Internal Revenue Code of 1986, as amended, or regulations issued pursuant thereto.
⁴ One could argue it is still not firmly established given the ability to effect tax-free section 355 distributions of corporations that subsequently convert to real estate investment trusts which are only subjected to one level of taxation.
period that Congress shifted from one level of tax to two for most corporations, Congress created exceptions permitting only one level tax on business conducted through cooperatives, S corporations, regulated investment companies (“RICs”), real estate investment trusts (“REITs”), and real estate mortgage investment conduits (“REMICs”). In each case, Congress chose to impose tax at the shareholder level. Moreover, businesses that did not qualify under one of the foregoing regimes have been able to effectively use self-help through publicly traded partnerships and, more recently, so-called YieldCos to effectively achieve the same results as publicly traded corporations but with one level of tax instead of two.

This debate over whether corporate profits should be taxed once at the corporate level and again at the shareholder level is frequently referred to as the “integration” debate. But, as has been pointed out many times, the word “integration” means different things to different people. True integration is not synonymous with merely eliminating double-taxation. Double-taxation can be avoided by simply excluding corporate dividends from the shareholder tax base, which is actually what the U.S. rules provided for at one point in our history. Yet, that is not the same thing as true integration. The ideal of true integration would seek to align the tax treatment of corporate profits with partnership profits. In a nutshell, this requires aligning the corporate and shareholder tax base for business income, aligning the rates that would apply on business income, and aligning the time at which business income is taxed to shareholders and corporations (i.e., ensuring there is no ability to defer shareholder-level taxation). Anything short of that ideal, which is often advanced for very valid administrative reasons, may be a worthy achievement, but is something less than true integration.

The integration debate is fascinating, and not just for tax professionals. This is because the debate covers so many different areas of thought. The debate necessarily involves economic, accounting and legal analysis. But it is also equally driven by historical, psychological and philosophical questions about the nature of corporations, especially publicly traded corporations. This paper seeks to address the different aspects of the integration debate in this paper and make a recommendation regarding same.

The thesis of this paper is that Congress should shift the burden of corporate tax to certain shareholders of those corporations. This is because Shareholder taxation is the logical end point of globalization and increasing international tax competition. The sooner the U.S. gets to that point, the better off it will be. Where capitalized throughout this paper, the term “shareholders” only includes U.S. individuals, accounts  

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5 Subchapter T of the Code.
6 Subchapter S of the Code.
7 Subchapter M of the Code, Part II.
8 Subchapter M of the Code, Part I.
9 Subchapter M of the Code, Part III.
10 See e.g., Amy S. Elliot, Year in Review: REIT and PTP Converters - The Other Corporate Deserters?, 2015 TNT 3-7 (Jan. 6 2015); and Roger Baneman, Legislative Proposals to Use REITs and RICs for Renewables, 2015 TNT 68-5 (Apr. 6, 2015).
11 Charles E. McLure, Jr., Must Corporate Income Be Taxed Twice?, 1-6 (1979).
12 The U.S. rules, for a time, excluded corporate dividends from the "normal" income tax, and only included the dividends in the base upon which the "surtax" was imposed.
13 Republican Staff of the Senate Committee on Finance, Comprehensive Business Tax Reform for 2015 and Beyond, p.125 ("In an ideal tax system, all business income would be taxed to the owners of the business.").
held by those individuals (i.e., 401(k) and IRA), U.S. tax-exempt entity shareholders, and foreign individuals and corporations (collectively, “Shareholders”).

To implement this concept, a two-pronged approach is recommended. For private companies whose shares cannot be transferred without notifying the company, this paper recommends the continuation of subchapter K but coupled with an expanded subchapter S regime which would permit a significantly larger number of shareholders, corporate and partnership shareholders, foreign shareholders and multiple classes of stock. Publicly traded companies present a unique challenge. For publicly traded companies the primary recommendation would be a Shareholder-level mark-to-market approach and a secondary recommendation would be a dividends paid deduction approach.

A. Globalization and Tax Competition Have Changed the Nature of the Integration Debate

What has been will be again,
what has been done will be done again;
there is nothing new under the sun.

- Ecclesiastes Ch. 1 verse 9

Much has been written about this topic already, and this paper, admittedly, borrows heavily from the excellent work of other authors. Thus, it is important at the outset to summarize the four (4) topics that are (hopefully) new in this paper, each of which is described below.


In the early 1990s when the last serious effort was made to consider integration of corporate and individual taxation, “neutrality” between entity choices was the stated goal. The point of integration was to try and reduce the incentives for investing capital in pass-through entities or debt instruments, rather than equity in corporations that were subject to two levels of tax. Although that was a worthy goal, this paper argues that the stakes are much higher now.

This paper links the century old intra-U.S. debate about integration with the more recent debate on international tax competition, the U.S. effort to combat corporate inversions, and the multilateral effort to combat base erosion and profit shifting (“BEPS”). Viewed in this context, the goal of any integration approach should not merely be to reduce the incentive to invest in flow-through entities or debt instruments. The focus should, instead, be on using integration as a way to extricate the U.S. from the current system of tax competition that prevails amongst countries. Stated differently, integration approaches should not be judged by reference to how closely they eliminate the distinction between

14 Noticeably absent are domestic corporations. These corporations would either be subject to a flow-through or a mark-to-market basis.

15 Not everyone agrees with the notion that subchapter S expansion would be this straightforward, however. In his paper on integration models for private companies, Professor Kwall distinguishes between simple and complex private companies. Simple private companies have a single class of equity interests whereas complex companies can have multiple classes of ownership interests. He suggests a shareholder level tax system akin to subchapter S for the former and an entity level tax for the latter. See e.g., Jeffrey Kwall, Taxing Private Enterprise in the New Millennium, 51 Tax Lawyer 229 (1998).


17 Report of The Department of the Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once, part I.C. (Jan. 1992) (“Integration would reduce and in some cases eliminate the distortions of business decisions under the current tax system by coordinating the individual and corporate tax systems so corporate income is taxed only once.”)
partnership and corporate taxation. The emphasis should be on how the approach minimizes tax competition.

Specifically, integrating corporate taxation in a way that shifts the corporate tax burden squarely on the Shareholder should not only reduce the distortions created by the current system, but also help the U.S. preserve what will likely otherwise become an increasingly smaller percentage of the global corporate tax base. In contrast, an integration approach that leaves the corporation in the role of taxpayer may achieve the worthwhile goal of reducing current distortions but will do very little to help the U.S. preserve its corporate tax base. This is because even if the U.S. were to adopt the most taxpayer favorable territorial regime possible tomorrow, and even if the U.S. were to substantially lower the U.S. corporate income tax rate, there will always be a better alternative. International tax policy is like chess, and other countries will be able to make a counter move. The question Congress should be asking is whether there is a move it can make that enhances the U.S.’s position without regard to what other countries choose to do.

In this regard, it is helpful to view the U.S. effort to combat corporate inversions and even the multilateral BEPS initiative in the larger context of tax competition between nations. Absent a coordinated effort among countries to have a common tax base, rate and level of tax enforcement, countries will engage in tax competition. Any attempt to prevent competition wholesale would be quixotic, as efforts to achieve a common base amongst relatively homogeneous countries and sub-national governments has proven in the past. Hence, the question is not how to prevent tax competition, but instead whether a country like the United States can unilaterally achieve an “acceptable” level of tax competition and whether that “acceptable” level of tax competition can be achieved through integration.

This paper argues that any form of partial or complete integration is a worthy goal, and that the corporate and shareholder base, rate and time for tax should be aligned to the limits of administrative capacity. The only cogent argument to the contrary is the same philosophical argument raised in 1894 - i.e., that corporations have separate “personalities” and, as such, should be taxed on an entity basis. This argument is addressed in detail in a later section.

18 It is important to point out that some economists have relied on empirical evidence to challenge the notion that tax competition necessarily leads to a race to the bottom in terms of the provision of public goods. Elizabeth Chorvat, The Tax Calculus of Corporate Locational Decisions, 32 Berkeley J. of Intl. L. 292 (2014). However, Dr. Chorvat's paper goes on to note that countries that retain high levels of public goods provision derive a higher percentage of their tax revenues from individuals rather than corporations. Id. at 303 (citing James R. Hines, Jr., Will Social Welfare Expenditures Survive Tax Competition?, 22 Oxford Rev. Econ. Pol'y 330 (2006)). This paper does not suggest that tax competition does or does not necessarily result in a lower level of public goods provision, a topic best left to economists. Instead, this paper proceeds from the common-sense premise that corporations do make decisions about where to invest and earn profits based on calculations of after-tax rate of return. All other factors being equal, they choose the location with the lowest tax cost.

19 John D. Wilson, Theories of Tax Competition, 52 National Tax Journal 269, 277 (1999) (“At the international level, there do not exist strong institutions for coordinating the activities of sovereign nations. The need to induce cooperation among such nations severely restricts the set of feasible policies.”).

20 States within the United States (and provinces within Canada) which share a common currency relatively similar levels of prosperity have resisted having a common base and rate. Similarly, countries within both the European Union and the Eurozone have resisted a common tax base and rate, although attempts have been made to push for a common base. The EU has flirted with, but thus far not adopted a common consolidated tax base (CCCTB). See EU Issues Q&A on Common Consolidated Tax Base, 2015 WTD 117-18 (June 17, 2015); The European Network on Debt and Development, UN Financing for Development negotiations: What outcomes should be agreed in Addis Ababa in 2015? available at 134 DTR I -1 (July 14, 2015) (recommending a worldwide tax body under the auspices of the UN). See also, EU Seeks Public Input on Rebooted CCCTB Proposal, 2015 WTD 196-3 (Oct. 9, 2015).

21 Republican Staff of the Committee on Finance for United States Senate, Comprehensive Tax Reform for 2015 and Beyond, p. 123 (December 2014) (“The difficult decision is not whether business income should be subject to more than one level of tax -- it should not -- but whether the business income should be taxed at the entity level or at the owner level.”)
Yet, integration alone is not sufficient. If the U.S. continues to impose tax on corporations, corporate managers will continue to have an incentive to erode the U.S. tax base and re-domicile to more favorable tax jurisdictions. If, instead, the U.S. were to tax Shareholders on corporate income, the U.S. system would better align the intrinsic motivations of those taxpayers with the government’s revenue raising objectives.

Corporate managers are motivated (and compensated) to maximize after-tax profits, with the tax being measured by reference to the corporate level tax. The entity level tax represents a cost, just like labor cost, which corporate managers will seek to reduce to the limits of the law.22 In contrast, as noted in Part IV, an individual shareholder’s choice of residency is motivated by a number of non-tax factors. Thus, a tax system that imposes corporate tax on Shareholders allows the U.S. to compete on other factors that are divorced from the corporate tax system.

A lot of the focus on integration over the years has, rightfully, centered around finding a approach that can actually be administered. This is the rock in the path over which integration advocates typically stumble.23 Proponents recognize that true integration as the ideal, but also recognize that it may simply be impossible to administer. That then causes integration advocates to seek slightly less perfect forms of integration that are easier to administer.

A pragmatic test for any integration approach should thus be whether the U.S. system for taxing corporate business profits has been modified in such a way that corporate managers start to be compensated more like mutual fund managers - i.e., on a pre-tax basis. If the integration approach achieves that objective, it will go a long way towards achieving acceptable tax competition, even if it falls short of integration in its purest form. Moreover, integration advocates should be willing to settle for less than the perfect ideal in order to accomplish this change in management incentives.

2. Additions to the Historical Record as it Relates to Integration.

This paper traces the history of the corporate income tax before summarizing prior works on the integration question. Although the U.S. has had some form of corporate tax (on and off) since 1864, it has only really had a tax on corporate entities specifically since 1894, and double-taxation of corporate dividends since 1936. Roughly every 20 years after that point there have been serious attempts to reverse that decision and consider some level of integration. Much of this has been relayed by others, but this paper seeks to combine this history into one summary. Along the way, the paper seeks to make some slight contributions to the historical record vis-a-vis two countries that adopted a dividends paid deduction.

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22 After the promulgation of the enhanced substantial business presence standards in section 7874, for example, domestic corporations seeking to invert simply found merger partners to enable their shareholders to get below the 80 percent stock ownership threshold. See e.g., Marie Sapirie, The Evolution of Inversions, 2015 TNT 154-1 (noting the irony of how inversions have increased as the rules have become more stringent).

23 George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 433 (1992) ("The debate about corporate integration has been described as a clash between idealists and pragmatists. Proponents of integration, the idealists, contend that all income, whether from a corporate or noncorporate source, should be taxed in the same way. By taxing certain corporate-source income twice, therefore, the classical system distorts the basic choice of whether to operate a business entity in corporate form. Further, there are other distortions creating the choice of debt or equity financing, the decision to distribute or retain corporate earnings and the choice of effecting a dividend or nondividend distribution. In contrast, those supportive of a corporate income tax separate from the shareholder income tax, the pragmatists, point out the tried and true nature of the corporate tax and its important role in the overall fiscal system. In addition, they question whether integrating the two taxes can be accomplished without making existing distortions and complexity even worse.")
3. Linking Corporate Integration with Foreign Deferral / Lockout Debate.

Much of the work that has been done on integration focuses on U.S. operations and foreign investment in U.S. operations. That is to be expected given that the focus has primarily been on reducing the economic distortions resulting from the tax preference for investing in non-corporate entities. Less emphasis has been placed on linking integration with the debate over territoriality and deferral of offshore investments made by multinationals.

Yet, these issues are linked. This paper advocates that the U.S. needs to come to grips with the former before it makes a long term decision about the latter. In brief, proponents of territoriality argue that the U.S. needs some form of territorial system to remain competitive, whereas opponents argue that territoriality will only exacerbate the incentive the Code already provides for shifting jobs, profits and cash flow to offshore subsidiaries. It is difficult to reach an answer that satisfies both sides, because . . . both are correct. This paper does not take a position on territoriality or full inclusion (or anything in between). This paper does, however, argue that if corporate and shareholder taxation of business profits were integrated, and integrated in a way that places the burden on Shareholders (as defined above), a full inclusion approach (or something approaching it) becomes much less anti-competitive, and therefore more palatable to both sides if that is what Congress should choose to do.24

4. Recent Developments that have Made Integration More Necessary and More Viable.

Lastly, this paper also seeks to update the discussion for changes that have occurred. A lot has changed since the last serious integration debate was held, and summarized by the American Law Institute report published in final form in May 1993 (hereinafter, “ALI Study”). Virtually all of these changes have made integration more necessary. Some changes have made the imposition of tax on the Shareholder more viable.

a. Changes that Have Made Integration More Necessary

Back in the 1977, when the U.S. considered integration, U.S. individual rates vastly exceeded corporate rates, and yet the U.S. had a competitive corporate tax rate. In the early 1990s, the corporate rate exceeded the individual rate, but the U.S. still had a competitive corporate tax rate.25 Today the U.S. individual rate exceeds the corporate rate, yet our corporate tax rate is already the highest in the world. Even the U.S.’s closest trading and treaty partners have, effectively, become tax havens as compared to the treatment U.S. multinationals enjoy by operating and paying tax in the U.S.26

The growth of limited liability companies has changed. Although limited liability companies existed prior to the last major review of integration in the 1990s, it was not until the so-called “Kintner regulations” were replaced with the entity classification (or “check-the-box”) rules in 1996,27 that

24 In the case of a mark-to-market regime the debate is rendered moot as all value (whether derived from U.S. sources or abroad) is reflected in the value of the company and taxed at the Shareholder level.

25 1992 Treasury Study (December) at p. 12 (“Under the current rate structure, in which the corporate rate is slightly higher than the maximum individual rate, there seems little reason to tax corporate income at shareholder rates. In contrast, an integration proposal developed in the late 1970s, when the maximum individual rate on capital income of 70 percent exceeded the corporate rate of 46 percent, might well have required taxation at shareholder rates in order to prevent avoidance of the higher shareholder rates.”) (citations omitted).

26 As an example, the UK rate is at 19% and scheduled to drop to 18%. Plus the UK has adopted the substantial shareholder exemption and an exemption for dividends and a much more lenient controlled foreign corporation regime than the U.S. subpart F regime.

domestic limited liability companies (or “LLCs”) became *de rigueur* for companies not seeking to list on an exchange.

Finally, the change in taxing systems amongst the U.S.’s trading partners have coupled with shareholder-level changes to drive companies to re-domicile. Prior to 1996, taxpayers sought tax-free inversions. The dot.com crash made taxable inversions possible in the late 1990s and early 2000s. Yet, when the stock market recovered, inversions didn’t stop. Instead, shareholders demonstrated an increased willingness to incur shareholder level tax in order to invert domestic corporations and leave the U.S. taxing net. Part of this is due to the fact that individuals hold their shares through “funds”, be they mutual funds or hedge funds. These fund managers are compensated on a pre-tax basis and make decisions accordingly. Thus, although the shareholders may not technically be “tax indifferent” the people making decisions about their investments are largely indifferent to the tax consequences of taxable share dispositions. This, in turn, has increased the pressure on Congress to enact a territorial regime to keep the U.S. system "competitive”.

b. Changes that have Made Shareholder Taxation More Viable

Various changes in the law have made certain integration approaches more viable. One perfectly legitimate objection to using a flow-through model for publicly traded companies is the incredible administrative burdens this places on taxpayers and the Internal Revenue Service (the "IRS" or "Service"), especially in the case of audit adjustments for past years that result in tens of thousands of amended returns. Publicly traded partnerships pre-dated the 1990s and the ALI Study. But at the time there were no special rules governing audits of large partnerships. Thus, not surprisingly, the ALI Study pointed to the retroactive effect of audit adjustments as an impediment to an integration approach that allows for flow-through (partnership-like) taxation.

In 1997, Congress enacted a simplified audit regime for large partnerships. These rules actually implement some of the concepts that were only discussed in theory during the prior integration debates by, for example, making audit adjustments prospective instead of retroactive to the years they relate. This prospective adjustment approach removes

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29 Section 7704(c) of the Code allows certain partnerships to be publicly traded and yet not taxed as corporations. At present, only certain partnerships with specified income can qualify, however. If 90 percent or more of partnership income is comprised of passive income (e.g., interest, dividends, rents from real property, gain from sale of real property, and income from commodity and commodity futures) or active income related to income from mineral or natural resources, the partnership can potentially be publicly traded and yet continue to be taxed as a partnership. Section 7704(c) and (d). The U.S. Treasury recently released guidance on the scope of this exception as a way to stem the tide of rulings it was getting in the area. *See* 80 F.R. 25970-25977 (May 6, 2015).

30 Congress enacted section 7704 in 1987 to restrict the extent to which publicly traded partnerships could retain their status as flow-through entities. *Omnibus Budget Reconciliation Act of 1987*, P.L. 100-203, §10215.

31 Alvin C. Warren, Jr., *American Law Institute, Federal Income Tax Project - Reporter’s Study of Corporate Tax Integration* at Part 3.H. (1993) (electronic ed.) (“The shareholder allocation system also requires substantial changes in the way corporations and shareholders are audited. In theory, under a shareholder allocation system, any increase or decrease in tax as a result of an adjustment to a tax return, resulting from an IRS audit or an amended return, should be reflected in the tax liability of the shareholders. The current system for partnerships carries an adjustment back to the partners’ taxable year in which the understatement arose.”).

32 Taxpayer Relief Act of 1997, P.L. 105-34, §§1221–1246. Importantly, unlike normal partnerships, the audit procedures allow audit adjustments to only be made prospectively, thereby avoiding the administrative nightmare for the partners and the Service of having thousands of amended returns, many of which may related to otherwise closed tax years.

33 It should be noted that PTPs have not widely embraced this prospective adjustment regime due to the corresponding requirement to issue Schedule K-1s by March 31st of the following year. Nevertheless, the point is that the use of prospective audit regime is in fact possible.
one significant objection to pass-through integration models in that it obviates the need to force thousands of shareholders to amend returns and keep taxable years open every time there is an audit adjustment.

When prospective adjustments were proposed, some argued that making audit adjustments prospective would penalize buyers who have uncertain information about the tax risks they are stepping into. Since that time, however, the Financial Accounting Standards Board has adopted FASB Interpretation No. 48 (a.k.a. “FIN 48”) in 2006. FIN 48 more precisely measures contingent tax liabilities for purchasers of publicly traded stock. This should at least make the idea of prospective tax adjustments somewhat more palatable.

Another key administrative change is the enhanced tax record keeping and withholding tax requirements that the law now imposes on brokers. These requirements force brokers to effectively serve a tax compliance function as a cost of doing business. The possibility of imposing responsibility on brokers to assist in the tax collection process significantly enhances the viability of those models that shift the responsibility for tax on to the Shareholder. As will be demonstrated below, this is particularly important in the case of a Shareholder mark-to-market approach.

c. Summary

It would be an overstatement to say that all of the practical administrative issues that were once thought to be insurmountable obstacles to pure integration back in 1977, or even in 1992, have been overcome. At the same time, however, it is also becoming increasingly difficult for opponents of integration, or proponents of integration models that insist on leaving the tax burden at the corporate level, to simply argue that a model that imposes one level of tax on corporate shareholders is impossible to administer. This paper argues that these changing dynamics all make integration with an emphasis on Shareholder level taxation more viable now than it has ever been before. This is because the need to do something transformational is higher due to tax competition, and the ability to administrate a Shareholder level tax (while admittedly daunting) is greater than it has ever been before.

B. What This Paper Doesn’t Do.

Pick battles big enough to matter, small enough to win.

- Jonathan Kozol

Before proceeding, it is equally important to recognize what this paper will not do. If no corporate level tax were imposed, and nothing else changed, there would certainly be a revenue loss to the U.S. government. The corporate income tax does raise revenue for the federal government, although it represents a smaller percentage of that revenue than it once did. There will likely have to be correlative changes, however, with any integration model, some of which would offset the revenue loss in whole or in part.

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34 This has now been codified as Accounting Standards Codification (ASC) 740-10.
35 Emergency Economic Stabilization Act, P.L. 110-343. See also, section 6045 and Instructions to Form 1099-B.
36 See e.g., the Foreign Account Tax Compliance Act (§§1471-1474) (imposing tax withholding obligations on foreign source gains of debt and equity instruments that generate U.S. source income) and also section 871(m) and T.D. 9734 (Sep. 18, 2015).
37 Immediately after World War II, corporate income taxes accounted for almost forty percent (40%) of federal revenue compared to approximately seven percent (7%) in the late 2000s. See Donald J. Marples, Federal Business Taxation: The Current System, its Effects, and Options for Reform, Fig. 2 (Sep. 9, 2010), reprinted in 2010 TNT 176-54.
38 For example, if Congress were to adopt a shareholder mark-to-market system for publicly traded stocks, this could substantially offset the corporate tax loss depending on what tax rate was applied.
This paper deliberately and strategically dodges the question as to how that revenue would be replenished. This is because (for the reasons we discuss below) the elimination of the corporate income tax should not be a liberal or conservative issue. It is simply the correct thing to do and in everyone's self-interest. In contrast, how one chooses to makes up the revenue loss is inherently an issue that will divide liberals and conservatives, Democrats and Republicans. This paper eschews the latter issue to avoid distracting from the former.39

Although we avoid making pointed recommendations for making up for the revenue loss, or suggesting which interest groups should be in favor of, or opposed to, any given integration model, we do point out, as a purely historical matter, how certain interest groups in this country have reacted at various points in time when the corporate tax system was significantly changed. Specific points of interest that we relay in more detail below would be the debates over the introduction of the corporate income tax in 1894, the ill-fated attempt to introduce a split rate corporate tax system from 1936 to 1938, and the attempt to exempt dividends from tax in 2003. The historical reactions by interest groups during each of these periods may provide useful lessons to anyone seeking to navigate future political fights over integration.

C. Outline of Arguments

To support the thesis that Congress needs to impose one level of tax, not two, on corporate profits, and that the liability must be shifted squarely to the Shareholders this paper makes five arguments and then summarizes in a concluding section.

Part II argues that the integration debate should not be about efficient allocation of capital between businesses operated in pass-through or corporate form (although that is a worthy objective), but should instead be discussed in the context of tax competition between nations.

Part III argues that U.S. attempts to curb inversions and the multilateral attempt to combat base erosion through the BEPS initiative should really be considered, at their root, attempts by countries to achieve what this paper refers to as an “acceptable” level of tax competition. These attempts are likely to, at best, represent temporary solutions that are not going to resolve the more systemic issue of tax competition between nations.

Part IV argues that the only way to “win” the tax competition game is not to play. Specifically, rather than trying to craft a tax regime that imposes a tax on business profits that depends on where a corporation is incorporated or where it does business, the focus should be on the individual shareholders who own those corporations. By shifting to such a regime, the U.S. (and other countries if they choose the same approach) can extract themselves from the tax competition game. Stated most succinctly, capital may be mobile, but individual investors of that capital generally are not. If the only tax on business income is a residence based tax on individual investors of capital, the U.S. will be able to

39 One reason to avoid a discussion of alternative revenue sources is because the answer to that question (for some folks) depends on a belief about who bears the corporate tax today. This is a question that economists do not seem capable of answering. Thus, the decision about an alternative revenue source cannot be based on a mathematical analysis of who bears the corporate tax today. It just has to be addressed through the natural give and take of the political system. Some have suggested that one should not address the desirability of integration without knowing what the alternative revenue source is and considering whether that alternative revenue source is more or less distortionary or regressive than the existing system. See, Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N. Carolina L. Rev. 613 (1998). This would be the case if it were not for international tax competition, and the only concern was whether capital was being efficiently allocated between business conducted in flow through form or corporate form. Yet, the thrust of this article is that integration is a way for the U.S. to extricate itself from the tax competition game as it has been traditionally played. In that sense, integration is more than just a debate about whether capital is allocated efficiently between businesses conducted in flow through and corporate form. It is about keeping preserving the tax base. Any tax system that shifts the corporate tax burden away from the corporation and imposes it on Shareholders reduces the incentive of corporate managers to erode the tax base through transfer pricing, inversions, etc…. Whether it turns out to be progressive or regressive will have to be determined through the political process.
compete more effectively on ground of its choosing rather than being forced to slash effective rates or move to a quasi-territorial system to compete with other countries.

In Part V, this paper reviews the history that lead to the enactment of the modern corporate income tax. In particular, we review the rationales that motivated the enactment of the corporate income tax (or were developed along the way as the tax was modified over the years). Part V asks whether any of these rationales withstand scrutiny today, and concludes that they do not.

Part VI approaches the most challenging question, which is "how" one would go about eliminating double-taxation. As alluded to above, Part V discusses subchapter K and an expanded subchapter S model to address those companies whose shares cannot be transferred without the issuer’s knowledge. For public companies, a mark-to-market and dividends paid deduction model are discussed and compared against an imputation model.

Finally, in Part VII, this paper concludes that the U.S. should adopt a shareholder mark-to-market system if politically and administratively feasible with a dividends paid deduction as a secondary approach.

II. THE INTEGRATION DEBATE SHOULD BE VIEWED IN THE CONTEXT OF TAX COMPETITION.

The concept of "tax competition" is important to the integration issue for two key reasons. First, it influences the debate over tax incidence. Who actually bears the burden of the corporate income tax? If the tax is actually borne by workers rather than shareholders, for example, it dramatically changes the political calculus for reform. Second, for the reasons discussed below, tax competition influences how one would should integrate.

It is important that non-economists at least have a rudimentary understanding of this literature, because all of this work is based on certain key assumptions. Yet, these assumptions are not all fixed. Many depend on law. Thus, many important assumptions can be modified by the laws that Congress chooses to enact.40

The scholarship in this area involves two key concepts: Pareto Optimality and the Nash Equilibrium. Both can be illustrated using a classic game discussed in virtually every college economics class - the Prisoner’s Dilemma. In this game, the police arrest two individuals (each, a “player” or “prisoner”) on suspicion that they committed a crime. The police put them in separate rooms and the prosecutor offers each the same deal. The deal is that if the prisoner (assume this is Player 1) confesses to the crime, but the other prisoner (Player 2) does not, then Player 1 can walk away a free man. On the other hand, if Player 1 does not confess, and Player 2 rats him out, then he will get 10 years in prison. If they both confess, then they will each get 8 years in prison. Each of the binary choices that each player can make (i.e., to confess or deny the charges) is considered a “strategy” and may be referred to S1 (for confess) and S2 (for deny). Each strategy and its expected payoff are set forth in the following matrix:

<table>
<thead>
<tr>
<th>Player 2</th>
<th>S1: Confess</th>
<th>S2: Deny</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1: Confess</td>
<td>-8, -8</td>
<td>0, -10</td>
</tr>
</tbody>
</table>

40 See e.g., Edward J. McCaffery, Cognitive Theory and Tax, 41 UCLA L. Rev. 1861, 1862 & 1866 (1994) (“In the case of my chosen area of legal academia, taxation, the interdisciplinary contributions have been dominated by economists, who have made many invaluable contributions to the field. . . .Too often, ‘law and X’ scholarship has brought the X discipline into legal scholarship as some kind of unquestioned and unquestionable paradigm. But it is a mistake in scholarship as in so many other areas of life to rush things, to assign false certitude to yet evolving areas of thought. ‘Law and X’ scholarship can and should work in both directions, using law to expose and develop the alternative discipline as much as the converse, and allowing the terms of the joint undertaking to be distinct.”).
The best outcome for both players is clearly for both to clam up and not cooperate. If they do, they both walk away free men. This “deny, deny” scenario is Pareto Optimal because there is no other result that makes one player better off without making another player worse off. The problem, of course, is that there is no external pressure forcing both players to agree, and each player knows that he and the other player have an incentive to confess. Thus, each prisoner figures out they are better off confessing regardless of the other prisoner’s strategy. Hence, they both choose S1 - the confession strategy. The confession strategy is considered a Nash equilibrium because it is utility maximizing strategy for both players regardless what the other player does. Importantly, being Pareto Optimal does not have any connection to equality. Even if the confess, confess payoff for Player 1 only was changed to -7, Player 1 and 2 should follow the same strategy.

Similarly, tax competition can be thought of as a game with multiple players. At the risk of oversimplifying, one need only expand the number of players and assume they are countries, not prisoners. The strategies are not confess and deny, but instead, tax at a low effective rate or a high effective rate (or somewhere in between). At the further risk of oversimplifying, the prisoner’s dilemma would suggest that the socially optimum response is to change the rules of the game, and have all countries cooperate and agree upon tax bases and rates.

Interestingly (and importantly for the later sections of this paper addressing motivation theory), they have actually tested the prisoner’s dilemma on real prisoners. For reasons that will be explained in later sections the prisoner’s dilemma is not necessarily a great predictor of what real life prisoners actually do. This is because economists assume a strictly rational human actor (a.k.a., *homo economicus*) whereas people are not strictly rational.

41 The name comes from Vilfredo Pareto, an Italian mathematician. He is also famous for developing the so-called “Pareto Principle” or 80-20 rule, which posits that 80 percent of the results of a given set of actions are caused by 20 percent of the actions which is sometimes referred to in business classes. In a game with a finite number of players (N) and a finite number of outcomes (O), any given outcome is considered Pareto Optimal if it is impossible to make one player better off without making another player worse off.

42 It is also considered a “strictly dominant” strategy, in that the confession strategy provides a greater utility for each player regardless what the other players do. See generally, William Spaniel, *Game Theory 101: The Complete Textbook*, Lesson 1.1 - 1.4 (2013).

43 Maybe Player 2 had a prior record, for example.

44 The prisoner’s dilemma would not necessarily dictate or require that the socially optimum outcome is that every country have the same base and the same rate. Instead, the point would be to cooperate such that everyone found themselves in the box that achieves Pareto efficiency. To illustrate, assume that only the payoffs to Player 1 were changed so that if he confesses and Player 2 denies, he still serves 2 years in prison, and if he denies and Player 2 denies, Player 1 serves 1 year in prison. The deny-deny outcome is still socially optimum and Pareto efficient, even though the results are not “equal”. Player 1 still has to spend a year in the clink.

45 Max Nisen, *They Finally Tested The 'Prisoner's Dilemma' On Actual Prisoners — And The Results Were Not What You Would Expect*, available at [http://www.businessinsider.com](http://www.businessinsider.com). For the actual results of the test itself see Menusch Khadjavi and Andreas Lange, *Prisoners and Their Dilemma*, 92 J. of Econ. Behavior and Organization 163, 166 (2013) (noting how when the prisoner’s dilemma game was conducted simultaneously and not sequentially, prisoners cooperated far more often (55.6% of the time) than students(30.2% of the time)).

46 Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA Law Review 1861, 1868-69 (1994) (“The chief foil for cognitive theory has always been expected utility theory (“EUT”) . . . EUT has been around, in some form, since at least the 18th Century work of the Bernoulli brothers, but it received a more formal statement and took off in popularity with the World War II era work of John von Neumann and Oskar Morgenstern. . . . What began as a supposition grew into an ideal paradigm and became implicitly accepted as being true . . . . This factual assumption has come under increasing challenge, however . . . .”).
Nevertheless, at this point in the paper it is sufficient to accept that there can be a value in assuming things that are not always true. For example, mathematics relies on the square root of negative one \((i)\) in to solve problems, even though there is no number that, multiplied by itself, yields negative one. But it is used anyway, because assuming such a number exists allows mathematicians to develop theories that are observably true. The economic models discussed below suggest that if countries do not cooperate with one another, choose to impose taxes on capital, and capital is mobile between countries, then the equilibrium result will be a less-than optimal level of taxation and public goods provision akin to the confess, confess scenario in the prisoner’s dilemma.\(^{47}\) Nevertheless, the assumptions used and the way the models get to that conclusion is important for this paper, because some of the key assumptions are based on laws, and Congress can choose to alter those assumptions if it wants.

A. Economic Models of Tax Competition

In 1986, Professors George R. Zodrow and Peter Mieszkowski\(^{48}\) and John D. Wilson\(^{49}\) created models of tax competition that have formed the basis for most of the scholarship in the ensuing years.\(^{50}\) These models are sometimes referred to collectively as the “ZMW” model and serve as the basic cornerstone of a lot of the literature in this area. The models essentially take concepts from microeconomics and modify them to model the behavior of different taxing jurisdictions. The early versions of the model effectively assume a number of taxing jurisdictions, each housing a single firm. The models seek to identify reactions based on the decision of any single jurisdiction to impose a tax. Importantly, these early papers refer primarily to sub-national tax competition (i.e., competition between States within the United States), but they clearly have implications for tax competition that crosses international boundaries as well.

The models make a number of assumptions, and it is important to understand those assumptions when considering the models in light of new tax policies. For example, the models assume that there are \(N\) regions \((n_1, n_2, n_3, \ldots, n_N)\), within which a variety of firms compete to produce a single output using only two factors of production: capital \((K)\) and labor \((L)\).\(^{51}\) A key assumption of these models, and one that will be revisited later in this paper, is that capital is entirely mobile, whereas labor is not at all mobile. Another assumption is that capital will only be taxed where it is invested. So if capital is invested in jurisdiction \(n_2\), it will only be taxed in \(n_2\). Importantly, the models don’t take into account the fact that the investor making the capital investment may be located in jurisdiction \(n_1\) and taxed on that basis. The ZMW model assumes that each jurisdiction \((i)\) is subject to a budget constraint whereby the value of public goods and services it can offer its residents \((G_i)\) is limited to the taxes it can collect. In other words, the models assume jurisdiction \(n_1\) cannot borrow from jurisdiction \(n_3\) to fund jurisdiction \(n_1\)'s deficit spending. The models further assume that the only tax is a tax \((t)\) on the amount of capital invested \((k)\). Thus, the budget constraint can be expressed as \(G_i = t_i \cdot k_i\). The government of the jurisdiction can only produce government goods or services to the extent it raises tax revenue (because it cannot borrow) and it can only raise tax revenue by taxing capital.

\(^{47}\) Again, this is not to say that Pareto efficiency would require every jurisdiction to tax the exact same base at the exact same rate. Larger countries with stable borders and developed infrastructure may be able to tax at higher rates and still achieve an optimal level of public goods provision.


\(^{50}\) Their work was based on prior works by Charles M. Tiebout and Wallace E. Oates. Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 Journal of Political Economy 416-24 (1956) (arguing that when people have freedom of movement between taxing jurisdictions, the effect is to keep rates low relative to the goods it is providing); and John D. Wilson, Theories of Tax Competition, 52 National Tax Journal 269, 272 (1999) (noting that Wallace E. Oates’s work pointed out that the competition to lower rates may result in a less than optimal level of goods provision).

\(^{51}\) John D. Wilson, Theories of Tax Competition, 52 National Tax Journal 269, 272 (1999).
To figure out what impact the imposition of taxes on capital have, the models create a function that expresses the “demand for capital” for each “firm” within the jurisdiction in order to analyze the impact of taxes on capital. For those who are interested in the math, Appendix I provides an example of how to arrive at a capital demand function if one were to assume that the quantity of goods produced in a jurisdiction is given by a Cobb-Douglas production function where $\alpha = 1/2$ and $\beta = 1/8$. This is solely for illustrative purposes to illustrate the math for those who are interested, nothing more.

What is important for our purposes is that the models show that the demand for capital is influenced by the return on capital ($r$) and the return on capital has to take into account the tax ($t$) that any jurisdiction imposes. Given that capital is assumed to be mobile, if the investor cannot get the necessary rate of return in jurisdiction $n_1$, the assumption is that the investor will move his or her capital to jurisdiction $n_3$ or $n_4$. The implications of the model are that if a tax is imposed on capital (as opposed to wages paid for labor) in jurisdiction $n_1$, one of two things needs to happen. Either the pre-tax return on capital has to increase to achieve the same required after-tax rate of return or, alternatively, the demand for capital in that jurisdiction will decrease in jurisdiction $n_1$. The models assume the former won’t happen, because $r$ is exogenous to the model and fixed and consistent across the different jurisdictions. Hence, the only way to achieve equilibrium is to have capital move out of jurisdiction $n_1$. The implication then is that jurisdiction $n_1$ needs to lower its taxes in order to compete for capital.

B. Is all “Tax Competition” Per Se “Harmful”?

The ZMW models beg an important question. Is the capital outflow they predict harmful? The commentary surrounding the BEPS discussion often uses the terminology “harmful tax competition”. The use of the adjective “harmful” begs a question. Is all “tax competition” inherently bad and something to be avoided? After all, economists advocate for competition in other areas—like wage competition and price competition. So why is tax competition any different?

It is a very difficult question to answer, especially if people don’t stop to define the term “tax competition” first before discussing whether it is “harmful”. Commentators have noted the lack of a coherent and

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52 The ZMW model was released in 1986. In the ensuing thirty (30) years, a number of economists have worked to refine the models and also attempt to perform empirical studies of tax competition. For example, economists have added refinements to take into account source-based taxes on both labor and capital. Sam Bucovetsky and John D. Wilson, Tax Competition with Two Tax Instruments, 21 Regional Science and Urban Economics 333 (1991). They have sought to extend the model to situations where both a capital-intensive good is manufactured and a labor-intensive good is manufactured. John D. Wilson, Trade, Capital Mobility, and Tax Competition, 95 J. of Political Economy 835 (1987). Economists have attempted to modify the assumption that public provision of goods ($G$) in a given jurisdiction $n_1$ has positive spillover effects which actually counteracts to the negative effects of tax competition and allows the system to achieve a Pareto efficient provision of public goods. Kjetil Bjorvatn and Guttorm Schjelderup, Tax Competition and International Public Goods, CESifo Working Paper Series (2000) available at http://papers.ssrn.com/sol3/paper261061 (arguing that if residents of jurisdiction $n_1$ benefit from public provision of goods in $n_2$, the fact that $n_1$ raises taxes and capital is shifted to $n_2$ does not automatically lead to a decrease in the utility derived by residents of $n_1$ from their consumption (C) plus the benefits they derive from public good provision (G)). Economists have also modified the model to show how the size of a jurisdiction’s economy can impact the flow of capital. See William Randolph, International Burdens of the Corporate Income Tax 5 Congressional Budget Office Working Paper 2006-009 (Aug. 2006) available at http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf. In addition, empirical research has also been done. Duane Swank, Funding the Welfare State: Globalization and the Taxation of Business in Advanced Market Economies, 46 Pol. Stud. 671 (1998); James R. Hines, Jr., Will Social Welfare Expenditures Survive Tax Competition?, 22 Oxford Rev. Econ. Pol’y 330 (2006); and Robert S. Chirinko and Daniel J. Wilson, Tax Competition Among U.S. States: Racing to the Bottom or Riding on a Seesaw, 63 National Tax Journal 967 (December 2010).


54 For examples of attempts to define and isolate the effects of tax competition see John D. Wilson, David E. Wildasin, Tax Competition: Bane or Boon? 88 J. of Public Economics 1065 (2004).
consistent definition as a problem. Politicians, the popular press and even tax law and accounting articles often imply that tax competition is equated with differences in bases and rates. Yet, economists do not define “tax competition” as mere differences in jurisdictional effective tax rates, but instead as a state of being where differences in rates leads to a less-than-optimal provision of public goods. It is not the mere existence of differences in effective rates, per se, that is problematic.

But if “tax competition” is defined as a state of being that provides less than socially optimum level of public goods, then all “tax competition” is, by definition, “harmful” and the adjective is superfluous. In this way, the economists’ definition simply changes the question. It does not really answer the question. This is because if you define tax competition as a less than optimum level of public goods, then you have to argue over what the socially desirable outcome is and that is not an easy question to answer either. For example, maybe it is socially optimal for governments to compete to provide the most amount of goods for the least amount of tax revenue. Similarly, if jurisdictions were not forced to competitively set their effective tax rates to attract mobile factors of production, perhaps that would simply lead to another bad result - i.e., governments that are larger than they optimally should be.

Thus, for purposes of this paper, it is probably safest just to define “tax competition” in the non-economic sense as simply the practice by which taxing jurisdictions use their tax systems to attract investment. There is a relevant range of what the international consensus (as expressed through the OECD or other multilateral bodies) would refer to as “acceptable” tax competition and anything falling outside of that is viewed as “harmful”.

The OECD’s BEPS project is probably best understood in this context, as an attempt to clarify the rules of the road, specifically with respect to stateless income, and ensure that countries are competing within

55 John D. Wilson, David E. Wildasin, Tax Competition: Bane or Boon? 88 J. of Public Economics 1065, 1084 (2004) (“Much of the literature fails to distinguish between good and bad tax competition.”)

56 In fact, certain extensions of the ZMW model have suggested that if one jurisdiction produces more labor-intensive products whereas another jurisdiction only produces more capital-intensive products, they may achieve a socially optimal result where the jurisdiction making the labor-intensive good has lower wages but higher taxes and levels of public goods than the other jurisdiction. John D. Wilson, Trade, Capital Mobility, and Tax Competition, 95 J. of Political Economy 835 (1987).

57 David E. Wildasin, Interstate Tax Competition: A Comment, 39 Nat. Tax J. 353, 355 (1986) (“One major reason why it is difficult to evaluate this ‘Leviathan’ argument is that it is not easy to ascertain how much public spending is really justified on efficiency grounds.”)


59 In 1651, Thomas Hobbes published his famous work Leviathan or The Matter, Forme and Power of a Common Wealth Ecclesiastical and Civil which advocates for a strong sovereign government (i.e., akin to the Biblical Leviathan) without what we would today consider to be traditional separation of powers in order to maintain order. Context is important, as Hobbes was an English philosopher and was writing during and in the immediate aftermath of the English Civil War. See generally, T.E.G. de Montmorency, Thomas Hobbes, 8 J. of the Society of Comparative Legislation 51 (1907). In any event, economists refer to this idea of sub-optimally large governments as the so-called “Leviathan” problem. See e.g., Geoffrey Brennan and James M. Buchanan, The Power to Tax: Analytical Foundations of a Fiscal Constitution (1980); and Jeremy Edwards and Michael Keen, Tax Competition and Leviathan, 40 European Economic Review 113 (1996). The counterargument to the foregoing is that if a mobile factor of production (i.e., capital) migrates out of a jurisdiction with an inefficiently large government, the capital outflow produces positive externalities (benefits) to the recipient jurisdictions without necessarily increasing the overall provision of goods or services. It may be that the outflow fails to cause the capital exporting jurisdiction’s residents to demand a reduced government. David E. Wildasin, Interstate Tax Competition: A Comment, 39 Nat. Tax J. 353, 355 (1986) (suggesting that capital outflow resulting from tax competition can be viewed as a positive externality generated by the high tax jurisdiction and provided to the low tax jurisdiction but noting that this could conceivably be a positive benefit for society as a whole if the movement resulted in an increased level of capital formation).
“acceptable” norms, however one chooses to define them. In 1998, the OECD released its report called *Harmful Tax Competition: An Emerging Global Issue* but noted that differences in base and rates were not automatically "harmful". More recently, the OECD, as part of its BEPS project, issued a report entitled *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance*. One of the purposes of this report to specifically delineate the outer boundaries of what an innovation box regime should look like. Thus, these reports do not reflect an attempt to eliminate tax competition, but instead define what constitutes "acceptable tax competition". The reader should bear in mind that the purpose of this paper is neither to support or criticize the BEPS proposals and/or U.S. efforts to combat inversions, but instead place these efforts in the context of tax competition and then explain how this relates to the historic debate over shareholder and corporate integration.

C. Congress Has the Ability to Change the Assumptions Underlying the ZMW Model and Thereby Preserve the U.S. Tax Base

The ZMW model suggests each taxing jurisdiction may seek to cut its taxes to compete with fellow jurisdictions and draw more capital to its location. Yet, this conclusion flows from certain key assumptions. It is up to policy-makers to determine whether (and to what extent) those assumptions are valid.

The first assumption is that a tax is imposed on capital invested in “firms”. The conundrum is that there is no distinction made between different legal forms (i.e., partnership, S corporation, C corporation etc...), even though the tax implications of choosing between these legal forms are profound. The distinction is not relevant to the early ZMW models because they simply assume a tax on “capital” instead of the more complex tax system we actually have.

Another assumption in the initial models is that all taxes are source-based, meaning that if capital is moved from jurisdiction \( n_1 \) to jurisdiction \( n_5 \), the capital is taxed in jurisdiction \( n_5 \). As noted above, some models have attempted to refine this assumption to make the models more realistic.

The key point is that although capital may be mobile, the individual investors of that capital are not mobile. Thus, to the extent that the tax burden is shifted away from a source-based tax on highly mobile capital to a residence-based tax on relatively immobile individual investors of that capital, the direct relationship between increased tax rates and capital outflows predicted in the models no longer follows.

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60 Tellingly, in 1998, the OECD issued a report entitled *Harmful Tax Competition: An Emerging Global Issue*. The report listed a number of negative results from what it referred to as “harmful” tax competition, including capital flight. *Harmful Tax Competition* at p. 16. Rather than suggesting that any setting of rates to attract capital was per se harmful, however, the report acknowledged in Chapter 1 that jurisdictions may have to use their tax system to attract investment in order to compensate for some other disadvantage they may have. The report noted that tax havens and preferential tax regimes could have the effect of diverting financial and investment flows, undermining the integrity and fairness of tax structures, discouraging compliance by all taxpayers, re-shaping the desired level and mix of taxes and public spending, causing undesired shifts of the tax burden to less mobile tax bases, and increasing administrative costs and compliance burdens. Importantly, however, the report then went on to say, “Clearly, where such practices have all of these negative effects they are harmful. However, in other cases, for example where only some of these effects are present, the degree of harm will range along a spectrum and thus the process of identifying harmful tax practices involves a balancing of factors.” See *Harmful Tax Competition* at p. 16. In Chapters 1 and 2, it defined “harmful” tax competition as the use of tax havens and aggressive preferential regimes, but even then acknowledged that they were only “harmful” if they had certain effects. *Harmful Tax Competition* at p. 15. Importantly, the report appeared to accept the fact that countries could simply set lower rates across the board. The report did not clearly articulate why a preferential regime to attract one industry was somehow harmful, whereas lower across the board rates to attract all businesses was not. As with the current BEPS project, the recommendations included changes to domestic laws, changes to treaties and greater international cooperation and transparency. *Harmful Tax Competition* at p. 39.

61 Ronald H. Coase, in *The Nature of the Firm* defined the “firm” as a collection of labor and capital combined in a way to reduce the transaction costs that would otherwise result if every single function had to be transacted for through contract. 4 Economica 386 (1937).
Some commentators have made this important distinction. To the extent that Congress were to impose the tax on business profits solely at the Shareholder level (not the entity level), and on a residency basis, raising taxes on those Shareholders does not automatically lead to an exodus of those Shareholders and a consequent reduction in the desire to invest in the U.S. market. We address the impact of increased individual tax rates on the incentive for individuals to give up their citizenship and expatriate in Part IV below.

III. MULTILATERAL INITIATIVES LIKE BEPS SIMPLY CHANGE THE NATURE OF TAX COMPETITION, THEY DON’T SOLVE IT

Instead of focusing on tax planning, please do the wonderful job you’re doing on innovation and be much more conservative on tax planning.

- Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration

The previous section suggested that if Congress were to impose one level of tax on Shareholders of corporations, increased taxes on business profits would not automatically lead to outflows of investment capital. A rational response would be that perhaps the U.S. should consider pursuing more multilateral efforts, like BEPS, before deciding to radically transform its tax system. For the reasons relayed below, such efforts are unlikely to be successful.

The above quote is taken from an interview with Pascal Saint-Amans, who was speaking with the BBC in reference to what he would advise multinationals to do in light of BEPS. He further noted that the public may view it as unfair that multinationals were generating significant revenues in a given jurisdiction and yet not paying tax there. In fact, some have even gone so far as to phrase the BEPS initiative in moral terms - as a contest between rich and poor, developed countries vs. developing countries, or as a necessary inducement for CEOs to prioritize patriotism over corporate profits.

The difficulty with all of these statements, of course, is that tax is a cost, just like any cost. All other things being equal, officers and directors of corporations seek to lower costs, which means they will seek to continue lowering their tax bills.

The stated rationale of the BEPS project was to address the fact that, “national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation.” In many (not all) cases, however, that double non-taxation was (and is) not some anomalous arbitrage identified by and known only to a handful of tax planners, but was instead part and parcel of well worn (and oft-publicized) tax strategies to convert an otherwise uncompetitive headline statutory rate into a much more competitive effective rate. In this regard, it is important to bear in mind that there are a number of countries where capital intensive

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62 Rosanne Altshuler, Benjamin H. Harris, and Eric Toder, Capital Income Taxation and Progressivity in a Global Economy, 30 Va. Tax Rev. 355, 357 (“In contrast, shareholder-level taxes are residence-based taxes imposed on worldwide dividends and equity of U.S. citizens, but not foreign investors.”)

63 Stephanie Soong Johnston, OECD Tax Chief Warns Tech MNEs Against Aggressive Tax Planning, 2015 TNT 94-10.

64 Id.

65 For the views of one outspoken development agency on the subject you can visit www.oxfam.org.

66 Allen Sloan, Positively un-American tax dodges, Fortune (Jul. 7, 2014). Although Mr. Sloan was specifically referring to corporate inversions of U.S. based multinationals a key component of most inversions is the introduction of debt pursuant to which an interest deduction is claimed in the U.S. while interest income is earned in a low tax jurisdiction.

manufacturing or high technology operations can enjoy a zero percent tax rate for more than a decade. It is hard to compete with a zero rate unless the government either slashes corporate tax rates, which often has negative political ramifications, or facilitates double non-taxation. It is tax competition and the reluctance of politicians to be more forthcoming about the realities of that competition with their voters, not double-non-taxation, which is the fundamental underlying issue. Thus, if BEPS accomplishes anything it will likely be to reduce instances of tax competition effected through what could be referred to as “off label” tax planning.

The now-famous double-Irish structure that has received so much press illustrates the point. Using this structure a U.S. multinational (“USCO”) could form an Irish private limited company that was tax-resident in a pure tax haven and considered a controlled foreign corporation (“CFC”) for U.S. tax purposes. The Irish non-resident CFC (“Holdco”) could acquire or develop intangibles which it then licensed to an Irish private limited company that had facilities and operations within Ireland but elected to be treated as a disregarded entity for U.S. tax purposes (“OPCO”). OPCO would make something that it sells to customers around the world and pay a royalty to Holdco. OPCO would pay a 12.5% corporate tax rate on its profits which would be net of the royalty OPCO would have to pay to Holdco. Holdco would pay no tax on its receipt of the royalty and would not incur a source-based Irish withholding tax on the royalty paid to it.

The low corporate rate of 12.5% imposed on OPCO’s earnings is explicit and transparent. Regardless whether the reader agrees that the low Irish corporate tax rate is a good idea or not, it cannot be denied that the Irish government has expressed its policy preference for a low rate explicitly and it has received buy-in and acceptance of that policy among its voting age population. After all, even U2’s Bono has defended the low corporate tax rate. It was this communal acceptance which allowed Ireland to maintain the low corporate rate throughout the financial crisis and while, importantly, the Irish population endured the government’s austerity measures. This “on label” tax planning - a straightforward easy to understand low tax rate on business income - had conceptual buy-in by the voters. In contrast, the double-Irish structure allowed multinationals to pay an effective rate far below 12.5%. This structure was not explicit and arguably did not have the same acceptance among the population. Hence, in response to pressure, the Irish government phased out the double-Irish.

Yet, the double-Irish was not some idiosyncratic and obscure arbitrage that governments were oblivious to. It was a plain vanilla and oft-used approach to investing in Ireland. Not surprisingly then, at

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68 Both Singapore and Malaysia are examples where capital intensive or high-technology businesses can enjoy very favorable incentives. See e.g., Amanda Athansiou, Foreign Interest in Singapore Is Strong, despite BEPS, 2015 WTD 128-2 (Jul. 6, 2015).

69 We borrow the phrase from the medical field where medical devices may be used in ways that have not yet been approved by the Food and Drug Administration and so do not appear as one of the authorized uses on the label. Doctors, patients, manufacturers, distributors and the FDA, may know about the uses, but the FDA has not explicitly sanctioned the use for that specific treatment.


71 Rupert Neate, Bono: controversial tax laws have brought Ireland the only prosperity it’s ever known, http://www.theguardian.com/world/2014/oct/12/bono-tax-laws-bring-ireland-prosperity-apple-google-u2.

72 Section 43 of The Finance Act 2014 - Corporation Tax Update provided that corporations incorporated in Ireland would be subject to Irish corporate taxation absent the application of the treaty provision to the country. Thus companies could no longer form under Irish law but claim that they are managed and controlled in a tax-haven jurisdiction.
approximately the same time the Irish government announced the phase out of the double-Irish, it announced plans for an innovation box regime.\textsuperscript{73}

In this sense, BEPS just changed the nature of, rather than the fact of, tax competition. Expect a similar pattern in other countries. Tax competition will be shifted from off-label to on-label with countries incentivized to compete more explicitly by either lowering their rates, or expanding the scope of income they exempt.\textsuperscript{74}

The latest tax-preference \textit{du jour} is innovation boxes.\textsuperscript{75} High-tech investors, like every investor, consider taxes when choosing where to start a business.\textsuperscript{76} Countries are competing for those investment dollars by considering or enacting innovation boxes at the exact same time they are professing cooperation through BEPS.\textsuperscript{77} At the same time, there are criticisms that the enactment of innovation boxes do not actually result in more R&D personnel.\textsuperscript{78} So why do countries advocate for the innovation box regime when they could just simply lower the rate across the board? The Centrism theory described in more detail below in the context of the U.S. corporate income tax system provides one answer. That is, innovation boxes, like any corporate tax preference, allow politicians to advertise a relatively high marginal corporate tax rate to the public while actually providing a much lower effective rate to businesses operating in the country.\textsuperscript{79} The possibility of an enhanced level of R&D activity (if it actually occurs) is simply a favorable byproduct. It is fortuitous rather than planned. The OECD's recent report on \textit{Countering Harmful Tax Practices} attempts to ensure that the preference is linked with employment through a nexus approach. Time will tell if the approach is successful.

Yet, even if it is successful, countries will still have to compete with one another for those investments in corporate capital. In this sense, BEPS should simply be seen as defining the rules of the road for countries to engage in “acceptable” forms of tax competition rather than an attempt to reduce the fact of tax competition. As these competitive pressures become more pronounced, there will likely be a subsequent spasm of activity under a different acronym.\textsuperscript{80} Predictably, some quarters are already

\textsuperscript{73} The Irish Minister for Finance announced the knowledge development box proposal in the same statement in which he announced the abolition of the double-Irish structures on October 14, 2014.

\textsuperscript{74} See e.g., Alex M. Parker and Aaron Lorenzo, \textit{Patent Boxes Focus of U.S. Debate; BEPS Project Seen as Major Driver}, 105 DTR G-3.

\textsuperscript{75} See e.g., Martin Sullivan, \textit{Economic Analysis: Can a Patent Box Promote Advanced Manufacturing?} 2015 WTD 119-3 (suggesting that while innovation generates positive externalities for society, a patent box is not the best approach for government to stimulate that innovation); Ajay Gupta, \textit{News Analysis: The Patent Box -- A Bad Idea Crosses the Atlantic}, 2015 WTD 138-2 (Jul. 20, 2015). See also, Ajay Gupta, \textit{Boxing the Box: Patent Boxes Take Center Stage at IFA Congress}, 2015 WTD 169-2 (citing economist David Bradbury for the proposition that although patent boxes do increase the number of patents and income from patents a country has, they do not necessarily increase innovation jobs or investment in innovation).


\textsuperscript{77} See e.g., Alex M. Parker and Aaron Lorenzo, \textit{Patent Boxes Focus of U.S. Debate; BEPS Project Seen as Major Driver}, 105 DTR G-3.


\textsuperscript{79} U.S. House W&M Staff Outline Reasons to Support International Tax Reform, 2015 WTD 157-17 (suggesting that the U.S. needs international tax reform or else cash that is trapped overseas will be spent in those countries with an innovation box).

\textsuperscript{80} Amanda Athanasiou, \textit{Competitive Interests Preventing Consensus on CFCs, Stack Says}, 2015 WTD 963 (quoting Robert Stack, Treasury deputy assistant secretary (international tax affairs) as pointing out that countries want to attract companies to their jurisdictions and so resist reaching agreement on common standards and rules).
suggesting that BEPS does not go far enough.81

This paper argues there is a better way forward, however, and the answer lies in focusing on the Shareholder as taxpayer.

IV. THE ONLY WAY TO WIN THE CORPORATE TAX COMPETITION GAME IS NOT TO PLAY

Stephen Falken: Did you ever play tic-tac-toe?
Jennifer: Yeah, of course.
Stephen Falken: But you don't anymore.
Jennifer: No.
Stephen Falken: Why?
Jennifer: Because it's a boring game. It's always a tie.
Stephen Falken: Exactly. There's no way to win.

- From the movie Wargames (1983)

So long as governments seek to impose taxes on corporate entities, corporate managers will continue to be incentivized to lower taxes and increase their after tax return. The capital invested in corporate entities will continue to be much more mobile than labor. Hence, countries that tax corporations more heavily will see capital leave their jurisdictions whether through inversion, outright foreign acquisition of U.S. multinationals, intangibles migration, etc....

If the reader accepts those arguments, it begs the question as to whether there is a better path forward. If countries want to achieve a level of acceptable tax competition; but a uniform tax base, rate and level of enforcement is unlikely; then is there a chess move that a given country, including but not limited to the U.S., can make unilaterally to achieve an acceptable level of tax competition for itself?

In a sense, the U.S. has already made attempts to unilaterally achieve acceptable tax competition. Tightening the anti-inversion rules, for example, represent an attempt to make it harder for companies to elect out of the U.S. tax regime in favor of a more business friendly regime.82 Another example is the recent set of proposals to change the U.S. model tax treaties to reinstate full U.S. source-based taxation on payments made to corporations resident within our treaty partners but which obtain favorable tax rulings in their jurisdictions.83

These approaches are merely delaying the inevitable, however. The U.S. may be able to delay the outflow of capital, but it cannot ultimately trap capital in this country. For example, the aforementioned treaty changes will not impact across-the-board reductions in corporate tax rates. Unless or until the U.S. chooses to do something transformational with its tax system, the U.S. will have to keep playing the tax

81 Stephanie Soong Johnston and David D. Stewart, CbC Reporting a Good Start but Not Enough to Analyze BEPS, 2015 WTD 96-1. See also, William Hoke, Independent Commission Calls for Formulary Apportionment by MNEs, 2015 WTD 106-4.
82 See e.g., Treas. Reg. §1.7874-3 (substantially raising the bar for what constitutes “substantial activities” within the meaning of section 7874, thereby making it virtually impossible for a company to invert without a merger partner); and Notice 2014-52, 2014-42 I.R.B. 712 (describing forthcoming regulations that, if valid, would render certain typical post-inversion planning unpalatable).
competition game. If other countries have a territorial system, the U.S. will be compelled to have some form of competitive territorial system. If other countries have an innovation box regime, the U.S. will be compelled to have some form of competitive innovation box regime, etc. etc...

Sometimes the only way to win a game is not to play it. Such is the case with the international competition over the corporate tax base. If a country like the U.S. chooses to integrate shareholder and corporate level taxes, and integrates them in a way that better aligns individual and government motivations and incentives, the U.S. will still have to live with tax competition, but will be able to do so in a manner that is more palatable to, and aligned with the motivations of, its citizenry. This requires a brief look into what those motivations are, and so that is what the next section addresses, the connection between individual motivation and tax policy.

A. Psychology, Motivation Theories and their Role in Tax Policy

A government that had only warfare to make its laws obeyed would be very near its ruin.

- Alexis de Toqueville

In this country, IRS agents are not going door to door forcing money out of people at gunpoint. People, for the most part, voluntarily comply even though, statistically, their chances of being prosecuted for not paying their full tax liability is quite low. Thus, individuals do not always act like homo economicus. Their actions are not always a strictly rational appraisal of costs and benefits. Or, perhaps it is more accurate to say, people are rational, but take into account a number of idiosyncratic values and beliefs that are not necessarily easy for an economist to identify or quantify.

84 Alexis de Toqueville, Democracy in America, p. 131 (edited and translated by Harvey C. Mansfield & Debra Winthrop) (2000). Published by the University of Chicago. Context is important in understanding this quote. Although the French revolution occurred in 1789, between then and 1835, de Toqueville had witnessed, among other things, the horror of Robespierre, Napoleon’s wars, and the restoration of the French monarchy. Thus, de Toqueville understandably did not reflexively embrace the notion that history inexorably marches in a straight line toward an end, with democracy as a steady end state. Compare Francis Fukayama, The End of History and the Last Man (1992) (suggesting that Western concepts of liberal democracy could represent the final end-state of human history in terms of how mankind chose to govern itself).

85 The IRS periodically measures the voluntary compliance rate (VCR) and the statistics are available on the IRS website. The compliance rate has been higher than 85 percent. There are different types of non-compliance. The statistics view non-compliance as falling into three buckets - non-filing, under-reporting tax liability, and under-paying reported tax liability. It is also important to bear in mind that non-compliance is, by its nature, difficult to accurately measure in the first instance, and the IRS does not even try to record the non-compliance resulting from illegal activity which, right or wrongly, represents a large sector of the economy. See Internal Revenue Service, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance, p. 6 (Aug. 2, 2007) (“It is important to emphasize that IRS estimates of the tax gap are associated with the legal sector of the economy only. Although tax is due on income from whatever source derived, legal or illegal, the tax attributable to income earned from illegal activities is extremely difficult to estimate. Moreover, the government’s interest in pursuing this type of noncompliance is, ultimately, to stop the illegal activity, not merely to tax it.”).

86 An example of one of the more cataclysmic disparities between what people would normally think of as “rational behavior” and the actual actor’s thought process was Saddam Hussein’s response to the coercive diplomacy used in the lead up to the second Iraq War in 2003. As a few pointed out before the war, and many pointed out after Saddam’s inner circle and troves of government records were seized, it was not correct to view Saddam as suicidal or even “not rational”. Instead, he was arguably acting rationally based on his idiosyncratic environment. Compare John T. Mearsheimer and Stephen M. Walt, An Unnecessary War, 134 Foreign Policy 50 (2003) (arguing before the invasion that Saddam, while barbarous, had operated rationally prior to the war based on considerations that were unique to him); with Amatzia Baram, Deterrence Lessons from Iraq, Foreign Affairs (July-Aug. 2012) (“Saddam was fully rational, in the sense that he could and did create a logical chain of how to get from point A to point B and achieve his goals, all of which were very much of this world. But the more one learns about him, the more one recognizes how delusional and reckless his thinking and behavior were in practice. He constantly sought to rationalize the pursuit of goals that were ultimately unobtainable or irreconcilable, and when anyone pointed out the flaws in his thinking, he simply dismissed the objections. This did not make him irrational -- but it did make him very dangerous and very, very hard to deter.”)
In this way, the economist’s “rational actor” assumption is akin to mathematician’s assumption about the imaginary number \(i\) we discussed in Part II.\(^{87}\) It is a useful assumption that can be used to develop theories that are observably true.

Yet, it is also important to remember when the assumption is not true and when the rational actor model is not always going to be a successful predictor of human behavior.\(^{88}\) Psychology can, in certain cases, be the bridge that helps explain the difference between what a rational actor should do, and what people actually choose to do. In fact, the entire field of behavioral economics is based on trying to identify the differences between the so-called “rational actor” and what people actually do in an interdisciplinary way with other fields, like psychology.\(^{89}\)

In the case of tax compliance, specifically, scholars have noted the difference between the level of tax compliance we enjoy with the level of tax compliance we would have if everyone simply weighed costs and benefits. They have labeled this difference between what we would normally expect and what we actually see in practice as “tax morale”.\(^{90}\) Although the study of tax morale may be more advanced now, it is not in any way a “new” concept to tax administrators. As noted below, during World War II, as the income tax base was broadened, then Treasury Secretary Henry Morgenthau placed a corresponding emphasis on public relations efforts to motivate people’s feelings of patriotism to voluntarily comply.\(^{91}\) A similar effort was used during World War I when Woodrow Wilson’s cabinet made a deliberate choice to effectively “tax” middle class Americans by issuing low-yielding war bonds rather than asking middle income taxpayers to pay more in taxes on their tax return.\(^{92}\)

The exact components making up the entirety of tax morale are not known and have not been quantified,\(^{93}\) but there has been theoretical and empirical research into various components of tax morale. For example, there has been research about the idea of “framing” - how to phrase a law may impact

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\(^{87}\) There are other reasons tax policy analysis does not necessarily lend itself to strict economic analysis. See e.g., Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 Cornell L. Rev. 523 (2012-2013) (noting a number of unique features of tax policy that make it different from environmental and other types of legal regulation, most notably that tax is concerned with redistribution, not just efficiency, and tax, unlike environmental regulation, does not seek to force people to internalize their externalities).


\(^{89}\) Thaler, *Misbehaving*, ch. 11 (2015) (electronic ed.) (“The economics training the students receive provides enormous insights into the behavior of Econs, but at the expense of losing common-sense intuition about human nature and social interactions. Graduates no longer realize that they live in a world populated by Humans.”)

\(^{90}\) Marjorie E. Kornhauser, *A Tax Moral Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599, 601-02 (2007) (“Theorists and researchers attribute the vast majority of compliance to what they loosely describe as internal motivations or ‘tax morale’ . . . . The key to the puzzle is ‘tax morale,’ the collective name for all the non-rational factors and motivations - such as social norms, personal values and various cognitive processes - that strongly affect an individual’s voluntary compliance with laws.”).


\(^{92}\) W. Elliott Brownlee, *Federal Taxation in America, a Short History*, pp. 67-68 (2004) (“Rather than tax middle-class Americans at high levels, the Wilson Administration employed a voluntary program to mobilize their savings, a strategy that McAdoo called ‘capitalizing patriotism.’")

people’s willingness to voluntarily comply with it. There have been studies of how culture influences tax morale. Theories have been advanced, based on empirical research, to identify whether taxpayers show a predilection towards risk-taking behavior (such that they are less likely to comply) vs. risk aversion (such that they are more likely to comply). There have been discussions about how social norms may advance, or hinder, tax compliance. There has also been research into the relationship between how people perceive a tax system and how compliant they are with it. As one paper puts it:

There is considerable theory and empirical evidence indicating that positive attitudes and feelings, through various processes, in turn lead to decisions to behave in manners consistent with those feelings. As long as the taxpayers can distinguish more or less accurately between compliant and noncompliant behavior, improving perceptions and attitudes consequently will over time increase compliance.

People whose willingness to cooperate depends on their beliefs about who else cooperates may be referred to as “conditional cooperators”. Think of the prisoners in the prisoner’s dilemma. If the prisoners are made to believe that the other prisoner is going to cooperate, they too will be more likely to cooperate. This then informs tax policy in the sense that compliance can be enhanced to the extent that people perceive others to be complying. The converse is also true. When taxpayers perceive the system to be rigged in favor of one group or another, or that others are not complying, they are going to be less likely to comply.

Tax morale is just one subset of the study of human motivation, a field of study that dates back to William James in the latter half of the 19th Century when psychology really differentiated itself as a separate field of study from philosophy. William James (among others) argued that much of human behavior was

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94 Marjorie E. Kornhauser, *A Tax Moral Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599, 607-609 (2007) (“According to prospect theory, tax compliance should increase if paying taxes is seen as a gain not a loss. If a taxpayer views his situation as interconnected with the nation’s either because s/he is a collectivist . . . and/or through identification with the nation, then taxpaying is more likely to be viewed as a gain than a loss.”) (citations omitted).


96 Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 Colum. L. Rev. 689 (2009) (suggesting a regime whereby taxpayers could self-select different regimes for tax payment and enforcement which would reveal their preferences for risk-taking behavior and allow the government to better allocate resources to so-called gamers as opposed to non-gamers).


98 Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. Chi. L. Rev. 601 (2007) (noting that social norms can also be used to circumvent the tax law where, for example, parties are able to rely on social norms rather than an explicit oral or written contract, to achieve a tax result that would not have been available had an oral or written contract existed).


100 Id. at 39.

101 Richard H. Thaler, *Misbehaving: The Making of Behavioral Economics*, ch. 15 (2015) (electronic ed.) (“Further research by Ernst Fehr and his colleagues has shown that, consistent with Andreoni’s finding, a large proportion of people can be categorized as conditional cooperators, meaning that they are willing to cooperate if enough others do.”). See also, Bruno S. Frey and Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 Journal of Comparative Economics 136 (April 2006) (discussing various reasons for conditional cooperation such as reciprocity, conformity, and environmental factors).

102 Prior to the late 1800s, philosophers and psychologists distinguished between the behavior of animals, which was purely instinctual, and humans, which was assumed to be rational. Herbert L. Petri and John M. Govern, *Motivation: Theory, Research
instinctual or borne out of habit, and not always the result of a rational thought process.\textsuperscript{103} Since then there has been a lot of work in the area of human motivation, generally, and employee motivation in particular.\textsuperscript{104}

Nevertheless, there are a couple of fundamental concepts from this field of study that should influence the integration debate. One basic concept underlying motivation theory is the concept of “needs”.\textsuperscript{105} People are motivated to perform an act because they have a specific need. For example, if a person is hungry, she may get up and make herself a sandwich. If she is not hungry, she has no impulse to make the sandwich. People are more complicated than other animals, however, and so we have needs that are not purely physiological. For example, an individual may have a need to believe she is honest or altruistic or that she rightfully belongs to a group of people believed to be honest or altruistic, and that motivates her to ensure she pays the taxes she believes she owes.

One famous theory that attempts to identify these other higher-order needs and also explain the relationship between them is Abraham H. Maslow’s, “hierarchy of needs”.\textsuperscript{106} Maslow posited that needs could be arranged in a hierarchy, with physiological needs for safety and food being at the bottom and the need for “self-actualization” being at the top. According to Maslow, the lower order needs had to be satisfied before the higher level needs would motivate behavior. Despite the Biblical arguments to the

\textit{Principles of Psychology}, p. 19 (6th ed. 2013) (noting that this approach was based on René Descartes views about the difference between animals and humans). William James (1842-1910) was an American natural science professor and one of the pioneers in the study of psychology and human motivation. One of his biographers lists three areas where William James made significant and long-lasting contributions: (i) his empirical work on conscious behavior; (ii) his status as a leader in the movement towards “pragmatism”; and (iii) his authoring an influential book on religious studies called\textit{The Varieties of Religious Experience}. Robert D. Richardson,\textit{William James: In the Maelstrom of American Modernism}, 95 and 221-228 (2006) (electronic ed.) (quoting Alfred North Whitehead, British mathematician and philosopher and John McDermott, American philosopher, as putting William James in the same category as Plato and Aristotle). See also, Gary P. Latham,\textit{Work Motivation: History, Theory, Research, and Practice}, 667 (2012) (electronic ed.) (“William James (1890) published one of the earliest textbooks on psychology, \textit{Principles of Psychology}. He was concerned with “the description and explanation of states of consciousness” (James, 1892, p.1). Unlike Freud, he eschewed hypothetical constructs of unconsciousness (\textit{i.e.}, id, superego, ego) and the use of dreams as a methodology for studying behavior. Instead, he studies his own consciousness through introspection.”).

\textsuperscript{103} Herbert L. Petri and John M. Govern,\textit{Motivation: Theory, Research and Application}, pp. 28-29 (6th ed. 2013) (“James (1890), from his writings on psychology, can be interpreted as emphasizing three important components in human behavior. There are instincts, emotions, and thoughts. . . . James’s writings seem very apt today. One source of motivation comes from mechanisms built into the nervous system as a result of millions of years of evolution. He called these sources of behavior instincts. A second source of motivation is associated with the experience of emotion. We behave differently when angry than when sad, happy, fearful, or ashamed. Our motivation (and subsequent behavior) depends in part on our emotional state. Although James was more concerned with how emotions occurred, it is clear that he realized that emotions also influenced future behavior (James, 1994/1936). Current thinking suggests that emotions may be thought of as genetically predisposed biases to behave in a particular way that had adaptive value in our ancestral past. For example, feeling fearful when threatened by a large animal and subsequently withdrawing from the vicinity of the animal would have been adaptive because it reduced the likelihood of being injured. Finally, James recognized the role of thoughts in our behavior. He called this process ideo-motor action. Although his thoughts about ideo-motor action are more complex than we can cover here, his ideas presaged the current emphasis on cognitive processes in the understanding of motivation.”)

\textsuperscript{104} There are, for example, very different perspectives by which people approach the study of motivation: (i) nomothetic (how similar persons act similarly) vs. idiographic (how persons act differently from one another); (ii) innate vs. acquired tendencies toward actions; (iii) mechanistic vs. cognitive; and (iv) internal (needs) vs. external (goals). Moreover, there are different ways to study the subject. Medical researchers, for example, may study motivation physiologically, to determine how our brains react to certain stimuli. In contrast, psychologists may study individuals values or beliefs. Herbert L. Petri and John M. Govern,\textit{Motivation: Theory, Research and Application}, p. 8-9 (6th ed. 2013).

\textsuperscript{105} Gary P. Latham,\textit{Work Motivation: History, Theory, Research, and Practice}, 3276 (2012) (electronic ed.) (“Needs are physiological as well as psychological. They affect a person’s survival and well-being. Hence, needs are the starting points of motivation (Lock, 2000). The form in which one experiences needs is through pleasure and pain. Need satisfaction is pleasurable. Need frustration is not only uncomfortable, it can also be life threatening.”)

\textsuperscript{106} Abraham H. Maslow,\textit{ A Theory of Human Motivation} (2013).
Maslow asserted that, “It is quite true that man lives by bread alone - when there is no bread.” On the other hand, when there is plenty of bread, and the man is no longer hungry, he starts considering the need for self-actualization, “Even if all these needs are satisfied we may still often (if not always) expect that a new discontent and restlessness will soon develop, unless the individual is doing what he is fitted for. A musician must make music, an artist must paint, a poet must write, if he is to be ultimately happy. What a man can be, he must be. This need we may call self-actualization.”

Thus, according to Maslow, we have lower order needs and higher order needs and they are ranked in a hierarchy. There are other ways to distinguish needs, however. For example, psychologists have distinguished between intrinsic and extrinsic motivation. A person is said to be intrinsically motivated to perform a certain task because he finds value or pleasure in the task itself, not necessarily the goal to which the task is directed (i.e., he plants and tends a vegetable garden because he likes gardening, even though he can buy carrots from the grocer down the street with a lot less effort). In contrast, a person is extrinsically motivated if he or she performs a task in order to reach a goal to which the task is directed (i.e., she works harder to earn a bonus so she can buy more carrots at the store). Maslow’s hierarchy relates to the foregoing distinction in that extrinsic rewards (i.e., paying a fixed cash reward for a specific behavior) will likely only satisfy lower order needs on Maslow’s hierarchy (i.e., the need to get money to pay for food, clothing and shelter). It is harder for employers to satisfy those higher order needs with a bonus or simple cash reward.

These twin concepts of intrinsic and extrinsic motivation can be potentially helpful in crafting tax policies. The idea is that if a law or legal system can be created whereby people are intrinsically motivated to act in the way society (through its laws) deems correct, then the laws become, at least in part, self-enforcing. There is a fair bit of literature on the intrinsic vs. extrinsic distinction as it relates to the crafting of laws, in general, not just tax laws. In that literature, researchers have noted a number of limitations in applying the intrinsic vs. extrinsic distinction. For example, the distinction between intrinsic and extrinsic motivation is not always clear. Many motivations may arguably fit within both definitions.

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110 Herbert L. Petri and John M. Govern, Motivation: Theory, Research and Application, p. 346 (6th ed. 2013). See also, Richard M. Ryan and Edward L. Deci, Intrinsic and Extrinsic Motivations: Classic Definitions and New Directions, 25 Contemporary Educational Psychology, 54, 56 (2000) (“Intrinsic motivation is defined as the doing of an activity for its inherent satisfaction rather than for some separable consequence. When intrinsically motivated a person is moved to act for the fun or challenge entailed rather than because of external prods, pressures or rewards.”)
111 Herbert L. Petri and John M. Govern, Motivation: Theory, Research and Application, p. 346 (6th ed. 2013). See also, Richard M. Ryan and Edward L. Deci, Intrinsic and Extrinsic Motivations: Classic Definitions and New Directions, 25 Contemporary Educational Psychology, 54, 56 (2000) (“Although intrinsic motivation is clearly an important type of motivation, most of the activities people do are not, strictly speaking, intrinsically motivated. This is especially the case after early childhood, as the freedom to be intrinsically motivated becomes increasingly curtailed by social demands and roles that require individuals to assume responsibility for nonintrinsically interesting tasks. . . . Extrinsic motivation is a construct that pertains whenever an activity is done in order to attain some separable outcome.”)
113 Marjorie E. Kornhauser, A Tax Morale Approach to Compliance: Recommendations for the IRS, 8 Fla. Tax Rev. 599, 607 (2007) (distinguishing between intrinsic and extrinsic motivations for tax compliance and subsequently recommending ways to enhance reliance on social norms to increase voluntary compliance).
Moreover, the two motivational types may interact with one another in rather surprising ways. Sometimes an extrinsic reward or punishment may correlate with an intrinsic motivation, whereas other times an extrinsic reward may serve to “crowd out” the intrinsic motivation. Crowding out occurs when the introduction of an extrinsic reward or penalty for performing (or refraining from performing) an act reduces or eliminates the intrinsic incentive to perform (or refrain from performing) that same act. A commonly cited study in the literature is one where researchers imposed a monetary fine on parents who were late picking up their child from a day-care facility. Contrary to what one would expect, the researchers noted a subsequent increase in the number of late pick ups following the introduction of the fine. Effectively, the fine had the effect of turning a behavior (arriving late) from an act that was considered wrong in and of itself, an act that individuals were intrinsically motivated to refrain from, into a transaction whereby parents believed they were effectively just paying a fee for extra time for which there was no stigma or moral opprobrium.

As with any motivational theory, the intrinsic vs. extrinsic distinction is just one way of looking at and trying to understand human behavior. Context matters in every case. The next section links this intrinsic vs. extrinsic distinction with the integration debate.

B. Application of the Foregoing to Tax Competition and the Integration Debate

A number of commentators have invoked terms like patriotism and morality, two very intrinsic motivations, in the debate over inversions and base erosion. This is somewhat puzzling from a practitioner’s perspective, because there is nothing about the current system of taxing corporate profits that seeks to align the U.S. government’s objectives (i.e., to preserve its corporate tax base and have tax revenue to provide public goods and services) with people’s intrinsic motivations. In fact, viewed holistically, the system is designed to have quite the opposite result.

Corporate managers receive extrinsic rewards (i.e., monetary compensation) for generating higher after-tax returns. They also seek to avoid an extrinsic penalty (i.e., removal by the board of directors or

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116 John T. Scholz & Neil Pinney, Duty, Fear and Tax Compliance: The Heuristic Basis of Citizenship Behavior, 29 Am. J. of Political Science 290, 291 (1995) (noting how those who are more intrinsically motivated to pay taxes also believed they were more likely to be audited).


118 Uri Gneezy & Aldo Rustichini, A Fine is a Price, 29 J. Legal Studies, 1, 3 (2000) (“After the introduction of the fine we observed a steady increase in the number of parents coming late. At the end of an adjustment period that lasted 2–3 weeks, the number of late-coming parents remained stable, at a rate higher than in the no-fine period.”)

119 Id. at 5-8.


121 Yuval Feldman, The Complexity of Disentangling Intrinsic and Extrinsic Compliance Motivations: Theoretical and Empirical Insights from the Behavioral Analysis of Law, 35 Wash. U. J. L. & Policy 48 (2011) (“there is no one-size-fits-all solution as to how policy-makers should think about the intrinsic vs. extrinsic dynamic.”).

reduced pay) for low after-tax profits. Corporate law in fact imposes a duty upon corporate managers to act in the best interests of their shareholders. So, if corporate managers can increase the after-tax returns for a corporation by inverting the corporation they work for because the U.S. applies vastly different and more punitive rules to U.S.-parented multinationals than foreign-parented multinationals, then, all other things being equal, they are very likely to do precisely that. Intrinsic motivations such as patriotism and morality simply do not come into the picture.

Nothing, however, prevents Congress from changing rules to better align the intrinsic motivations of corporate managers with the desired policy outcome - the maintenance of a U.S.-headquartered company. In fact, in a rare mea culpa, the members of the Senate’s permanent subcommittee on investigations (“PSI”) recently acknowledged that Congress (not corporate America) was to blame for the current state of affairs.

There have been suggestions that perhaps foreign corporations should be treated as domestic if their “mind and management” remained here. Depending on how such a law is drafted, this approach could be thought of as a way to force corporate managers to take certain intrinsic motivations into account. If, to successfully invert, the top officers of a company have to physically leave the United States and live abroad, there a number of Maslow’s higher order needs that are not going to be met by simply providing additional extrinsic compensation to those corporate managers. The Achilles heel of this theory, of course, is that while a rule requiring corporate managers to live outside of the United States may reduce (but not eliminate) their incentive to invert, it will not reduce the shareholder incentive to replace those corporate officers with people who are willing to live abroad. In short order, the U.S. will be back to the same problem.

For this reason, if integration is to be seriously considered, it is important to shift the burden of the business income tax to the shareholder, and away from the corporation. Individuals are motivated to live

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123 In a sense, the section 7874 rules already do this, by requiring an inverted company where 80 percent or more of the foreign company’s shareholders are former shareholders of the domestic company to have a substantial business presence in the country they are inverting to. Some have called for the 80 percent figure to be dropped even further. It is unlikely the U.S. is going to be able to write a rule which prevents foreign companies from acquiring U.S. companies, though, and so, in the end, any attempt to tighten the inversion rules without systemic reform of the U.S. tax system is likely to be quixotic.

124 Technically, the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations.

125 Amy S. Elliott, Congress to Blame for Tax-Driven Offshoring Pressures, PSI Says, 2015 TNT 147-1.

126 U.S. NYSBA Discusses Corporate Inversions, 2002 WTD 106-31 (May 24, 2002) (“Many of us feel that the ‘real’ problem of inversions is that they are tax-driven transactions through which nothing changes in a true business sense, and that these companies are still ‘really’ United States companies that should be taxed accordingly. If this is the real problem, it may make sense, as a long-term solution, to change the definition of a domestic corporation, which now looks entirely to the laws under which a corporation is formed, and supplement it by providing that a corporation will also be treated as a domestic corporation based on its substantive business contacts, such as where it is truly headquartered, or its senior management are based, or some other ‘mind and management/managed and controlled’ concept. Many of our trading partners use this concept in their tax systems. However, it would be a sea change in United States corporate taxation, the implications of which should be studied thoroughly before it is enacted.”). See also, Testimony of Prof. Reuven S. Avi-Yonah, Hearing on International Tax Issues before the Senate Committee on Finance, reprinted in 2011 WTD 175-44 (Sep. 8, 2011) (“Does ‘managed and controlled’ still have a role to play in US tax policy if it is not needed to stop inversions? In my opinion the answer is a resounding yes. As Willard Taylor has shown, shell corporations are ubiquitous in US inbound and outbound international tax planning. Adopting ‘managed and controlled’ would be a significant deterrent to this type of planning, because it would require all foreign corporations to be actually run from abroad to avoid being re-defined as US corporations.”) (citations omitted).

127 An analogy could be drawn to the Clinton Administration’s ill-fated attempt to police deferral by enacting section 956A and the excess passive asset regime. Instead of solving the lockout problem and incentivizing taxpayers to bring cash back home, taxpayers instead ceased waiting for tax-reform and instead converted their passive offshore cash investments into new plant and equipment overseas. Thus, the provision had the exact opposite effect of what was intended. Attempts to unilaterally combat inversions will likely suffer the same fate.
in the country where they live. A person who is born in the United States may remain a U.S. citizen or resident for a whole host of reasons that have nothing to do with the U.S. tax system (i.e., family ties, knowledge of the language, national pride, basic inertia, fear of moving to an unknown jurisdiction, etc...). One could characterize some of these motivations as intrinsic, and perhaps some may be extrinsic. One could respond that if individuals are taxed more heavily than their foreign counterparts, they will simply expatriate to avoid the tax. Interestingly, this concern was raised by policy makers as far back as the 1860s, a time when people were far less mobile than they are today.

Yet, in practice, individual (as opposed to corporate) expatriation is far easier to contemplate than to actually do. Anecdotal stories of non-resident citizens who have renounced their citizenship in response to the implementation of the foreign account tax compliance act (“FATCA”) are illustrative. Although a number of reports have cited the significant rise in Americans renouncing their U.S. citizenship in the wake of FATCA implementation, those choosing to expatriate still represent a very small fraction of American citizens living and working abroad. Moreover, these are largely folks who have long been resident outside of the United States, not individuals who are all of a sudden picking up stakes and heading for more tax-favored locations.

In fact, there are a lot less drastic ways to reduce a U.S. individual’s tax burden, such as becoming a tax-resident in a U.S. possession like Puerto Rico. Puerto Rico has plenty of incentives for U.S. individuals who want to move to Puerto Rico and start a business. U.S. citizens don’t even have to surrender their citizenship. Nevertheless, there has not been a mass exodus of wealthy individuals to Puerto Rico.

Thus, if individuals (as opposed to corporations) are intrinsically motivated to live where they live and/or retain their citizenship, and the U.S. tax system were to only tax individuals (as opposed to corporations) on a residency and citizenship basis, the U.S. could largely extricate itself from the tax competition game. As noted in Part II, capital may be mobile, but individual investors of that capital are typically not. Thus, by shifting the corporate tax burden to the shareholder who is taxed on a citizenship and/or

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128 Patriotism and pride could perhaps most clearly considered intrinsic, whereas the fact that the country speaks a language that is known to the taxpayer could in some respects just be considered an extrinsic motivation.

129 Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 Wm. & Mary L. Rev. 447, 520 fn. 323 (2001) (citing Statement of Representative Morrill, “I believe the result of this differential system of duties upon men of large wealth will be to make them go abroad in order to escape the taxation. On the boundary line of my own State I fear it may be so.” Cong. Globe, 38th Cong., 1st Sess. 1940 (1864)).


133 To be clear, this does not mean that residence based individual income taxation would be the only basis of taxation. It just means that that is the way U.S. income tax would be imposed on individual residents. Foreign residents would still be taxed on business profits on a source basis, consistent with current law.
residency basis, the U.S. could better align the tax rules with more intrinsic motivations such as patriotism, familial ties, and, yes, possibly morality.

A pragmatic test for the success of this integration approach would be to measure its impact on the compensation of corporate managers. Imagine a world, for example, where corporate managers of Fortune 500 companies were compensated in a manner that more closely resembled that of mutual fund managers - i.e., they were compensated solely on pre-tax returns. Although their decisions would certainly have tax ramifications for their shareholders, their shareholder base would be so diffuse that it would simply not be possible for them to be compensated on a basis that takes into account the myriad tax issues their shareholders are concerned about.

One could argue that a system that excludes dividends from shareholder gross income (or grants an imputation credit) only if paid by U.S. corporations from profits that have been taxed in the U.S. (but not abroad) would shift the emphasis away from corporate earnings to dividend distributions, discourage inversions and discourage erosion of the U.S. tax base. For example, empirical evidence suggests that the 2003 tax cut in the U.S. for dividends has lead to increased dividend payments. In addition, commentators have pointed to empirical studies of Australia as an example of how enacting such a territorial regime coupled with an imputation credit, like Australia, would decrease the incentive to erode the U.S. tax base. There are a couple of responses to this argument, however. First, a shareholder exemption or imputation credit only provides an incentive to avoid eroding the U.S. tax base to the extent the company distributes dividends. If the company does not distribute dividends, or won’t distribute dividends until some point in the distant future, the imputation credit is not an incentive to keep profits in the U.S. Even then, it only incentivizes retention of a base large enough to support anticipated dividends. Second, the pressure to distribute dividends out of profits that have been taxed in the U.S. is reduced as the percentage of tax-indifferent shareholders in the shareholder base grows. Third, if the U.S. were to adopt an Australian-style approach to integration but fail to enact a territorial system, it would only prevent inversions so long as there is no better option. If companies can invert to a jurisdiction with an imputation system and a territorial system (or a foreign tax credit system but a very low rate like Ireland) and not pay dividends, companies will still have an incentive to invert. Thus, the logical endpoint of this debate is to figure out how to shift tax onto the Shareholder (as defined above).

C. Psychology Offers Some Cautionary Notes as Well

The foregoing section suggested that if the U.S. tax system were better aligned with people’s intrinsic motivations the U.S. could extract itself from the tax competition game. Psychology has a cautionary note about this suggested approach, however. As others have noted, the corporate tax is popular in large part precisely because it is hidden. People don’t realize that they pay it. In this sense, the corporate income tax is akin to the employer’s share of the social security tax. The employee likely bears the tax in the form of lower wages, but he/she does not see the money being taken out of his/her check every two weeks. If Congress were to do what is suggested here, and shift the tax squarely on to the Shareholder, individual voters will be keenly aware of the tax that they are paying.


V. THE ORIGINAL RATIONALES FOR THE CORPORATE INCOME TAX ARE NO LONGER VALID

The foregoing parts argue that the only way for the U.S. to unilaterally achieve an acceptable level of tax competition is to align the tax system with the intrinsic motivations of individuals and this means imposing business taxes on Shareholders. Yet, at the same time, it has to be recognized that the U.S. (and virtually every other country on the planet) imposes an income tax at the entity level and has done so for over 100 years now. The 18th Century philosopher and politician, Edmund Burke, would likely caution that it would be precipitous in the extreme to advocate a removal of any long-standing law without first pausing and asking a couple of key questions. First, why did the U.S. enact the corporate income tax in the first place? Second, why did the U.S. retain it? Third, do any of the reasons for enacting or retaining the income tax stand up to modern scrutiny?

A. Why Does the U.S. Have a Corporate Income Tax?

There is nothing new in the world except the history you do not know.

- President Harry Truman

As long as the U.S. has had an income tax, the law seems to have not quite known what to do with corporations. In some cases the tax law views them as distinct entities with their own set of legal rights and privileges that should bear tax just like individuals (an “entity theory”). In other cases, and other times, the U.S. has viewed corporations as aggregates of their shareholders (“aggregate theory”). Interestingly, both theories have been invoked at one time or another as support for imposing a corporate level tax.

Understanding how the current system developed may help illuminate what direction the U.S. should take. Numerous rationales have been advanced over the years for imposing the corporate income tax. Rather than simply listing those rationales, stripped of their historic context, this part raises each rationale within

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137 In his comparison of Burke and Thomas Paine’s political philosophies, Yuval Levin summarizes Burke’s belief that, “history, and not only nature, must inform political life, and existing political forms should not be abandoned lightly. This does not mean that history is always an honor roll of great and wise accomplishments. Human history, Burke writes in the Reflections on the Revolution in France, ‘consists for the most part of the miseries brought upon the world by pride, ambition, avarice, revenge, lust, sedition, hypocrisy, ungoverned zeal, and all the train of disorderly appetites,’ but it also consists of efforts to address these vices, and in both its best and worst manifestations, history offers lessons no statesman can afford to ignore.” Yuval Levin, The Great Debate: Edmund Burke, Thomas Paine, and the Birth of Right and Left, 56 (2014). He goes on to conclude that, “Burke thus offers a model of gradual change—of evolution rather than revolution. In a sense, he sees tradition as a process of something of the character that modern biology ascribes to natural evolution. The products of that process are valuable not because they are old, but because they are advanced—having developed through years of trial and error and adapted to their circumstances.” Id. at 67.

138 Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L. J. 53, 85-86 (1990-1991) (summarizing the Supreme Court’s decision in Hubbard and how the court had to wrestle with whether a corporation’s undistributed profits could really represent taxable income to a shareholder under the Civil War corporate tax discussed below and whether the corporation should be viewed as a distinct entity or not from a tax perspective).

139 Professor Steven A. Bank has argued persuasively that there is no real historical basis for the entity theory. Professor Bank separates the history of the corporate laws prior to the enactment of the corporate income tax as falling into three periods: (i) the special-charter era in the first half of 19th century; (ii) the rise of general incorporation statutes prior to the Civil War; and (iii) the growth of the large corporation at the end of the century. Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447 (2001).

140 A proponent of corporate tax could, for example, argue that large corporations have accumulated huge sums of money that will likely never be distributed to shareholders. Corporate managers control that wealth and have interests that are distinct from that of their shareholders. One could argue, then, that the U.S. therefore needs an entity level tax to reach that wealth. Alternatively, one could argue that corporations are really aggregates of their shareholders, stockholders tend to be wealthy people, and so we need a corporate tax as an efficient collection vehicle to tax those wealthy corporate shareholders.
the historical context of the time in which it was advanced advanced. Only two (2) of those rationales have any arguable validity today, the first being the entity view (i.e., the view that corporations are so widely held and disconnected from their shareholders that they should be viewed as distinct entities) and the second being administrative ease. Nevertheless, this part concludes that the first rationale does not justify the U.S.’s current corporate tax system. The administrative concerns associated with changing policy are addressed in Part VI.

So what was it, exactly, that motivated Congress to impose income tax on corporations and then tax that same income again in the hands of its shareholders? The classical corporate tax system did not spring into existence fully formed. Instead, the United States has moved through a series of epochs, each of which possessed its own set of historical, philosophical and political forces, and resulted in the system we have today.

1. Civil War Era Taxes

The federal entity level tax starts with the Civil War.141 Prior to the Civil War, the U.S. had raised revenue primarily through import tariffs and excise taxes.142 In fact, immediately prior to the outbreak of the war, over 92 percent of the federal revenue was derived from customs tariffs.143 The war created a need for significantly more revenue, however.144 Moreover, there was a societal limit on how much revenue could be further raised by tariffs and excise taxes. In this regard, it is important to point out that while there was an element of conscription (i.e., a draft) during the Civil War, there was also a well known practice of wealthier individuals “purchasing” a substitute to serve in their stead.145 Forcing the relatively less well off to fund a war that they themselves were fighting would likely prove politically unpalatable. To raise revenue for the war in a socially acceptable way, Congress enacted an income tax in the Act of Aug. 5, 1861.146 There was, at the time, a debate over whether the tax should be imposed on “net” income, which implied that various deductions could be claimed, or whether the word “income” was sufficiently clear to allow for deductions from gross receipts.147 Regardless of the ambiguity, the law was applied on the basis that deductions could be claimed from gross income.148 As one author has noted,

141 William A. Sutherland, A Brief Description of Federal Taxes on Corporations Since 1861, 7 Law & Contemporary Problems 266, 267 (1940). Prior to that time, revenues were primarily raised through the import tariff. When the tariff revenue plummeted during the War of 1812, an income and inheritance tax was suggested but was not adopted. See Arthur A. Ekirch, Jr., The Sixteenth Amendment: The Historical Background, 1 Cato J. 161, 163 (1981).


145 Ron Chernow, Titan: The Life of John D. Rockefeller, Sr., 69 (“Like J. P. Morgan, Grover Cleveland, Theodore Roosevelt, Sr., and other well-heeled young men, Rockefeller hired a substitute for $300 and ended up outfitting a small army.”).


this distinction was the precursor of our current debt-equity distinction because interest on “debt” was
deductible in computing “net” income whereas dividends paid on equity were not.149

This tax was imposed on “persons”, but it was not until the Act of June 30, 1864 (“1864 Act”) that
Congress clarified the role of “corporations” in the tax regime.150 There were different regimes for
different types of corporations, and the statute, as drafted, is not a model of clarity. What is interesting is
that the 1864 Act assiduously attempted to avoid the double-taxation of corporate profits.

As a preliminary matter, only businesses conducted in select industries151 were even subject to an entity
level tax. It is important to note that the 1864 Act specified the industry in which the business was
conducted, but not the legal entity form in which it was conducted. Specifically, banks, trust companies,
insurance companies, railroads, and canal companies were required to withhold 5 percent of any profits
distributed to shareholders as dividends.152 Shareholders were entitled to exclude those dividends that
had been subject to the 5 percent tax from their gross income in computing their personal tax liability.153

These enumerated corporations were also subject to a 5 percent tax on any undistributed profits.154 When
those undistributed profits were subsequently paid, the corporation could subtract the 5 percent tax paid
with respect to that dividend against the tax the corporation was otherwise obligated to withhold.155 The
shareholder would then be able to avoid paying tax on the receipt of that dividend.

Thus, corporate profits were only taxed once, by virtue of the 5 percent tax withheld at the corporate level.
The difficulty with this system is that it favored taxpayers who were in the higher, 10 percent, bracket.
Their dividends had been subjected to a 5 percent withholding tax, but they then excluded the dividend in
computing their personal tax liability. Thus, although double-taxation was avoided, true integration was
not achieved for those higher income taxpayers.

In addition, railroad, canal, turnpike, canal navigation and slackwater companies which had issued bonds
or other evidence of indebtedness were required to withhold 5 percent of any interest paid.156 Holders of

149 See Camden Hutchinson, The Historical Origins of the Debt-Equity Distinction, p. 7 available on the Social Science Research
Network.

150 Section 116 of the 1864 Act imposed a graduated income tax at 5 percent on incomes above $600 and up to $5,000; 7.5
percent of income over $5,000 up to $10,000; and 10 percent on incomes above $10,000. Act of June 30, 1864, ch. 173, §116.
Before the law went into effect, however, Congress eliminated the middle bracket and so imposed the 10 percent rate bracket on
all income over $5,000. See Scott A. Taylor, Corporate Integration in the Federal Income Tax: Lessons from the Past and a

151 Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447, 457 (2001)
(noting that the act imposed an entity level tax on businesses conducted within certain industries, without regard to whether they
were conducted in corporate form).

152 Act of June 30, 1864, ch. 173, §§120 and 122.

153 The language is phrased in the form of a “deduction” it had the effect of an exclusion. Act of June 30, 1864, ch. 173, §117
(“and there shall also be deducted the income derived from dividends on shares in the capital stock of any bank, trust company,
savings institution, insurance, railroad, canal, turnpike, canal navigation, or slack water company, and the interest on any bonds
or other evidences of indebtedness of any such corporation or company, which shall have been assessed and the tax paid, as
hereinafter provided;”).

154 Act of June 30, 1864, ch. 173, §120.

155 Act of June 30, 1864, ch. 173, §121 (“Provided, That when any dividend is made which includes any part of the surplus or
contingent fund of any bank, trust company, savings institution, insurance or railroad company, which has been assessed and the
duty paid thereon, the amount of duty so paid on that portion of the surplus or contingent fund may deducted from the duty on
such dividend.”) (emphasis added)

Past and a Proposal for the Future, 10 Va. Tax Rev. 237, 261 (Fall 1990) (positing that the reason for imposing the withholding
those debt instruments could exclude the interest received in computing their gross income. 157 Again, this
system created an advantage for those taxpayers in the higher 10 percent income tax bracket.

One year later, however, in 1865, Congress revised the exclusion so that taxpayers were only allowed to
deduct the amount of tax withheld against their tax liability on the dividends and interest, thereby
effectively turning the exclusion into a credit and removing the windfall for those in the 10 percent
bracket. 158 As others have noted, in retrospect, this is a surprisingly sophisticated system for the 1860s. 159

Income of corporations other than the ones specified above were simply supposed to be included in the
shareholder’s income on a current basis. 160 The 1864 Act was not clear what happened when profits from
these corporations were subsequently distributed, but presumably they were to be excluded from income.
Interestingly, the tax effectively treated corporations as flow-through entities. 161 Eventually, after the war
ended, and after the government had finally paid off its war debt, the revenue need ended, and so did the
tax. 162

2. Act of August 28, 1894 (the “1894 Act”)

A little less than thirty years after the Civil War, the United States suffered the financial panic of 1893. 163
One year later, in 1894, another attempt was made to impose a broad based income tax and, as part of the
scheme, a tax on corporate profits. 164 Some have suggested that the 1894 Act was really the first act to

tax on interest paid by these corporations was that railroads tended to issue large denomination bonds, and so the interest was
more likely to be received by individuals who were wealthier and would actually be subject to the tax).


158 See Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L. J. 53, 83 (1990-
1991) (citing to Act approved Mar. 3, 1865, ch. 78, 13 Stat. 469, 479). The relevant portion of the actual text of the amendment
is, (“and in ascertaining the income of any person liable to an income tax, the amount of income received from institutions whose
officers, as required by law, with hold a per centum of the dividends made by such institutions and pay the same to the
commissioner of internal revenue, or other officer authorized to receive the same.”)


160 Act of June 30, 1864, ch. 173, §117 (“and the gains and profits of all companies, whether incorporated or partnership, other
than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person
entitled to the same, whether divided or otherwise.”) The Supreme Court held that the term “or otherwise” included
undistributed earnings in Collector v. Hubbard, 79 U.S. 1 (12 Wall. 1870). See Scott A. Taylor, Corporate Integration in the
Federal Income Tax: Lessons from the Past and a Proposal for the Future, 10 Va. Tax Rev. 237, 262 (Fall 1990). See also,
Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447 at fn. 37 (2001)
(citing to the Digest of Decisions and Regulations Made by the Commissioner of Internal Revenue 1864-1898 (1906)).

161 John K. McNulty, Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and
Individual Income Taxes, and International Aspects, 12 Int’l Tax & Bus. L. 161, 166 (1994). But compare, Steven A. Bank,
From Sword to Shield, The Transformation of the Corporate Income Tax, 1861 to Present, pp. 15-19 (2010) (suggesting that
although corporate profits were generally imputed to shareholders, a special tax was imposed on “businesses” (regardless of
entity form) in certain industries like banking, insurance and transportation and so the modern corporate income tax could be
traced to these earlier Civil War era tax acts).

162 An Act to Reduce Internal Taxes, and for Other Purposes, §6, 16 Stat. 256 (1870). During the period from 1864-1871, a
number of limitations were placed on interest deductibility depending on whether the interest represented interest on mortgaged
property or whether the interest was related to a “business” or “personal”. See Camden Hutchinson, The Historical Origins of the
Debt-Equity Distinction, p. 11 available on the Social Science Research Network.


target corporations specifically. After all, the 1864 Act did impose an entity level tax, but only on businesses conducted in certain industries, regardless whether conducted through corporate or partnership form. Businesses conducted outside of those industries were taxed on a flow-through basis, whereby the owners recognized the income on a current basis.

The question is . . . why? Why did Congress choose to impose an income tax at that point in time, and why did it choose to impose a specific tax at the entity level on corporations?

a. Rationale for the Income Tax

One cannot address the rationale for the corporate income tax without first addressing Congress’s rationale for the income tax. Scholars have suggested various rationales for why Congress decided to enact the income tax at that precise moment in time, with one of the most cited works since the 1990s being Robert Stanley’s, *Dimensions of Law in the Service of Order*. The difference in proffered rationales depend largely on the scholar’s philosophy of history and why societies do what they do. These theories have been summarized as progressivism, pluralism, democratic institutionalism, socio-institutional, and centrism.

b. The Rationale for the Corporate Income Tax

The rationale for the income tax may be, but need not necessarily be, the same as the rationale for the corporate income tax. There are a number of theories that align with the evidence. It is difficult to settle on any one as “the” right answer.

i. Centrism

Centrism puts the state, itself, at the center of the action. Under this view, “the state, not society, institutes the income tax. It does so not to redistribute society’s wealth, but rather to palliate discontents

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165 Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 Wm. & Mary L. Rev. 447, 463 (2001) (“The 1894 Act’s primary innovation was to impose an income tax on corporations directly. Although the 1864 Act had imposed both a gross receipts tax and a dividends and undistributed profit tax on businesses operating in certain industries, these businesses ostensibly were not specifically targeted because of their corporate status. The 1894 Act was thus the first to impose a true ‘corporate’ income tax.”).


167 Richard J. Joseph, *The Origins of the American Income Tax: The Revenue Act of 1894 and its Aftermath*, pp. 4-9 (2004). In the progressive view, society is separated into “classes” and history unfolds as a competition between these social classes for control over the state. Id. at 9-16. To the extent that the income tax, in general, and the corporate tax, in particular, effects a redistribution of wealth from the less numerous members of the wealthier classes to the more numerous but less wealthy classes, the tax represents progress towards greater equality. Id. at 7.

168 Id. at 9-16. The pluralist view rejects class distinctions. At the same time it accepts the notion that there are a variety of social groups, each competing for its own interests (i.e., Western ranchers vs. Northeastern manufacturers). Id. at 13. Importantly, the pluralist view does not recognize the preeminence of one social group over another. Id. at 15 (“The pluralist view gives the impression that all group demands are of equal force, hence of equal consideration. That they are not is implied by the unequal distribution of wealth and power in society.”).

169 Id. at 25-29. In contrast, democratic institutionalism focuses on events, more than social groups. Id. at 26. It suggests that laws are precipitated by crises. Thus, for example, the income tax of the Civil War era was necessitated by the revenue needs of that war, just as the 1894 income tax was a reaction to the economic depression of 1893. Id. at 16-25.

170 Id. at 29. Another view is the socio-institutional view. Id. at 29. It explains the enactment of the income tax as the result of multiple social, political, historical and economic forces.

171 Id. at 16-25.

172 Id. at 17 (“At the heart of the centrist order is the state. It is not an extension of society, but rather a separate and autonomous unit.”).
with rhetoric so as to preserve the existing status quo.”\textsuperscript{173} This is an interesting theory and one revisited from time to time throughout this paper. In this theory, the purpose of the income tax in general, and corporate income tax in particular, is not to accomplish some grand redistributive end, but instead to keep a lid on dissent. After all, as Alexis de Toqueville, a keen observer of early American politics and society, once said, “In civilized nations it is generally only those who have nothing to lose who revolt.”\textsuperscript{174} Thus, there is an incentive to keep the masses relatively content. Under centrisim, the purpose of a tax is to make the common man believe they have a enough of a stake in the system to stay in line. Under this view the tax system serves politicians of every stripe because, “Politicians can defend the tax system to poor people by pointing to the highly progressive rates. At the same time, wealthy and powerful interests are not upset because there are loopholes to protect them.”\textsuperscript{175}

The reason centrisim is a very interesting theory is because it is the easiest to rationalize with the actual incidence of the corporate income tax - i.e., who ultimately pays it. As will be discussed below, even fervent advocates of the corporate income tax appear to recognize that labor is bearing at least some portion of the tax. Russell B. Long, a long-serving Senator and Chairman of the Senate Finance Committee from 1966 to 1981, summarized the American public’s view of tax policy as, “Don’t tax you, don’t tax me, tax that fellow behind the tree.” Corporations are the ultimate “fellow behind the tree”. People would like to believe that there is some impersonal entity out there that can be taxed without negative ramifications to themselves. It is also consistent with the ensuing century of tax preferences that Congress has sought to grant one interest group or the other. Thus, an advocate of centrisim may argue that the corporate tax is simply an opiate for the masses, which allows people to delude themselves into thinking that someone else is really paying for their schools, parks and museums. Centrisim is a pretty cynical theory, however, and there are other explanations that are compelling and amply supported by the historical record as well.\textsuperscript{176}

\textit{ii. Progressivism}

Alternatively, for those who believed that corporations were merely aggregates of their shareholders, the corporate tax could make sense as a way to reach the wealth of those shareholders who were otherwise off-limits politically. In this sense, it is important to understand the context of this time. The country was largely divided between Northeastern manufacturers and transportation conglomerates vs. Western and Southern farmers and ranchers. As previously noted, the U.S. federal government’s primary revenue source before the introduction of the income tax was the customs tariff.\textsuperscript{177} Although the tariff was regressive, in the sense that it was really a tax on consumption and so fell disproportionately on the

\textsuperscript{173} \textit{Id.} at 18.

\textsuperscript{174} Alexis de Toqueville, \textit{Democracy in America}, p. 231 (edited and translated by Harvey C. Mansfield & Debra Winthrop) (2000). Published by the University of Chicago.

\textsuperscript{175} Thomas J. Reese, \textit{The Politics of Taxation} at xi (1980).

\textsuperscript{176} Richard J. Joseph, \textit{The Origins of the American Income Tax: The Revenue Act of 1894 and its Aftermath}, p. 45 (2004) (“Thus, contrary to centrist claims, the impetus for the income tax came from ‘below’ not ‘above’. In 1878, for example, the Knights of Labor demanded a graduated income tax. Eleven years later the Northern Alliance and twelve years later the Southern Alliance, followed suit. Successively, in 1877, 1879, and 1880 the Greenback Party endorsed the income tax. Its lead was followed in 1884 by the Anti-Monopoly Party, in 1892 by the People’s Party, and also in 1892 by the Socialist Party. These moves can hardly be described as ‘state initiatives’ or elitist attempts to palliate the masses with rhetoric. They reflect a grassroots effort to forge a new fiscal order, a broad-based drive to realize a political idea.”) (citations omitted).

poor, it also impacted different businesses differently. Whereas Western cattle ranchers and Southern farmers preferred tariffs on raw materials, Northeastern manufacturers preferred protective tariffs on manufactured goods.

At the same time debates were brewing about the gold standard and access by Western ranchers and Southern farmers to credit, largely advanced by Northeastern banks. This was the atmosphere in which William Jennings Bryan delivered his famous “cross of gold” speech, a speech believed to be one of the most successful (if not the most successful) political speeches of all time at the 1896 Democratic convention in Chicago. If you believe the income tax is an effective tool for shifting the costs of the state away from the less wealthy majority towards the more well off minority, you believe the corporate income tax falls on shareholders (not consumers or laborers), and shareholders tend to be wealthy, then the corporate income tax advances your goals. This progressive philosophy of history does accord with the sentiment of the time and many of the expressed statements made in the Congressional Record. There was a generally held belief that the tax would fall on the shareholders. There was also a generally held belief (despite references in the debates to widows and orphans holding shares as their sole source of sustenance) that the majority of those shareholders would be wealthier people.

The problem with the progressive theory is that the premise that the corporate tax was borne by shareholders was debatable, even in the 1890s. After all, at the same time the income tax was being discussed, the public and politicians were also concerned about the rise of monopolies, and one of the nice things about a monopoly is that it can usually pass its costs (including tax costs) onto the consumer without fear of being undercut by a competitor.

### iii. Corporations as Separate Entities

Another theory is simply that corporations became so large and their owners so diffuse that they began to be thought of as separate persons. It is the case that by the latter half of the 19th Century large corporations with diffuse shareholders emerged and the 1864 Act’s approach of imputing the taxable profit of corporations to their shareholders was simply no longer administrable. Yet, if you were to take the actual statements made during the debates in 1894 at face value, it does appear that more was

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178 Steven A. Bank, *From Sword to Shield, The Transformation of the Corporate Income Tax, 1861 to Present*, pp. 15-19 (2010) (citing an economic study prepared by Thomas G. Shearman indicating that whereas the tariff consumed anywhere from 70 to 90 percent of the poor’s income, it only consumed 3 to 10 percent of the income of wealthier persons).


180 Although one author has noted that bondholders were considered uniformly well-off, whereas there was a recognition that at least some equity holders were in fact “widows and orphans”. See Camden Hutchinson, *The Historical Origins of the Debt-Equity Distinction*, p. 16 available on the Social Science Research Network.

181 See Bank, *From Sword to Shield*, at p. 75 fn. 84 (citing statements from Senator Borah and articles published in 1909).

182 Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 Wm. & Mary L. Rev. 447, 522-23 (2001) (“The early American business corporation shared more in common with the partnership than a true corporate organization. . . . Before the 1880s, even the largest factories employed no more than a few hundred workers, and even these larger enterprises were still predominantly family owned. By contrast, the business corporation of the latter half of the nineteenth century grew in size and complexity. Each of the large railroads employed more than 100,000 workers by 1890 and the common stock of many of the largest corporations was publicly traded.”); Majorie Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 Ind. L. J. 53 (1990-1991) (“Although the rise of large scale corporations preceded the Progressive Era, consolidation did not begin until the early 1890s. Rapid consolidation and merger started in 1898; by 1904, the wave of consolidation was basically over.”) (citations omitted).

183 Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 Wm. & Mary L. Rev. 447, 522-23 (2001) (“Enforcement of the income tax during the Civil War and Reconstruction was not aided by the fact that Congress defined income in the 1864 Act to include the undivided profits of a corporation. This is not surprising because a similar provision was used by several states during this period, either to enforce a dividends tax or in the definition of income, with unsatisfactory results.”).
going on here than concerns about administration. Certain members of Congress, rightly or wrongly, firmly and philosophically appeared to believe that large widely held corporations were distinct creatures who derived their own set of benefits from the government and had a duty to pay for those goods and services.\footnote{See e.g., 53rd Cong., 2d Sess., 1894, vol. 26, Part 7: 6866 (Statement of Senator Vest) (“It is complained that small stockholders in these corporations are made to pay. We do not deal with the stockholders. We deal with a corporation as a legal being, doing business, artificially created, receiving protection upon its property from the General Government like citizens receive protection upon theirs.”)}

\textit{iv. Corporate Tax as Regulatory Tool}

Even if one didn’t believe that the burden of the corporate tax fell mainly on the individual shareholder, the tax also served a regulatory function.\footnote{Bank, \textit{From Sword to Shield} at p. 43 fn. 97.} At the time there was no regulatory mechanism to force corporations to make an accounting of their profits and report them to the federal government. This regulatory aspect of taxation will take on increasing importance in the first half of the 20th Century. As noted below, the tax was first viewed as a regulatory window into what corporations were doing in the first decade of the 20th Century, and it was later viewed as a way to regulate the economy.

c. Failure to Achieve a Common Tax Base: Prelude of Challenges to Come

The debate over the 1894 Act highlighted another issue that was to haunt integration advocates for the next century. It is really difficult to perfectly align the corporate and shareholder tax base of a widely held public company. In 1894, the specific question related to the fact that individuals were not required to pay income tax on income up to $4,000. Corporations did not receive the same standard exclusion. Thus, when a corporation paid tax, and distributed a dividend to a lower income shareholder, tax would have been paid even though no tax would have been due had the corporation been a partnership and the shareholder would have been able to use his standard deduction.\footnote{See also, Richard J. Joseph, \textit{The Origins of the American Income Tax: The Revenue Act of 1894 and its Aftermath}, 79 (2004) (noting that Massachusetts Senator George Hoar advocated that if a corporation had 10 shareholders, then the corporation should be entitled to exempt up to $4,000 x 10, or $40,000, of income); and Marjorie E. Kornhauser, \textit{Corporate Regulation and the Origins of the Corporate Income Tax}, 66 Ind. L. J. 53, 88 (1990-1991).} The debate put corporate tax advocates on the defensive, because the failure to give relief actually harmed lower income shareholders. Nevertheless, in the end, it was considered too administratively difficult to align the corporate and shareholder tax base.\footnote{Richard J. Joseph, \textit{The Origins of the American Income Tax: The Revenue Act of 1894 and its Aftermath}, 79-80 (2004) (noting that Senator Vest rejected Senator Hoar’s proposal as impractical).} This was a foretaste of one of the biggest challenges to full scale integration in the years that followed.

d. The Operation of the 1894 Act

The actual operation of the 1894 Act is important for purposes of our discussion. The 1894 Act did impose a tax on the corporation as an entity.\footnote{Act of August 28, 1894, §28 (“That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income above actual operating and business expenses . . . of all . . . and all other corporations, companies, or associations doing business for profit in the United States, no matter how created, but not including partnerships.”).}\footnote{Act of August 28, 1894, §28 (“The net profits or income of all corporations, companies or associations shall include the amounts paid to shareholders, or carried to the account of any fund, or used for construction, enlargement of plant, or any other expenditure or investment paid from the net annual profits made or acquired by said corporations, companies or associations.”).} It was also the case that dividends were not deductible.\footnote{Notwithstanding the foregoing, a proposal had been made to allow a limited form of deductible dividends in an effort to give}
Yet, double-taxation was avoided because when the dividends were paid to the shareholders, the shareholders were permitted to exclude the dividends from their income to the extent the entity level tax had already been paid.190 The 1894 Act created a slight preference for debt financing over equity financing in that individuals were only taxed on income over $4,000, whereas there was no such exclusion for corporate entities.191 Hence, to the extent interest was paid by a corporation to an individual who only had $4,000 of income, it was possible no tax would be applied at all, whereas earnings distributed as dividend would have at least attracted the 2 percent income tax. Otherwise, however, the profits earned by a corporation would be taxed at 2 percent. Either the corporation would pay the tax on its earnings and the shareholder would exempt the dividends from its income, or the corporation would deduct the interest from its earnings and the wealthy bondholder would recognize the interest income and pay tax at 2 percent.

e. Constitutional Barriers to Imposing an Income Tax

Before leaving this passage of history, it is important to point out that the 1894 Act was enacted almost twenty years before the ratification of the Sixteenth Amendment to the United States Constitution (“Constitution”), granting the federal government virtually unrestrained power to impose income taxes. To pass constitutional muster prior to the adoption of the Sixteenth Amendment a federal tax had to withstand the scrutiny of sections 2, 9 and 8 of Article I of the Constitution.

Article I, section 2 of the Constitution, provides, in pertinent part, that, “direct Taxes shall be apportioned among the several States.” Similarly, Article I, section 9 provides that, “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census . . ..” These two provisions provide that if the tax at issue is a “direct” tax, then the burden of that tax must be apportioned based on the population of the various states. 192

This presented a conundrum for a progressive system that taxes wealthier people more heavily than people of more moderate means. If a tax on income were considered a “direct” tax, then the Congress would have to vary the level of the tax to ensure that people in Wyoming paid, on a per capita basis, the same amount of income tax that people in New York did.193

small lower-income shareholders the benefit of the $4,000 income exemption that corporations were not entitled to. See Richard J. Joseph, The Origins of the American Income Tax, p. 80-81 (2004).

190 Act of August 28, 1894, §28 (“Provided also, That in computing the income of any person, corporation, company, or association there shall not be included the amount received from any corporation, company, or association as dividends upon the stock of such corporation, company, or association if the tax of two per centum has been paid upon its net profits by said corporation, company, or association as required by this Act.”).


192 The original rationale for the “direct” taxes clause was odious, and had no particular economic rationale, but it has remained in our Constitution. The reason for requiring apportionment of any taxes can be traced to the three-fifths rule pursuant to which the Southern delegates to the Constitutional Convention wanted representation in Congress for their slaves. Many of the Northern delegates opposed slavery but also opposed the notion of imposing taxes on a State without giving that State commensurate representation. The compromise was that the South would be able to count three-fifths of its slaves in determining its representation in the House of Representatives, but they would have to pay more in the event the newly formed federal government imposed any “direct” taxes. It is unlikely that the drafters knew what the word “direct” meant or attached any significance to it other than the fact that it served to narrow the types of taxes that would be subject to apportionment. See Bruce Ackerman, Taxation and the Constitution, 99 Col. L. Rev. 2-9 (1999); and Edwin R.A. Seligman, The Income Tax, 569-70 (1911) (“The exact distinction between direct and indirect taxation . . . was beyond peradventure of doubt not understood by the framers of the Constitution and those who adopted it. All that can be said is that, in a general way, import and export duties were considered indirect taxes, and that land and poll taxes were considered direct taxes; but farther than that it is impossible to go.”)

193 Bruce Ackerman, Taxation and the Constitution, 99 Col. L. Rev. 2-3 (1999).
Article I, section 8, however, is much more flexible and provides that “The Congress shall have Power To law and collect Taxes, Duties, Imposes and Excises . . .but all Duties, Imposes and Excises shall be uniform throughout the United States.” Section 8, which applies to “direct” and “indirect” taxes simply requires that the federal government not discriminate by applying the federal tax one way in New York and another way in California.

Thus, prior to the adoption of the Sixteenth Amendment, if you were a legislator interested in enacting a progressive income tax, it was very important that the income tax (be it imposed on individuals or corporations) not be considered a “direct tax” and, hence, subject to apportionment under Article I, section 2 of the Constitution.

Prior to 1894 the Supreme Court had exercised restraint in striking down taxing laws based on these provisions. During and after the Civil War, Congress enacted, and the courts upheld as constitutional, income taxes, even though the burden of the tax did not fall in proportion to the population of the various States. Specifically, in *Springer vs. United States*, the Supreme Court held that the income tax provisions of the 1864 Act were constitutional because the tax was not a head tax or a tax on real property and, so, was not “direct”. Thus, the drafters of the 1894 tax law had good reason to believe the Supreme Court would exercise similar restraint with respect to the 1894 Act. Nevertheless, in 1895, even before the tax could be collected, the Supreme Court in *Pollack v. Farmers’ Loan & Trust Co.* held that a tax that was imposed on income derived from property was effectively a tax imposed on the property itself and, thus, was thus a “direct tax”. Given that the tax imposed by the 1894 Act was not apportioned, it was unconstitutional.

3. **The Payne-Aldrich Tariff Act of 1909.**

Fast forward thirteen years and the United States suffered another financial crisis. This time it was the financial panic of 1907. President William Howard Taft had just been elected as a successor to the progressive Republican President Theodore Roosevelt. Roosevelt had skillfully used the press and his “bully pulpit” to rail against the abuses of industry and unbridled accumulation of wealth, but it really fell

194 Bruce Ackerman, *Taxation and the Constitution*, 99 Col. L. Rev. 4 (1999) (“The courts of the early Republic were entirely aware of the compromised origins of the ‘direct tax’ cases. And from the very beginning, they responded with extraordinary restraint in construing their scope. . . . This tradition of restraint continued through the 1880s, when a unanimous Supreme Court upheld the income taxes imposed by Congress during and after the Civil War.”). See also, William A. Sutherland, *A Brief Description of Federal Taxes on Corporations Since 1861*, 7 Law & Contemporary Problems 266 at fn.2 (1940).

195 102 U.S. 586 (1880).

196 See *Pollack v. Farmers Loan & Trust Company*, 157 U.S. 429 (1895) (emphasis added). As others have pointed out, the Court did not address the corporate income tax provisions specifically, but nevertheless ruled that the entire act was unconstitutional and so the corporate income tax could not be enforced. Scott A. Taylor, *Corporate Integration in the Federal Income Tax, Lessons from the Past and a Proposal for the Future*, 10 Va. Tax Rev. 237, 271-72 (1990) (“The Court did not directly address the taxation of corporate income, probably because it would have found that the taxation of business profits was not a direct tax under the Court's definition. Arguably, therefore, the income tax on corporations should have survived constitutional scrutiny. The Court, however, held that the defective portions of the statute caused all other provisions of the income tax measure to fall.”) (citations omitted).


to President Taft, his long-time number two,\textsuperscript{199} to implement the statutory and regulatory framework that advanced Roosevelt’s goals.\textsuperscript{200}

A key issue related to tariff policy. To be clear, the existence and application of the tariff was an issue during the debates in 1894 as well. President Grover Cleveland referred to the tariff as “ruthless extortion”.\textsuperscript{201} Nevertheless, tensions reached a boiling point by 1909, and the relative positions of Republicans and Democrats and liberals and conservatives on this issue would, at least in certain respects, be hardly recognizable today.

Conservative Republican orthodoxy at the time supported high tariffs and protectionism, whereas the more liberal or progressive position was to advocate for reduced tariffs and enhanced flow of imports and exports.\textsuperscript{202} It is hard to believe today, given the relatively free flow of goods and the current debate about how free trade actually depresses wages,\textsuperscript{203} but it was thought at the time that high tariffs only served to increase the profits of manufacturers while making it harder for the average wage earner to afford necessary purchases.\textsuperscript{204} In other words, lower tariffs and freer trade was actually a more liberal or progressive goal at the time.

President Taft supported tariff reduction, as did the progressive wing of the Republican party. Chief among the opponents, however, was Republican Senator Nelson W. Aldrich who, it appears, never met a tariff he did not like.

Senator Aldrich represented Rhode Island and, by 1909, was a towering figure in the Senate. Although very powerful, Senator Aldrich exercised his powers subtly. As evidence, his biography quotes one of the Senator’s daughters as saying, “Papa never preached to us and yet, somehow, we were all so eager to do just what he wanted us to do.”\textsuperscript{205} He is considered one of the chief architects of our Federal Reserve system having chaired the commission which drafted the outlines of what eventually became the Federal Reserve Act.\textsuperscript{206} He is also credited by one of his biographers as being one of the first national politicians to see his political “constituency” in terms of shared interests, rather than a shared geography.\textsuperscript{207} In his

\textsuperscript{199} See e.g., Edmund Morris, Theordore Rex, p. 380 (2002) (describing Roosevelt’s relationship with Taft and how Roosevelt assigned crisis management powers when he was unavailable to Taft); Doris Kearns Goodwin, The Bully Pulpit: Theodore Roosevelt, William Howard Taft, and the Golden Age of Journalism, p. 426 (2013) (when asked how Roosevelt would deal with pressing matters when away from the White House he responded that things would be fine, because “I have Taft sitting on the lid.”).


\textsuperscript{201} Sharon C. Nantell, A Cultural Perspective on Tax Policy, 2 Chapman L. Rev. 33, 45 (1999). In fact, even though President Cleveland was generally in favor of a corporate income tax, he refused to sign the bill which eventually became the income tax of 1894 because it failed to sufficiently reduce the tariff. See Arthur A. Ekirch, Jr., The Sixteenth Amendment: The Historical Background, 1 Cato J. 161, 167 (1981) (“President Cleveland, though he did not oppose it in principle, was fearful that an income tax would divide the Democrats and jeopardize his efforts at tariff reform. The Wilson-Gorman tariff bill, with its provision for an income tax, was indeed so unsatisfactory to Cleveland, because it failed to lower customs duties significantly, that he allowed it to become law without his signature.”).

\textsuperscript{202} Goodwin, The Bully Pulpit, at 583.


\textsuperscript{204} Goodwin, The Bully Pulpit, at 584.

\textsuperscript{205} Nathaniel Wright Stephenson, Nelson W. Aldrich, a Leader in American Politics, 124 (1930).

\textsuperscript{206} Nathaniel Wright Stephenson, Nelson W. Aldrich, a Leader in American Politics, 124, 331 (1930).

\textsuperscript{207} Nathaniel Wright Stephenson, Nelson W. Aldrich, a Leader in American Politics, 60-61 (1930) (“What Mr. Aldrich was capable of thinking about one industry he was capable of thinking about all. He saw that the time was coming when America would have to redefine the word ‘constituency’. . . . The idea of an economic constituency was becoming very real indeed.”).
case, the interest group that Senator Aldrich sought to represent consisted of manufacturing companies (inside and outside Rhode Island) that would benefit from high tariffs on imported manufactured goods and were less impacted by tariffs on imported raw materials.208

To that end, Senator Aldrich had long supported high tariffs on finished goods to keep out foreign goods and protect domestic industry.209 Senator Aldrich was a good politician, however, and realized that, by 1909, there was a groundswell of general support for tariff reduction. Hence, Senator Aldrich cooperated with President Taft to craft tariff reductions on raw materials while at the same time attempting to lessen the pain for his constituency.210

To offset the revenue lost from the tariff reductions, the more progressive wing of the Republican party and like-minded Democrats proposed an income tax.211 The politics and law supporting such a tax were tricky, however. On the political front, Senator Aldrich, perhaps the most powerful person in the Senate, opposed an income tax on principle.212 One can understand why, given the extent to which the Northeastern United States at the time was much more heavily developed than the rest of the country. During the Civil War, the last time the United States sought to impose an income tax, over 60% of the tax was paid by taxpayers in just three states: New York, Massachusetts and Pennsylvania.213 Thus, a Senator from the Northeast would be justifiably concerned that the burden of this new tax would fall primarily on his constituents and campaign donors.

Yet, at the same time, the Senator was becoming increasingly infatuated with establishing a central banking system. Hence, he was leery of appearing to be too far out ahead in advancing the moneyed interests by simultaneously opposing a progressive income tax on wealthy Americans while he worked to advance the interests of banks and other creditors.214 Moreover, the Supreme Court’s decision in Pollack, holding the 1894 income tax unconstitutional was still fresh in everyone’s mind, especially those like President Taft, who favored the introduction of an income tax.

In the face of overwhelming support for an income tax, Senator Aldrich sought to delay, rather than prevent, the imposition of an individual income tax.215 To that end, Aldrich introduced the Sixteenth Amendment to the United States Constitution and, simultaneously, introduced a proposal into the 1909 tariff act, to assess an “excise tax” on the privilege of doing business at the rate of 1% of net income of

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209 For example, in the late 1880s the federal government had a significant budget surplus which lead to the creation of a tariff commission, which recommended a general reduction in the tariff. A bill was drafted to that effect, but in conference committee, the bill was so substantially reworked that it hardly lowered tariffs at all. One of the members of this conference committee was a young Mr. Aldrich, who subsequently defended the move as a legitimate defense of interested industries. As one of his biographers noted, “Thus began for Aldrich an activity which with the increase of experience he was to develop into a fine art.” Nathaniel Wright Stephenson, Nelson W. Aldrich, a Leader in American Politics, 49-50 (1930).
210 Goodwin, p. 593 (“Aldrich himself, the shrewdest and most discerning political animal in the Senate, knew precisely where to yield and where to hold fast. He bartered reductions on some schedules for increases in others, confident that in the end, the bill would emerge essentially his own.”)
212 Id. at 353. See also, Ackerman, Taxation and the Constitution, at 34 (“Aldrich was opposed to all forms of income taxation and grimly rejected the Progressives’ repeated efforts to force a Senate vote on their statute.”).
215 But see Bank, From Sword to Shield, at 66 fn. 44 (citing correspondence which suggests that the idea to impose a corporate excise tax to pay for tariff reform may really have originated with President Taft).
the corporation exceeding $5,000. Ostensibly, the tax was imposed “on” the privilege of doing business. It just happened to be “measured” by reference to income over a certain threshold. In this way, it was hoped that the tax would pass Constitutional muster. Although the phraseology was clearly designed to withstand constitutional scrutiny, it is also the case that the prevalence of general incorporation laws was relatively new, even in 1909. In Antebellum America, incorporation conveyed not only limited liability, but special privileges or concessions in specific industries. It took decades for incorporation statutes to become more democratized. As late as 1899, as Governor of New York, Theodore Roosevelt had fought to impose state taxes on corporations that had been given special concessions to operate businesses such as streetcars, telephone networks and telegraph lines. Thus, phrasing the tax as a tax on the privilege of doing business was not quite as transparently legalistic in 1909 as it may seem today.

In any event, Senator Aldrich’s biographer views the introduction of this excise tax as a political masterstroke for Aldrich. First, the tax was imposed on corporations for the privilege of doing business through a limited liability entity and so appealed to those who sought to survive a Supreme Court challenge. Second, the tax solved the revenue problem without taxing individuals. Moreover, the tax only lasted for two years. Third, the introduction of the Sixteenth Amendment served to defer (and possibly kill) the imposition of an income tax on wealthy individuals, and thwarted any attempt to introduce an income tax on individuals in 1909. Today, with the benefit of hindsight, Senator Aldrich’s move appears to be merely a delay of the inevitable, given that the Constitutional amendment ultimately passed. However, at the time, it was certainly not a foregone conclusion that the amendment would gain the necessary state approvals. It was certainly possible that the amendment would not gain the necessary ratification by the States and never become law. By proposing the amendment, Senator Aldrich put the Democrats and progressive Republicans in a box. After all, how could the Democrats and progressive Republicans argue they had the right to impose an income tax on individuals after they had just cast a vote in favor of a constitutional amendment (which had not yet been ratified) to authorize the imposition of an income tax on individuals? Depending on who the reader believes ultimately bears the burden of the corporate income tax (i.e., shareholder, labor, consumer, or a combination of many groups) Senator Aldrich’s compromise was either a political masterstroke we are living with to this day or a decidedly pyrrhic victory.

216 William A. Sutherland, A Brief Description of Federal Taxes on Corporations Since 1861, 7 Law & Contemporary Problems 266, 267 (1940).
218 Doris K. Goodwin, The Bully Pulpit, p. 246 (2013) (“For decades, the state of New York had granted exclusive franchises to corporations to operate under immensely lucrative electric street railways, telephone networks, and telegraph lines. These franchises, often secured by outright bribery had been awarded with no attempt to obtain tax revenues from the corporation in return. After investigating the issue, Roosevelt concluded ‘that it was a matter of plain decency’ for these corporations to pay their share of taxes for privileges worth tens or even hundreds of millions.”).
219 See 44 Cong. Rec. 3929 (1909) (statement of Senator Aldrich) (“I shall vote for a corporation tax as a means to defeat the income tax.”)
220 44 Cong. Rec. 3344 (statement of President Taft) (“It is said the difficulty and delay in securing the approval of three-fourths of the States will destroy all chance of adopting the amendment. Of course, no one can speak with certainty upon this point, but I have become convinced that a great majority of the people of this country are in favor of vesting the National Government with power to levy an income tax, and that they will secure the adoption of the amendment in the States, if proposed to them.”).
The ultimate compromise was called the Payne-Aldrich Tariff Act of 1909 ("Tariff Act"), and it is generally considered the predecessor to our modern corporate income tax system.\(^{222}\) It is also considered to be the origin of the tax preference for debt financing as corporations were permitted to claim interest deductions under the act.\(^{223}\) Unlike the 1894 tax, the Supreme Court ultimately concluded in *Flint v. Stone Tracey Co.*, 220 U.S. 107 (1911), that the corporate income tax provisions of the Tariff Act were not a "direct" tax and so were constitutional.

The same motivations discussed above in regards to the 1894 Act apply equally to the Tariff Act, but with a notable difference. As Professor Kornhauser has pointed out, the debates leading up to the Tariff Act evidence much greater emphasis on the use of the corporate income tax as a regulatory tool to get information about what corporations were doing.\(^{224}\) As Professor Kornhauser noted in her article on the Tariff Act, the New York Stock Exchange had had a policy requiring listed companies to publish annual financial statements since 1869, yet it was not until 1910 that they actually enforced the rule, and even then it was under threat of government regulation.\(^{225}\) The Tariff Act would have actually required public disclosure of corporate tax returns, but the Act was somewhat ambiguous. One section of the law required public disclosure of tax returns.\(^{226}\) Another section made it illegal for any government employee to disclose taxpayer information (akin to current Code section 6103).\(^{227}\) Despite the ambiguity, Professor Kornhauser notes that one of President Taft’s primary motivations for enacting the corporate income tax is that it would provide transparency into what corporations were doing.\(^{228}\)

4. 1909 through 1935 and the Deferral of Domestic Profits

Double-taxation was avoided from 1909 through 1935 using tax rates. Specifically, there was a normal income tax on corporations and lower-income individuals and a “surtax” on wealthier individuals. Shareholders were allowed to exclude corporate dividends from the normal income tax, but had to include them in gross income for surtax purposes. Effectively double-taxation was avoided in a fairly straightforward manner through manipulation of the rate structure.\(^{229}\)

Although this approach avoided double-taxation, it was not true integration for a couple of reasons. First, the “normal tax” on corporate profits and the “normal tax” on individuals was only imposed at the same rate for five (5) of the years during the 1913-1935 period.\(^{230}\) In the remaining years, the corporate rate exceeded the normal tax rate on individuals and so the common tax rate element of true integration was

\(^{222}\) Pub. L. No. 61-5, §38, 36 Stat. 11, 112-17 (1909). William A. Sutherland, *A Brief Description of Federal Taxes on Corporations Since 1861*, 7 Law and Contemporary Problems 266 (Spring 1940) (noting how the 1909 act was in effect until 1912 and then extended with the Revenue Act of 1913).

\(^{223}\) Bank, From Sword to Shield at 77-78.


\(^{225}\) Id. at 71.


\(^{229}\) Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. Rev. 613, 618-19 (1989-1990); Steven A. Bank, *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present*, 83-85 (2010);

missing. Less well off shareholders were more heavily taxed on their share of corporate profits in these years than they would have been had they earned the profits through a partnership. Second, even in those years when the “normal tax” rates on corporate and individual income were identical, individuals were entitled to a personal exemption as they are today. Corporations were not entitled to any exemption and so the common base element of true integration was missing. Third, and perhaps most importantly, the surtax lacked the common timing element of true integration in that the surtax was only imposed once corporate profits were actually distributed to the wealthier shareholders. This incentivized shareholders (in periods when the surtax was high) to cause corporate managers to “defer” paying dividends so that the present value of the surtax could be reduced. In response, Congress enacted the accumulated earnings tax (“AET”) and, subsequently, the personal holding company (“PHC”) tax, both of which seek to penalize “unreasonable” accumulations of earnings and both of which are still in the Code today. The AET proved incapable of preventing significant accumulations of cash and earnings at the corporate level, however. The failure of the AET to effectively police Domestic Deferral led to the ill-fated attempts at the undistributed profits tax that we will address in the next section.

One important lesson from this time period is that even if there is only one level of tax, whenever shareholder tax rates on dividend income exceed corporate rates, and business profits are not immediately recognized by shareholders, there is an incentive to hoard earnings at the corporate level and thereby decrease the present value of the shareholder tax. Today this issue is more typically discussed in terms of deferral of foreign corporate earnings. In the first decades of the 20th Century, the concern related almost exclusively to domestic corporations. This paper refers to this issue as “Domestic Deferral” to distinguish it from the related but distinct issue of deferring foreign profits from U.S. taxation, or “Foreign Deferral”.

Another important lesson is that the deductibility of interest on debt financing went from being strictly limited to being unlimited during this period. Initially, in 1909, interest could only be deducted on debt equal to the amount of paid up capital. Thus, the tax law imposed what would be referred to today as a thin-capitalization limit of 1:1 with the equity being measured by invested capital, not value. Over time,

231 Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax, 97 (1940) (noting that in 1913, the personal exemption was $3,000 per taxpayer plus an extra $1,000 for married couples).
232 Bank, From Sword to Shield at 84-110 and 145-179. The Senate Finance Committee inserted a provision in their draft of the bill which eventually became the Act of 1913 that would have required shareholders to immediately include their share of a corporation’s undistributed profits in their incomes for surtax purposes. This was opposed, primarily by Senator Elihu Root, on the basis that shareholders simply did not have the right to demand payment of undistributed profits that a corporate board of directors had chosen not to distribute. Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax, 91-92 (1940).
233 See §531. The accumulated earnings tax was originally enacted as §II(A)(2) of the Tariff Act of 1913, ch. 16, 38 Stat. 114, 166-67.
234 See §§541-547. The personal holding company regime was originally enacted as Title II of the Revenue Act of 1934, 75 P.L. 377, §201; 50 Stat. 813; 75 Cong. Ch. 815.
237 Pub. L. No. 61-5, §38, 36 Stat. 11 (1909) (in computing net income, the corporation could subtract, “interest actually within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, all interest actually paid by it within the year on deposits.”).
this limitation was eroded and effectively disappeared during World War I.\footnote{See Camden Hutchinson, The Historical Origins of the Debt-Equity Distinction, p. 10 available on the Social Science Research Network.} Given that corporations were not subject to two levels of tax, however, the preference for debt financing was still not as large as it is today.

5. Revenue Act of 1936 and the Beginning of Double-Taxation

President Franklin Roosevelt (or FDR) (1882-1945) defeated the Republican incumbent Herbert Hoover in the 1932 U.S. presidential election during the depths of the great depression. Despite some of the rhetoric used during the campaign, FDR did not really push for significant tax increases on the wealthy until 1935, when he faced a challenge on his left flank from former Governor and then sitting Senator Huey P. Long, Jr. (a.k.a., the Kingfish).\footnote{Joseph J. Thorndike, Their Fair Share: Taxing the Rich in the Age of FDR, 157 (2013) (“Pressure from a disappointed left, coupled with a potential third party challenge from Huey Long or some other radical tribune, almost certainly prompted Roosevelt’s new interest in tax policy during the first half of 1935.”).} Long considered himself the successor to William Jennings Bryan and his progressive causes.\footnote{Steve Neal, Happy Days are Here Again: The 1932 Democratic Convention, the Emergence of FDR - and How America was Changed Forever, p. 220, 225 (2005) (“At thirty-nine, he was a champion of the powerless an d had accumulated more power at the state level than anyone in American history. ‘There may be smarter men than me,’ Long said, ‘but they ain’t in Louisiana.’ . . . Long, whose slogan, ‘Every man a king,’ was inspired by a line in William Jennings Bryan’s 1896 ‘Cross of Gold’ speech, styled himself as among the Great Commoner’s populist heirs.”)} This political pressure led to the enactment of the Revenue Act of 1935, which increased the surtax rates, increased marginal tax rates on high income individuals, and imposed a graduated income tax on corporations.\footnote{Joseph J. Thorndike, Their Fair Share: Taxing the Rich in the Age of FDR, 174-75 (2013).} Had it not been for a couple of unexpected events, President Roosevelt may not have sought further tax reform in 1936 and so the direction of corporate tax policy would likely have taken quite a different turn.\footnote{Id. at 181 (citing evidence in support of the proposition that had Roosevelt not needed the revenue, he would not likely have sought another significant tax bill in 1936).}

As it happened, however, on January 6, 1936, the Supreme Court invalidated the Agricultural Adjustment Act in United States v. Butler.\footnote{297 U.S. 1 (1936).} One of the components of that act was a processing tax which was expected to raise $500 million.\footnote{Joseph J. Thorndike, Their Fair Share: Taxing the Rich in the Age of FDR, 181 (2013).} A month later, Congress passed a bill for the payment of soldiers’ bonuses in 1936 instead of 1945.\footnote{Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax, 401 (1940).} These two events created an urgent need for new revenue, and thus triggered deliberations over the rather ill-fated undistributed profits tax (“UPT”).\footnote{Id.} For a very interesting discussion as to why FDR’s administration turned to the UPT rather than other revenue replacements, see Joseph J. Thorndike’s, Their Fair Share: Taxing the Rich in the Age of FDR. Only a portion of this history is relevant to the integration debate, however.
The UPT had first been proposed during World War I, but was never enacted into law. The underlying theory for the tax was that it would combat the problem referred to above as Domestic Deferral and the corresponding hoarding of cash at the corporate level. The AET, inserted into the Revenue Act of 1913, was supposed to resolve this problem, but failed to. The UPT would be more definitive and less subject to manipulation. The proponents of the tax believed it served multiple purposes beyond merely raising revenue. For starters, the proponents believed that hoarding cash within the corporate form allowed managers access to capital that was not subject to the typical scrutiny imposed by creditors (in the case of new borrowing) or shareholders (in the case of an equity issuance). This easy access to capital was, in their view, one of the reasons corporate managers were able to over-invest in productive capacity and this, in turn, was one of the causes of the Great Depression. Another rationale was that by forcing corporations to pay out dividends, they would put cash in the hands of individuals who would purchase goods and services, and thereby stimulate demand.

Proponents of the UPT also believed it promoted vertical equity, because by deferring the receipt of dividends, wealthy shareholders were engaging in Domestic Deferral and avoiding the surtax that would otherwise apply. Interestingly, in this case, it was the aggregate view of corporations that was advanced as a rationale for corporate taxation. A correlative benefit of the UPT was that it would eliminate the penalty imposed on operating in non-corporate form. Recall that, at this point, the corporate profits were not double-taxed as they are today. The corporation and shareholders were subject to the normal tax, but only shareholders were subject to the surtax. Moreover, corporate dividends were exempt from the shareholder’s income for purposes of computing the normal tax. Thus, operating in corporate form could result in a lower tax bill than a partnership, provided corporate dividends (and the corresponding shareholder surtax) was deferred.

President Roosevelt and his team initially sought a very significant undistributed profits tax but, importantly, distributed profits would only be subject to one (not two) levels of tax. The House of Representatives passed a bill in line with the President’s wishes which would have provided for no corporate income tax on distributed profits and a graduated rate of tax on undistributed profits. To ensure that at least one level of tax was imposed, however, the exemption of corporate dividends from the “normal tax” imposed on individuals was repealed. Had the House version been enacted, corporations


248 Joseph J. Thorndike, Their Fair Share: Taxing the Rich in the Age of FDR, 186 (2013); and Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax, 410 (1940) (noting how Republican members of the House Ways and Means Committee sought to associate the UPT with Mr. Rexford Tugwell of the Agricultural Adjustment Administration, who had written a book called Industrial Discipline arguing that capital would be better allocated if corporations were forced to distribute their surplus and compete for new equity and debt capital).


250 Id. at 187.

251 Id. at 189.

252 Intriguingly, the proponents of the UPT in Roosevelt’s administration argued that it advanced vertical equity on the theory that, ultimately, the corporations were mere aggregates of their shareholders, not separate and distinct entities. Id. at 188-89 (“The rise of the UPT can be explained by the actions of one person: Herman Oliphant, the administration’s leading champion of social taxation. . . . His argument depended on the presumption that all taxes were ultimately borne by people, not companies. ‘When all is said, taxes come out of the pockets of individuals,’ he told the Senate Finance Committee.”).

253 Id. at 190.


would have been incentivized to distribute their profits, and one level of tax (not two) would have been imposed on distributed profits at the shareholder level.

Importantly, for purposes of this discussion, corporate officers took umbrage at the notion that the government would play any role in influencing their corporate dividend policy. As a result, the approach was watered down in the Senate. The result was a compromise whereby corporate undistributed profits would be taxed a higher rate than distributed profits, but shareholders would no longer be allowed to exempt dividends from their income. Thus to reduce the tax penalty for corporate earnings retention, corporate interests traded away the shareholder exemption for corporate dividends. Thus, double-taxation of corporate profits was born.

During 1936 to 1937, the U.S. imposed a split-rate system on corporate profits whereby distributed profits were subject to a regular tax ranging from 8 to 15 percentage points, and undistributed profits were subject to a higher rate of tax. It was estimated that corporate dividends increased one-third over this period. The penalty for retaining earnings was reduced in the Revenue Act of 1938 and expired in 1939.

Commentators have suggested that this tension between good tax and economic policy, on the one hand, and the short-term interests of corporate managers, is one of the reasons the U.S. has failed to achieve full integration before now. The argument is that corporate managers are more interested in lobbying for tax preferences (i.e., accelerated depreciation) which impact the corporation’s after tax profits than with integration, which would only benefit the shareholders. Under this theory, corporate managers also advocate for policies that enhance retained earnings (the so-called “retained earnings trap”) because reinvestment of retained earnings is subject to less scrutiny than new equity or debt issuances. Some have intimated that the first push by corporate managers for the retained earnings trap took place during this debate between 1936 and 1938.

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257 Bank, From Sword to Shield, at 179 (“The price corporate managers paid for gutting the bill of its coercive power over dividend policy was the introduction of full double taxation of corporate profits.”).
258 See also, Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax, 422 (1940) (“The Conferees retained also the normal tax on dividends received by individuals, a provision inserted when the House proposed to tax corporation income when distributed.”). The U.S. did not impose double taxation on all corporate profits until 1986, when the last vestiges of the small shareholder dividend exclusion was eliminated together with the repeal of the General Utilities doctrine.
260 Id.
261 Id.
262 Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 Yale L. J. 325, 327 (1995) (“the resilience of the corporate tax is a manifestation of the most enduring source of problems in corporate law, the separation between ownership and control of large corporations. Large corporations might be expected to lead the fight against the double tax. Their managers, however, have chosen not to lobby vigorously for integration, even though shareholders often would benefit from integration. In this managerial diffidence lies the key to explaining the failure of integration efforts.”).
263 Id. (“Shareholders benefit both from measures such as integration that provide windfalls to their existing shares and from measures such as accelerated depreciation (ACRS) and investment tax credits (ITCs) that increase the return on new investments. Managers, in contrast, benefit only from policies that stimulate new investment.”)
265 Id. at fn. 144. See also, Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. PA. L. Rev. 1469, 1496-98 (1991).
Moreover, the loosening of restrictions on interest deductibility during World War I, coupled with the introduction of full double taxation of corporate earnings in the latter half of the 1930s, firmly entrenched the preference for debt financing that exists today.266

6. The End of World War II Creates Another Opportunity for Reform

The war years changed American society in a number of ways, only one of which is pertinent here. As tax historian, Joseph Thorndike, has noted, during the war years, the application of the income tax was broadened tremendously and it went from being a “class tax” to a “mass tax.”267 Thus, it was no longer possible to think of the income tax (in general) and the corporate tax (in particular) as a narrow tax designed to reach the incomes of only wealthier individuals. Even smaller shareholders with middle incomes now paid income tax, and were double-taxed on dividends since the 1936 repeal of the dividend exemption for normal tax purposes.

With the war over, a number of influential commentators suggested that something be done about corporate taxation. Beardsley Ruml, then Chairman of the Federal Reserve Bank of New York and Chairman of the Board of R.H. Macy & Co., co-authored a plan for post-war taxation referred to as the “Ruml-Sonne” plan, which received a hearing in front of Congress. Mr. Ruml was against taxing corporations, in general, and double-taxation, in particular.268 Similarly, Roy G. Blakey, a noted economist and tax historian at the University of Minnesota highlighted the problems with the double-taxation of corporate profits.269

In 1946, the Treasury published “The Postwar Corporate Tax Structure” by Dr. Richard B. Goode which suggested taxing closely held corporations as partnerships.270 The proposal had a significant influence on tax reform in the latter half of the 1950s.271 The proposal applied to corporations with simple capital structures (i.e., one class of stock) and no corporate shareholders.272 The proposal provided that corporate

266 See Camden Hutchinson, The Historical Origins of the Debt-Equity Distinction, p. 31-33 available on the Social Science Research Network.


268 Beardsley Ruml, Fiscal Policy and the Taxation of Business, 1 Tax L. Rev. 75, 79 & 82 & 83 (1945-1946) (“Taxes on corporation profits have three principal consequences -- all of them bad. . . . The corporation income tax is an evil tax and should be abolished. . . . The question will of course be asked: Can the government afford to give up the corporation income tax? But this is not the real question. The question is: Is the corporation tax a favorable method of assessing taxes on the people -- on the consumers, the workers and the investors -- who are after all the only real taxpayers.”)

269 Blakey, Postwar Fiscal Policy, 24 Taxes 574 (June 1946) ("The present taxation of business and corporations in particular exhibits numerous instances of restriction and discrimination, for example: (1) different provisions for the taxation of business, depending upon whether it is conducted by a corporation or a partnership or an individual; (2) double taxation of corporate earnings, first to the corporation and then to the recipient of dividends; (3) discrimination in favor of undistributed corporate earnings; (4) discrimination in favor of interest and rents as compared with corporate dividends; (5) discrimination in favor of “long-term” capital gains; (6) failure to make adequate offsets for losses as compared with gains; (7) heavier taxation of irregular than of regular incomes; (8) graduation of corporation income taxes on the basis of amount of earnings rather than on the rate of earnings in relation to capital invested."). See also, Sol Levinson, The Integration of Taxes on Income, 25 Taxes 404 (May 1947) (stating, “Congress inevitably must come to grips with the problem of integrating taxes on income.” and recommending a dividends paid deduction would address the issue).


income would be currently taxed, whether distributed or not, at the rates applicable to the individual shareholders in the corporation. Capital gains traceable to such profits and dividends paid out of such previously taxed profits would not be subject to individual income tax in the hands of the stockholder. The rationale set forth for taxing such corporations as partnerships was the same one put forth by various Congressmen in opposition to the corporate tax in 1894 - i.e., that a “corporation and its stockholders are substantially the same economic entity.”

A series of hearings followed during 1947. Dr. Goode wrote a more detailed report by the same name (“Second Goode Report”) in 1947 which was submitted as part of the hearing before the House of Representatives on tax reform. In the Second Goode Report, Goode analyzed four (4) means of eliminating double taxation: (i) exempting corporations from tax, but imposing tax at the shareholder level on dividends and capital gains; (ii) applying a partnership-like approach; (iii) a dividends paid deduction; and (iv) an imputation credit.

After the hearings concluded, a report was issued to the House Ways & Means Committee which identified three (3) methods of eliminating double-taxation: (i) only tax the shareholder on a realization event (like a dividend or sale); (ii) permitting a dividends paid deduction; (iii) allowing the shareholder a credit against their own tax liability equal to the amount paid by the corporation either by providing the shareholder a credit or by treating the corporate tax paid as a withholding tax imposed on the shareholder. The report recommended permitting shareholders a credit for corporate taxes paid. The reforms were not enacted, but commentators continued advocating for integration.

The idea of doing something to alleviate double-taxation arose again in the lead up to the enactment of the Internal Revenue Code of 1954. President Eisenhower was keen to eliminate double taxation and advocated that smaller corporations be allowed to elect to be taxed as partnerships. Again, a number of hearings were held. Most of those who testified on the taxation of dividends suggested some form of

273 Goode, Postwar at 18-19.
274 Goode, Postwar, at 20.
275 See e.g., Hearings before the Committee on Ways and Means, 80th Cong. 1st Sess. Part 2, p. 1009, 1013 (1947) (Statement of O.A. Reardon, Representing the National Association of State Chambers of Commerce, Alexandria Va.) (“For corporations with a few owners who hold their stock of long periods of time, and with only common stock outstanding, the partnership method of taxation would seem to be practicable if there is general agreement among the owners of its desirability. But for corporations with a considerable number of shareholders, with stocks often changing hands, and with complicated financial structures, this method would appear to be impracticable.”); Hearings before the Committee on Ways and Means, 80th Cong. 1st Sess. Part 2, p. 1018 (1947) (Statement of Theodore K. Warner, Jr., Representing the National Association of State Chambers of Commerce, Philadelphia PA.) (discussing the feasibility of exempting dividends, treating corporations like partnerships, taxing interest like dividends, imposing an undistributed profits tax, the British advanced corporation tax regime, and using surtaxes and rates to avoid double taxation).
276 Id. at 1137-38.
278 Id.
281 See e.g., Hearings Before the Committee on Ways and Means, Forty Topics Pertaining to the General Revision of the Internal Revenue Code, 83rd Cong. 1st Sess., Pt. I pp. 574-84 (1953) (suggesting various ways to ameliorate double taxation). There appears to have been significant pushback from organized labor during the Senate Finance Committee’s deliberations, however.
relief for double-taxation.\textsuperscript{283} As part of the initiative which resulted in the Internal Revenue Code of 1954, the Senate did take up and pass H.R. 8300, section 1351 of which would have allowed certain corporations to be taxed as partnerships.\textsuperscript{284} Section 1351 of the Senate bill applied only to corporations with one class of stock outstanding and ten or fewer active domestic shareholders. Partnerships of individuals were permitted to own stock in the corporation.\textsuperscript{285} The House of Representatives and Conference Committee eliminated section 1351, however, and so no relief was granted for small businesses.\textsuperscript{286}

Although President Eisenhower did not get complete pass-through treatment for small businesses, modest reforms were enacted. Specifically, a $50 per shareholder exclusion was permitted for dividends.\textsuperscript{287} In addition, shareholders were permitted a credit against their personal tax liability equal to 4 percent of the dividends they received from domestic corporations (other than insurance companies).\textsuperscript{288} The credit was repealed 10 years later,\textsuperscript{289} and the exclusion was eliminated in 1986.\textsuperscript{290}

Four years later, in 1958, President Eisenhower tried again, and recommended that some tax relief be provided to small businesses.\textsuperscript{291} Treasury drafted a version of subchapter S for the House Ways and Means Committee to include in what was referred to as the Small Business Tax Revision Act of 1958.\textsuperscript{292} Congress eventually passed, and President Eisenhower signed, the Technical Amendments Act of 1958, containing new subchapter S of the Internal Revenue Code of 1954.\textsuperscript{293}

Today, subchapter S remains available only to companies with simple capital structures that do not have any non-U.S. shareholders, although they can issue non-voting shares. It would be a mistake to think that S corporations are only conducting “small” businesses, however. In 1958, S corporations were only entitled to have 10 shareholders, whereas now they can have 100.\textsuperscript{294} Moreover, they were originally prevented from generating significant amounts of passive income and wholly owning corporate subsidiaries. Those prohibitions are both gone now.

See Hearings Before the Committee on Finance, \textit{H.R. 8300 An Act to Revise the Internal Revenue Laws of the United States}, 83rd Cong. 2d Sess. Pt. 2 at 803, 808-09 (Apr. 13, 1954) (Statement of Walter Reuther, Congress of Industrial Organizations) (suggesting that there was no “double-taxation” problem and that corporations were entities that should pay taxes just like individuals).


\textsuperscript{284} H.R. 8300, 83d Cong., 2d Sess. (1954)


\textsuperscript{287} Internal Revenue Code of 1954 at §116.

\textsuperscript{288} Internal Revenue Code of 1954 at §34.


\textsuperscript{290} \textit{Id.}


\textsuperscript{293} P.L. 85-866; HR 8381, 85th Cong., 2d Sess. (1958).

\textsuperscript{294} P.L. 104-188, §1301 (raising the number of permissible shareholders from 35 to 75); and P.L. 108-357, §232(a) (raising the number of permissible shareholders from 75 to 100).
Given the forceful push for corporate tax reform in the immediate aftermath of World War II, it is unclear why more fundamental reforms were not enacted. One possibility is that public expenditures, particularly defense outlays, remained staggeringly high as the U.S. moved into the Cold War and both Presidents Truman and Eisenhower were committed to balanced budgets.\(^{295}\) The corporate tax brought in a larger percentage of federal revenue at the time and there wasn't sufficiently strong appetite to risk losing that revenue. Another argument, and one that aligns more with the centrisms theory, is that corporate managers were simply more concerned with advocating for tax-preferences like accelerated depreciation, than advocating for tax relief on behalf of their shareholders.\(^{296}\) In all events and whatever the reason, corporate tax reform began the 1950s with a roar and ended the decade with a wimper.

Finally, before moving to the next section it is important to dwell on another aspect of Dr. Goode’s report. Although the partnership approach advocated by Dr. Goode motivated the enactment of subchapter S, it is important to remember that Goode only highlighted the partnership model as an ideal, which he noted was impractical and likely unattainable for larger widely held corporations. The first pragmatic suggestion he outlined after highlighting the partnership ideal was the idea of a dividends paid deduction which, in his words would, “practically eliminate the present premium on debt financing and the present tax discrimination against the corporate form of doing business. The approach would also lower any tax barriers that may now exist to corporate investment. It would be well calculated to counteract any tendency of corporations to shift their taxes to consumers and wage earners.”\(^{297}\) The next section discusses two countries that adopted such an approach.

7. Afghanistan and Mauritius

It is important to bear in mind that while the U.S. and other major industrialized countries waffle back and forth on important tax issues (including but not limited to integration), the laws in place at any one point in time are often advocated as “best practice” by advisors to developing countries. This is true even though, as we have seen as an example, the U.S.’s policy on the issue of integration has been far from uniform or linear over the years.

The U.S. government (and other governments) has had a long history of funding advisory missions to developing countries for not entirely altruistic reasons.\(^{298}\) Non-military advisory assistance, including tax advisory assistance, has been one of the foreign policy tools that the U.S. and other governments have used to gain influence in other countries for a long time.

Two of these countries are relevant for purposes of this paper, because they both chose, unlike the imputation system of many European countries, to use a dividends paid deduction approach to avoid double-taxation. One of the countries has retained that approach and the other has since abandoned it.

\(^{295}\) Julia E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945-1975*, p.87 (1998) ("Unlike his Republican predecessors after WWI, Eisenhower refused to dismantle the wartime income tax following the end of the Korean War. Eisenhower, like Truman, remained more committed to balancing budgets than reducing taxes. As a result, the budget was balanced in fiscal years 1947, 1948, 1949, 1951, 1956, 1957 and 1960; deficits in the remaining years merely averaged about 1 percent of GNP.").


\(^{298}\) Michael R. Adamson, *The Shoup Missions to Cuba*, pp. 86-88 in *The Political Economy of Transnational Tax Reform: The Shoup Mission to Japan in Historical Context* (eds. W. Elliot Brownlee, Eisaku Ide, and Yasunori Fukagai) (2013) (noting that the reason the State Department sent Carl Shoup to Cuba was to shore up their tax system so that they could repay Wall Street creditors).
a. Deductible Dividends in Afghanistan

Now I shall go far and far into the North playing the Great Game.

- Kim, Rudyard Kipling

Although the U.S. failed to embrace full integration for all entities during the 1950s, the debates in the U.S. may conceivably have influenced the advice of U.S. advisors to Afghanistan during this time frame. The evidence is not clear, but unconstrained by U.S. political considerations, these U.S. advisors may have advocated abroad an integration approach that the U.S. failed to enact at home.

Specifically, during the 1950s, the Cold War was in full swing, and would remain so for another 40 years. The United States and the Soviet Union vied for influence in countries all over the world through overt use of military force, covertly, or by competing with each other for the provision of non-military assistance. One of the best examples of a government which did not hesitate to play both sides against the middle in order to maximize its foreign assistance was the Royal Government of Afghanistan, which was headed by King Mohammad Zahir Shah.

Afghanistan’s history dates back millennia, but only a couple of major historical points are relevant for our purposes. Specifically, in 1893, Sir Mortimer Durand, then Foreign Secretary of India during the British colonial period, negotiated an agreement with the Abdur Rahman, the Emir of Afghanistan establishing what became known as the “Durand Line”. This line is profoundly important because it neatly divides one of the largest ethnic groups in that area - the Pashtuns - and includes land that, at one point at least, was part of Afghanistan, thereby reducing the Pashtun percentage of the population that remained in Afghanistan proper.299

In any event, within two (2) years of World War II ending, India and Pakistan gained their independence in 1947. The Afghans, sensing an opportunity based on Wilsonian principles of self-determination, and during a period of declining Afghan-Pakistan relations, 300 rejected the Durand Line and attempted to set up a separate government for what is referred to as “Pashtinustan”.301 Ever since, the “Pashtunistan issue” has been a source of constant concern to Pakistan, which, in turn, fuels a Pakistani foreign policy that (viewed through a Western lens) seems somewhat schizophrenic and self-defeating.302

In the 1950s, the U.S. sought good relations with Afghanistan, and wanted to keep the Afghans out of the Soviet fold, or at least not entirely within the Soviet fold. At the same time, however, the U.S. wanted

299 At the time it served then as the border between the Northwest frontier of British India and the Eastern border of Afghanistan. Today it serves as the border between Afghanistan and Pakistan. There is some historic disagreement, on the Afghan side at least, as to whether the agreement executed with Sir Mortimer was actually a treaty that established an international border as opposed to an agreement regarding general spheres of influence. See generally, Leon B. Poullada & Leila D.J. Poullada, The Kingdom of Afghanistan and the United States 1828-1973, pp. 82-92 (1995).

300 In March of 1949, a Pakistani Air Force plane bombed an Afghan village resulting in 26 deaths and multiple injuries. Pakistan accepted responsibility and paid damages, but the bombing created very significant tensions between the two countries. See generally, Leon B. Poullada & Leila D.J. Poullada, The Kingdom of Afghanistan and the United States 1828-1973, p. 98 (1995).


302 Husain Haqqani, Magnificent Delusions: Pakistan, the United States, and an Epic History of Misunderstanding, p. 31 (“The demand for Pashtunistan became part of the combination of perceived security threats that required Pakistan’s military buildup, which would need to be backed by great power alliances. Although India publicly did not support the Afghan claim, Pakistan’s early leaders could not separate the Afghan questioning of Pakistani borders from their own position of an Indian grand design against Pakistan.”).
good relations with Pakistan, which made overt U.S. diplomatic support for the concept of Pashtunistan inherently problematic.

The U.S. did have lots of cash and military hardware, however, but the return on investing in Afghanistan was apparently not obvious in the early 1950s. George McGhee was the Assistant Secretary of State for Near Eastern and South Asian Affairs at the time and recounts in his autobiography how Prince Mohammed Naim, the Afghan ambassador, met with him in 1951 and indicated that if the U.S. was not prepared to provide military aid, Afghanistan would have to seek assistance from the Soviet Union. McGhee believed the Prince to be bluffing, and so he simply handed the Prince the telephone number for the Russian embassy. McGhee relays that they both laughed at the time.\textsuperscript{303} The Afghans apparently did not find the joke quite as amusing as the Assistant Secretary, however. By 1955, Nikita Kruschev openly supported an independent Pashtunistan and the Soviet Union started sending military equipment into Afghanistan.\textsuperscript{304}

To retain influence, while recognizing the balancing act with Pakistan, the U.S. provided technical support in the form of advisors in the 1950s and then much more so in the 1960s.\textsuperscript{305} The stated objective of the aid was to maintain Afghanistan as a non-aligned buffer state between the Soviet Union and India.\textsuperscript{306} The agency we know of today as the United States Agency for International Development ("USAID") was not created until November 3, 1961, a month after President Kennedy signed the Foreign Assistance Act of 1961 in an attempt to unify all foreign non-military assistance agencies under one umbrella agency. During Eisenhower’s administration, the U.S. had a number of agencies that provided non-military assistance to developing countries. One of those agencies was the International Cooperation Agency ("ICA"). During the Eisenhower administration, the ICA hired a number of contractors to provide technical assistance to Afghanistan, one of which was the Public Administration Service ("PAS").\textsuperscript{307} The backstory regarding the individuals forming the successive PAS teams working under


\textsuperscript{304} See generally, Leon B. Poullada & Leila D.J. Poullada, The Kingdom of Afghanistan and the United States 1828-1973, p. 107 and 149 (1995) (noting that Kruschev arrived in Afghanistan in 1955 and offered $100 million in loans for Afghan development and stating that, “In the eyes of most Afghan officials, even more important was Soviet support for Pakhtunistan.”).

\textsuperscript{305} There are a lot of interesting and entertaining anecdotes about the experiences U.S. individuals had in Afghanistan during the 1960s, in particular. For one summary, please see Francis Hopkins Irwin and Will A. Irwin, The Early Years of Peace Corps in Afghanistan, a Promising Time (2014).

\textsuperscript{306} USAID, Proposed Regional Programs for Fiscal Year 1963: vol. 3, p. 187 (1963). (“Although it is unlikely that the Afghans would yield their independence willingly, there is considerable danger that Afghanistan will become overly dependent upon the Soviet bloc, which has supplied $217 million in assistance and credits in the last five years. The major U.S. objective in Afghanistan, therefore, is to help Afghanistan maintain her freedom against pressures of Russian domination, and to promote friendly relations with the neighboring states of Iran and Pakistan both of which are pro-Western in orientation.”); USAID, Foreign Assistance Act of 1966; Objectives and Proposed FY 1967 Program p. 148 (1966). (“The U.S. objective is to help maintain an independent and nonaligned state between the Soviet Union and the South Asian subcontinent friendly to the broad objectives of the Free World. The A.I.D. program supports this broad objective by assisting Afghanistan's orderly economic development and eo providing an alternative to excessive dependence on the Soviet Union.”)

\textsuperscript{307} The PAS was founded in 1933 in Illinois as part of President Roosevelt’s New Deal. Its initial focus was to improve governance at the domestic local level. After World War II, it began providing technical assistance to various countries around the world, and remains in operation today. Additional information about PAS can be found at http://www.pitt.edu/~picard/PAS/history.htm. Interestingly, when the author interviewed children who had lived in Kabul with their parents who had worked for PAS in Afghanistan, some immediately remembered the precise address of the PAS headquarters in Chicago during the 1950s and 1960s, which was 1313 East 60th Street, Chicago, IL 60637. This is because it was the address PAS employees used for their correspondence while on assignment in various countries. The address is now home to the University of Chicago’s Urban Education Institute. Source: Telephone interviews with Bradley Nemetz and Rod Olson.
contract for ICA and subsequently USAID is relayed in more detail in Appendix II, for those who are interested.

One of the tasks for the PAS team was to develop an income tax system. In this regard, people have been studying what the “best practice” is with respect to tax systems for developing countries for a very long time. At the risk of overgeneralizing, historically, a nascent tax system tends to begin raising revenue through land taxes, excise taxes and customs tariffs. The latter two are not particularly progressive, but they have the advantage of being comparatively easier to administer than the income tax. An income tax, be it imposed on corporations or individuals, is only viable once the society has developed sufficient accounting rules, and administrative capacity etc... to administer the system. In the U.S., for example, in the 1850s, over 92 percent of the federal revenue was derived from customs tariffs. Afghanistan similarly drew (and continues to draw) significant portions of its revenue from customs tariffs.

In 1956, however, Afghanistan had issued its first “five-year plan” which recommended that Afghanistan begin to derive more income through “direct” taxation (i.e., “income tax”). To that end, the first task of the PAS team during 1957-1959 was to draft an income tax law. The law was not enacted in 1959, however. Instead it went through six successive drafts and multiple PAS missions before the law was finally passed by the council of ministers and published in the month of Sunbola, 1344 (or August, 1965). Not surprisingly, the income tax was very difficult to actually collect in practice.

Interestingly, Article 19, paragraph (k), of Afghanistan’s Income Tax Law of 1965 provides that corporations are entitled to deduct dividends from their taxable income. Article 51 imposed a withholding tax equal to the corporate tax rate on the gross amount of all dividends paid. Those provisions of the law remain in force today.

Despite much searching and multiple FOIA requests, the precise rationale for why the law contains a deductible dividends provision may, at this point, be lost in the sands of time. Based on the backgrounds

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311 Final PAS Report p. 7.

312 Final PAS Report p. 7.

313 Final PAS Report p. 7 (“The advisor who ultimately succeeded in developing an acceptable law has stated that the USAID objective was the enactment of a progressive global income tax law while the main purpose of the Afghans was the incorporation of their existing taxes and a workable income tax in a general tax law. The law as approved attempts to include both objectives.”).

314 Harley H. Hinrichs, *Certainty as Criterion: Taxation of Foreign Investment in Afghanistan*, National Tax Journal, vol. XV, 139 (noting how even prior to the enactment of the revised income tax law in 1965, foreign and domestically owned businesses were, in theory, subject to a tax on “net income” but that since records were spotty and computing “net income” is difficult to do even in more developed countries, the Afghan officials would simply impose a four percent (4%) tax on imports and two percent (2%) on exports, effectively converting the income tax into a tariff.); Kabul Times p. 2 (Jul. 29, 1968) (“The ministry of finance in the past year has advertised in the newspapers and over the radio on the legal consequences of paying taxes. It has repeatedly called on the public to cooperate in the payment of taxes.”); Kabul Times p. 2 (Sep. 12, 1971) (“The income tax is the most delicate aspect of the issue. At present, the civil servants are the ones who pay their obligations in meeting the income tax dues. From their salaries the state revenue is directly deducted and deposited in the state account. But what about the businessmen, the commercial firms, etc? It is here that a better account keeping system is needed.”).
of the individuals assisting Afghanistan during the relevant time period relayed in Appendix II and information gleaned from the National Archives, an educated guess is that the provision originated with Ben Eaton, a lawyer and economist who worked with the Afghans from 1960-1962, or Irving Olson, who worked there from 1963-1965. The precise author of that provision and the rationale for same appear, unfortunately, to be unanswerable questions at this late date.

b. Deductible Dividends in Mauritius

On July 25, 1974, the Republic of Mauritius also enacted a deductible dividends provision. Specifically, section 55 of Mauritius’s Income Tax Act 1974 provided, in pertinent part, that:

(1) Subject to subsections (3) and (4), the chargeable income of a resident company, in any income year, shall be the amount remaining after deducting from the gross income of the company derived in that income year –

   a. All allowable deductions; and
   b. Any dividend paid in that income year in cash out of the funds, not being capital or capital profits, of the company.

(2) …

(3) Where at any time any amount which is the whole or part of a dividend paid by a company comes within the possession or under the control of the company or is used for the purposes of the company, that amount shall be deemed not to have been paid as a dividend by the company.

(4) Subsection (3) shall not apply to a company the paid up share capital of which does not exceed two hundred thousand rupees.\[315\]

Again, the rationale for this provision is not entirely clear. The legislative history of this provision is scant, but Mr. Veerasamy Ringadoo (then Minister of Finance) stated that during the parliamentary debates on the bill that, “The new Bill makes provision against such tax avoidance practices as excessive management expenses, excessive remuneration or share of profits, and excessive undistributed profits of companies.”\[316\] Mauritius abandoned this approach in 1995, when a new income tax law was implemented.

The relevant point is that Mauritius negotiated bilateral tax treaties while it had a dividends paid deduction. During those negotiations, it had to ensure that it could retain its right to tax Mauritian source dividends at the full withholding rate. This then required atypical provisions in their treaties which did not grant the typical reciprocal provisions we see in most treaty withholding tax provisions (e.g., we will only withhold 5% if you only withhold 5%).

Thus, to illustrate, Article 10(2) of the Mauritius-India tax treaty provides for the normal reduction of source-based withholding tax on dividends paid. If a dividend is paid by a company resident in one country to a shareholder resident in the other country, the maximum withholding rate is either 5% or 15% depending on the percentage of stock held by the shareholder. This is the typical type of provision you would see in most treaties. However, Article 10(3) goes on to say:

\[315\] Translated from French by International Financial Services Limited.

Notwithstanding the provisions of paragraph 2, dividends paid by a company which is a resident of Mauritius to a resident of India may be taxed in Mauritius and according to the laws of Mauritius, as long as dividends paid by companies which are residents of Mauritius are allowed as deductible expenses for determining their taxable profits. However, the tax charged shall not exceed the rate of the Mauritius tax on profits of the company paying the dividends.\(^{317}\)

This will be instructive in the following sections that discuss the administration issues associated with various integration approaches.

8. The Rise of Foreign Deferral - President Kennedy Suggests Full Inclusion for Foreign Earnings

Going into the 1960s, the rules of the road for the taxation of business profits were well established. After 1936 introduced double-taxation of corporate profits, it was clear that large publicly traded corporations had no choice but to be organized in a form which resulted in their profits being taxed twice. Congress had enacted the AET and PHC regimes to combat Domestic Deferral - *i.e.*, domestic corporations hoarding cash beyond the reasonable needs of the business in order to “defer” the ultimate individual shareholder-level tax on business profits.\(^{318}\) In 1937, Congress enacted a regime specifically designed for foreign entities called the “foreign personal holding company regime”.\(^{319}\) Its application was narrowly tailored to the foreign incorporation of passive income (foreign incorporated pocketbooks), however. It did not apply to large, publicly traded, U.S. based multinationals who chose to build a plant or distribution facility in a low-tax jurisdiction owned by, what was referred to at the time, as a “base company” to earn and “defer” active profits from current U.S. corporate taxation.

Again, context is important here. The year 1960 was a mere 15 years after the end of World War II. Europe and Japan’s industrial base had been bombed into near oblivion. The U.S. industrial base, already strong before the war, had not only remained untouched, but had greatly expanded to meet the demands of the war effort. By 1960, U.S. businesses were making investments abroad that were nearly unimaginable before the war. As an example of this trend, the Kennedy Administration observed that 500 American-owned companies had been formed in Switzerland in 1960 alone, for example.\(^{320}\)

One of the primary benefits of President Kennedy’s proposal, which did not get as much attention at the time as it probably would today if it were re-proposed, is that the proposal would have largely eliminated the battles the Service is currently fighting with respect to outbound transfer pricing.\(^{321}\) If all profits flowed through to the U.S. parent, there would be little incentive for the U.S. parent to set its transfer pricing policy in a way that maximizes non-U.S. profits *vis-a-vis* U.S. profits.\(^{322}\)

\(^{317}\) Mauritius-India Double Tax Convention Article 10(3) (1983).

\(^{318}\) Professor Seligman pointed out in 1921 that even when there was no double taxation it was still dangerous for Congress to impose a fundamentally different rate structure on flow through entities and corporations. *Proposed Revenue Act of 1921: Hearings Before the Senate Finance Comm.*, 67th Cong. 453, 476 (1921)


\(^{321}\) Inbound transfer pricing would remain an issue, of course, as foreign multinationals would still have an incentive to affirmatively use transfer pricing to reduce the profits of their U.S. subsidiaries whenever the U.S. effective rate exceeded the foreign rate.

\(^{322}\) In the event Congress retained our current subpart F and foreign tax credit system, or transitioned to a full inclusion system with a foreign tax credit, one could see a scenario where companies may still have an incentive to generate low-taxed foreign source income to facilitate claiming credits generated by operations in higher tax jurisdictions. This, however, should be viewed
In response, President Kennedy proposed to end deferral altogether for majority-owned foreign subsidiaries of U.S. based multinationals. Large multinationals lobbied against this approach, and the compromise result became subpart F. Under subpart F, the general rule is that U.S. tax on profits generated by foreign subsidiaries is deferred until remitted back to the U.S. parent, but there are exceptions for passive income, certain types of active income, and “disguised” repatriations of foreign property (i.e., by having the foreign subsidiary loan property to the U.S. parent).

Again, today, 60 years later, the debate rages on. Many argue that the subpart F regime is out of step with the regimes governing foreign investment in other countries and that the U.S. should seek to follow this international trend of only (or nearly only) taxing corporate income generated within the U.S. Others argue that U.S. corporations are not at a disadvantage relative to their foreign competitors, and that, if anything, the U.S. should be going in the other direction.

The debate over whether the U.S. should move to some form of territorial system or a full-inclusion system is linked to the integration discussion. Specifically, if the U.S. refuses to shift the burden of business taxation on to the Shareholder, then the U.S. will likely be forced by tax competition to move to a territorial system simply because its trading partners have such a system. In contrast, if only one tax were imposed, and imposed at the shareholder level, the U.S. would have the flexibility to choose between a territorial system, a full inclusion system, or some hybrid of these approaches.

9. Congress Exempts Whole Classes of Business Income from Double-Taxation

At the time that Congress sought to expand and more firmly entrench corporate taxation, it started creating exceptions cooperatives, RICs, REITs and REMICs, which allowed individuals to invest in entities that resulted in one level of tax, at the shareholder level. Notably, in each case, Congress put significant constraints on the types of shareholders that could participate, the income that could be earned, the dividend policy of the entity, the capital structure employed, or some combination of all of these as a cross-crediting problem to be dealt with in any number of ways including, nit not limited to, a per country limitation. It is not reason for not having a full inclusion system.

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323 Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 140, 87th Cong., 1st Sess. 6, 26 (1961), reprinted in Committee on Ways and Means, 90th Cong., 1st Sess..


325 The foreign base company sales and services rules found in sections 954(d)(3) and (4) were designed to serve as a backstop to the transfer pricing rules and, in fact, there was some question at the time whether the rules were even needed given the existence of section 482. See also, The Deferral of Income Through U.S. Controlled Foreign Corporations A Policy Study, Office of Tax Policy, Department of the Treasury p. xiii (2000). Nevertheless, the depth and breadth of controversy in this area since 1962 suggests that neither the foreign base company sales nor services rules have quelled the Service’s concerns over outbound transfer pricing.


327 The domestic international sales corporations (DISCs) are not discussed in this section, because the DISC was specifically designed to provide a tax incentivze for export activities. A DISC does effect a form of integration, however, as a DISC’s income is not taxed when earned. Section 991. Instead, the shareholder is taxed when the DISC distributes a dividend. Section 995. One benefit is that corporate income that would otherwise incur a corporate level federal tax of 35% plus individual rates over 40% (39.6% + 2.8% net investment income tax) would instead be converted (by virtue of having the corporation pay a deductible commission to the DISC) a DISC dividend taxed at capital gains rates plus the net investment income tax. Another benefit is that a DISC is designed to permit deferral of a domestic corporation’s income, provided the entity engages in export related activities. This is because no tax of any kind is imposed unless or until the DISC distributes a dividend. The benefits of deferral are limited, however, by the fact that the rules impose an interest charge on any tax deferred through the use of the DISC. See section 995(f). Hence, DISCs are referred to as interest-charge DISCs, or IC-DISCs.
restrictions. As Part VI will demonstrate, these restrictions are not arbitrary. They are, instead, restrictions Congress imposed to make these pass-through regimes administrable.

The main reason for reviewing these regimes, however, is that the existence of foreign individuals and corporations as shareholders present particularly nettlesome problems for some integration approaches. U.S. tax treaties have already reduced the U.S. withholding tax on interest and royalty payments to zero in most cases, and modern treaties have even reduced the dividend withholding rate to zero.

The treaties are all based on an assumption that one level of tax has been imposed at the corporate level on profits that are distributed as dividends. Yet, the theme of this paper is that the corporate tax burden must be shifted to the Shareholder, in which case no corporate level tax will have been imposed. One of the problems this creates is that any integration approach that does not impose tax at the corporate level must: (i) follow the treaties and potentially exempt U.S. business income attributable to foreign shareholders from any tax; (ii) override the treaties, or (iii) come up with a withholding regime that does not violate the existing treaties. For this reason, it is useful to review what Congress has done in other cases where it has imposed tax on the shareholder and not the corporation.

In the case of cooperatives, patronage dividends deducted by the cooperative and paid to foreign persons are subject to U.S. withholding. Even though no entity level tax has been imposed on the profits out of which the dividends are paid, the U.S. has reduced the withholding tax rate under applicable treaties. Stated differently, the U.S. has not sought special treatment for cooperatives to retain source-based taxation of dividends from cooperatives even though they have not suffered a U.S. corporate tax.

Similarly, RICs are subject to corporate tax, but can claim a deduction for dividends paid. To the extent the RIC distributes a dividend characterized as a capital gain dividend, the RIC does not have to withhold on the distribution. Otherwise, the RIC is required to withhold 30 percent of any dividend paid to foreign persons, subject to a reduction by treaty. Although the treaties often reduce the tax rate,

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328 See generally, section 7852(d)(1) (“For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.”); and Whitney v. Robertson, 124 U.S. 190, 194 (1888) (“By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other.”).

329 It is important to note that the omission of section 7704 and the publicly traded partnership rules in this section, because the introduction of section 7704 was, in fact, a Congressional attempt to limit (not expand) taxpayers’ ability to avoid double-taxation. H.R. Rep. No. 100-391, pt. 2, at 1065-66 (1987). Section 1361(a)(1) (defining an “S corporation” as a small business corporation that has made an election under section 1362).

330 From the moment Congress considered imposing an entity level tax on corporations, Congress has been concerned about how cooperatives were taxed. In 1894, William Allison, Senator from Iowa, sought to exempt all corporations with paid in capital less than $100,000 specifically to ensure the new corporate income tax would avoid reaching agricultural cooperatives. Cong. Rec., 53rd Cong., 2d Sess., 1894, 26 pt. 7:6832-34 and 6870. See also, Richard J. Joseph, The Origins of the American Income Tax: The Revenue Act of 1894 and its Aftermath, 77 (2004).


many do not permit the lower "direct dividend" rate to be applied. This is the case even though the RIC may only own shares of domestic corporations that have already paid one level of tax.

Like RICs, REITs are required to distribute at least 90 percent of their income no less than annually and can deduct those dividends in computing their income. There was a significant debate in the 1990s over whether and to what extent existing U.S. treaties should apply to reduce the withholding tax rates on dividends paid to foreign REIT shareholders, with the U.S. Treasury initially arguing that the lower treaty rates should not be available since no corporate level tax is imposed on the profits out of which the dividend is paid. The case for full withholding is more compelling with REITs than RICs. If a RIC only owns stock of domestic corporations, at least one level of corporate tax will have been paid. A REIT, however, would primarily hold rental properties or real property mortgages. To the extent the payments of rent or interest generate a deduction, the REIT is not subject to corporate tax, and can pay a dividend to a foreign person without withholding, no tax is collected. Nevertheless, a compromise was reached whereby a lower treaty rate could apply, but only with respect to smaller shareholders.

Congress went in a different direction with REMICs, than it did with RICs and REITs. Specifically, the interests in a REMIC need to either be considered “regular” interests or “residual” interests. A “regular” interest is effectively treated a debt instrument where the holder has to recognize income on a constant accrual basis. When amounts are distributed with respect to the residual interests to the foreign shareholder, the distributions are subject to the normal 30% withholding rate, but this rate cannot be reduced by treaty because it represents an “excess inclusion.”

Thus, any integration approach that shifts the corporate tax burden from the corporation to the shareholder needs to consider applicable tax treaties. On a prospective basis, treaties need to be modified to preserve source-based taxation of corporate dividends.

10. Shareholders Engage in Self-Help Mechanisms to Avoid Double-Taxation

Importantly, while all of the foregoing was unfolding, business people did not sit on their hands. There was a huge demand for investment vehicles which provided limited liability, provided more flexibility than S corporations, and yet bore only one level of tax. The demand was satisfied with the rather quick
rise and spread of limited liability companies, which has been recounted in numerous other sources before now. \(^{344}\) As Professors Michael J. Graetz and Alvin C. Warren have noted:

> For many years, the corporate-level tax was a necessary concomitant of limited liability for investors. The rise of limited liability companies substantially undermined that relationship. More recently, the ability to amass large amounts of capital from investors without going to the public equity market, such as from private equity and sovereign wealth funds, has facilitated the creation and maintenance of very large businesses operating as partnerships. Also, the ability to spin off assets into passthrough entities, such as real estate investment trusts, has further destabilized the border between taxable and passthrough entities. \(^{345}\)

It has also lead to the rise in companies spinning out their real estate holdings to their shareholders as REITs. \(^{346}\)

The holy grail of course is to achieve one-level of taxation on business profits while at the same time being publicly traded and without being constrained by the mandatory dividend distribution and asset ownership rules contained within the subchapter M regimes outlined above. To achieve this, companies have turned to publicly traded partnerships (“PTPs”), when possible, \(^{347}\) and, even more recently, so-called Yieldcos. \(^{348}\)

As a result of this activity, the business revenue of C corporations has fallen dramatically over the last thirty-five years. \(^{349}\) The tax revenue collected from those C corporations has taken a corresponding hit. \(^{350}\) The corporate tax base would be eroded further were it not for the fact that a publicly traded partnership can only earn certain select types of income while retaining its flow-through status. \(^{351}\)


\(^{347}\) For an early discussion of this phenomenon, see Lou Freeman, _Some Early Strategies for Methodical Disincorporation of America_, 64 Taxes 962 (Dec. 1986).

\(^{348}\) Yieldcos are just corporations that happen to own properties which generate a lot of predictable cash flow and non-cash deductions. Yieldcos take advantage of the interest deduction on debt and non-cash deductions (i.e., depreciation) to eliminate the corporate level tax and yet retain flexibility over when they distribute cash to their shareholders.


\(^{350}\) Republican Staff of the Senate Committee on Finance, _Comprehensive Tax Reform for 2015 and Beyond_, p. 171 (December 2014) (noting corporate tax revenue peaked at 39.8% of federal revenues in 1943 and declined to a low of 6% during the financial crisis, but have leveled off now in the present to where they average about 10%).

\(^{351}\) Section 7704(c) requires that at least 90 percent of the publicly traded partnership’s income consist of “qualifying income”. The types of income constituting “qualifying income” are listed in section 7704(d)(1) and, for the most part, consist of passive income, with the notable exception of the business of exploring, mining, producing and refining minerals and natural resources. See section 7704(d)(1)(E).
The fundamental difficulty with applying a flow-through or profit allocation approach to owners of an entity that is widely held and frequently traded during the year is that there needs to be some sort of simplifying convention to allocate earnings to that equity owner for only a part of the year. Normally, when a partner sells his or her entire partnership interest, the partnership’s year closes with respect to that partner and income earned from the beginning of the year through the disposition date is allocated to that partner.\textsuperscript{352} The regulations do permit the partnership to pro rate earnings in order to avoid having to perform an interim closing of the books, but only with agreement among the partners.\textsuperscript{353} Even with a pro ration method, however, publicly traded equity interests can change hands every second during a day. So some convention is needed to allocate income. Comments made by the National Association of Publicly Traded Partnerships suggests that PTPs typically take their income for the year, divide by 12 (if they use a monthly convention) and take a consistent position with respect to any equity holder who transfers equity interests within that month (i.e., they are deemed to hold the equity for the entire month even though they dispose during the month).\textsuperscript{354} There are proposed regulations which would allow PTPs to treat all transfers of publicly traded equity interests occurring during a month as occurring on the first day of the following month.\textsuperscript{355} Thus, while complicated, PTPs have managed to address the income allocation issue, even in the context of publicly traded equity interests.

Another important issue that PTPs have had to overcome is the administration of tax audits. Publicly traded partnerships with the requisite amount of qualifying income are not subject to tax, their partners are. Thus, if the PTP’s income is adjusted upward, this requires an adjustment to the tax return of every single partner in the partnership during the period the adjustment relates to. One regime designed to simplify this process is the “electing large partnership” regime.\textsuperscript{356} For our purposes, the most important change the rules make is that any audit adjustment is made prospectively, not retroactively, and the partnership can elect to pay the imputed adjustment.\textsuperscript{357} PTPs may not choose to participate in the electing large partnership regime for a number of administrative reasons,\textsuperscript{358} but for purposes of this discussion, it is only important to point out that this mechanism currently exists in the Code.

11. Numerous Attempts Are Made to Integrate Corporate and Shareholder Taxation

A number of significant attempts have been made by government officials over the years to revisit this issue in a fundamental way.\textsuperscript{359} Thirty years after the post-World War II literature advocated for integration, and less than 20 years after subchapter S was enacted, the U.S. Treasury Department issued a report in 1977 (hereinafter, the “1977 Treasury Report”) advocating that the subchapter S provisions be

\textsuperscript{352} Section 706(c)(2)(A).
\textsuperscript{353} Treas. Reg. §1.706-1(c)(2)(i).
\textsuperscript{354} Publicly Traded Partnerships Comment on Proposed Regs on Determining Distributive Share When Partner’s Interest Changes, 2009 TNT 137-15 (July 21, 2009).
\textsuperscript{356} See Taxpayer Relief Act of 1997, P.L. 105-34, §§1221-1246.
\textsuperscript{357} Section 6242(a)(1).
\textsuperscript{358} Matthew W. Lay, Eric B. Sloan, and Amy L. Sutton, Tax Management Portfolio: Publicly Traded Partnerships, A-115 (2015) (noting that many PTPs refuse to elect into the regime because of the rule mandating that all Schedule K-1s be issued to partners by March 31st of the following year without extension).
extended to all corporations.360 Again, in 1984, the U.S. Treasury suggested allowing corporations to deduct up to 50% of their distributed earnings.361 The U.S. Treasury Department issued a report on business tax integration on January 6, 1992 (hereinafter, “1992 Treasury Report (January”). The 1992 Treasury Report (January) analyzed a variety of approaches, but perhaps the most provocative was the comprehensive business income tax (“CBIT”) proposal which would seek to rationalize the federal tax on all business operations regardless how they are organized (i.e., whether sole proprietors or publicly traded corporations). The CBIT would impose an entity level tax, provide a dividend exclusion at the shareholder level, and deny interest deductions, thereby ensuring all business profits were taxed once, at the corporate (not shareholder) level.362 Later that same year, the United States Treasury issued a second report (“1992 Treasury Report (December”).363 The December report advocated a dividend exclusion approach, which was one of the proposals analyzed in the January report, but did not advocate the more sweeping CBIT approach which would have eliminated the tax distinction between sole proprietorships, S corporations and publicly traded companies.364 The exclusion of corporate dividends incentivizes shareholders to form new businesses as flow-through entities and cause existing corporate subsidiaries to defer dividend payments whenever shareholder rates significantly exceed corporate rates.365 The ALI Study (referred to in the introduction) was published in 1993 and suggested a shareholder imputation credit rather than a dividend exclusion.366 The ALI Study’s recommendation had the advantage of eliminating the incentive for flow-through entities but not the deferral incentive when shareholder rates substantially exceeded corporate rates.367

Congress made a partial attempt to integrate through the rate structure in 2003 when it enacted the Jobs and Growth Tax Relief Reconciliation Act of 2003 and reduced the tax rate on qualifying dividends.368 The administration’s original (and much more ambitious) proposal (which did not get enacted) called for a complete exemption for dividends from domestic corporations.369 The operation of the proposal and various political forces that opposed it are illustrative of the challenges any integration proposal will face.

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368 This provision is now enshrined in section 1(h)(11) of the Code.
In brief, under the administration’s proposal, a corporation would calculate its income and pay tax as it normally would. Each year, the corporation would compute its excludable dividend amount “EDA” by dividing the U.S. corporate taxes paid in the prior year by the corporate tax rate (i.e., 35%). Thus, while the corporation would have some idea what its EDA will be as of beginning of each year, it would not actually know until it filed its tax return, nine months into the following year. The grossed-up amount represented the EDA that, if the corporation chose to distribute it, could be excluded from the shareholder’s gross income. Rather than making audit adjustments prospective, the proposal would have retroactively adjusted the EDA for the year following the year to which the audit relates. In all events, the EDA was limited to current and accumulated earnings and profits. Thus, earnings and profits could exceed the EDA, but the EDA could not exceed the earnings and profits. Importantly, a distribution out of earnings and profits that was not made out of the EDA would be taxed. The ramification is that even the administration’s proposal did not align the shareholder and corporate tax base. If the corporation, for example, earned exempt municipal bond interest, that interest, when distributed, would be taxed to the shareholder even though the shareholder could have excluded that interest had he/she earned the income directly. Moreover, foreign taxes were not viewed as equivalent to U.S. taxes. If a corporation earned 100 of profit from foreign sources, but paid 40 of foreign income taxes on that profit such that the corporation paid no U.S. corporate income tax, the corporation’s EDA would not be increased. Thus, the administration’s proposal was not true integration in that neither the time in which tax was imposed nor the tax base of the shareholder and corporation were aligned. It did contain an interesting feature to prevent double tax when shareholders sold stock of a corporation that had retained its earnings. Specifically, the proposal would allow each shareholder a retained earnings basis adjustment (“REBA”) which would be equal to the undistributed portion of the EDA allocable to that shareholder. Yet, it was not entirely clear how that allocation was to be performed given that it would seem to have had to occur daily. Even the corporation would not likely know its EDA for sure until nine months after the close of its prior tax year.

In any event, there was no need to sort out the actual mechanical operation of the proposal because it did not pass. It is important to ask why it didn't pass and what can be learned about that experience for any upcoming battles over integration.

The agency-cost theory advanced by professors Arlen and Weiss to explain the UPT and the brief period from 1936-1938 when the U.S. had a split rate system for corporate profits provides one explanation. The theory is that as companies have grown, the interests of shareholders and corporate managers have become attenuated. The agency cost theory suggests that corporate managers will not actively support any integration approach that may interfere with their retention of corporate assets.

A more nuanced explanation directed specifically at the Bush’ administration’s 2003 integration proposal has been offered by Professor Michael Doran, however. Professor Doran argues that the corporations (and their managers) and shareholders are very heterogeneous, the existing system benefits different

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people in different ways, and that one of the chief opponents of the 2003 proposal actually came from shareholders, like pension funds and insurance companies who sold annuities, who feared they would lose what they perceived to be a competitive advantage once individuals could receive dividends and capital gains without tax. Moreover, there are what Professor Doran notes “collateral interests”. An example were the real estate investors and brokers and property managers, etc... who indirectly benefit from the existence of the low-income housing credit to reduce corporate tax liabilities. If the Bush proposal went forward, those credits would be less valuable, as the more they are used, the lower the corporation’s EDA and its ability to pay tax-excluded dividends. Professor Doran suggests that one take-away from this experience is that lawmakers who favor integration may consider using transition rules as political currency for gaining the support of different interest groups, like the ones mentioned above.

B. The Historic Rationales for Double-Taxation Do not Stand Up to Modern Scrutiny

The U.S.’s modern corporate income tax contains a number of features. A tax is imposed on the corporate entity as a preliminary matter. The corporate tax base and rate is divorced from the shareholder base and tax rate. The timing of the second, shareholder-level, tax can be deferred so long as the corporation hordes its cash. The business profits are taxed a second time when distributed. As has been frequently noted, these features: (i) discourage incorporation; (ii) encourage retention of corporate earnings and deferral of the shareholder level tax; (iii) favor debt capital over equity capital; (iii) encourage share redemptions and corporate stock sales rather than dividends; and (iv) favor foreign and tax-exempt shareholders over domestic individuals. In addition, and more importantly in our view, the current system encourages U.S. base erosion and corporate inversions.


377 Michael Doran, Managers, Shareholders and the Corporate Double Tax, 95 Va. L. Rev. 517, 581 (2009) (“Although the dividend-exclusion proposal would not have changed the tax treatment of tax-qualified retirement plans, it would have extended that tax result to stock held outside a tax-qualified plan. The plans would be worse off under the proposal, as a relative matter, than they were under the corporate double tax.”).

378 Michael Doran, Managers, Shareholders and the Corporate Double Tax, 95 Va. L. Rev. 517, 583-84 (2009) (“Insurance companies sell deferred annuities to individuals as tax-favored investments; the amount paid by the individual typically is invested by the insurance company in a mutual fund, but the earnings from the mutual fund are not taxed to the individual until she receives distributions under the annuity. Thus, from the perspective of the individual, investing in a mutual fund that holds dividend-paying stock through a deferred annuity generally provides a better tax outcome than investing in such a mutual fund directly. The dividend-exclusion proposal would have reversed that outcome, making the deferred annuity disadvantaged as a tax matter. Although the life insurance industry dutifully claimed to support the Bush administration’s legislative package, it nevertheless threatened to oppose the dividend-exclusion proposal unless the Treasury Department agreed to provide a basis adjustment for annuity contracts that held investments in mutual funds receiving dividends.”)

379 Michael Doran, Managers, Shareholders and the Corporate Double Tax, 95 Va. L. Rev. 517, 563 (2009) (“Consider two trade associations: one that represents service providers for tax-qualified retirement plans and one that represents brokerage firms. A proposal for integration that eliminates the shareholder-level tax - such as the dividend-exclusion model - could be expected to cause individuals to shift investments away from tax-qualified plans. That should draw the opposition of the trade association representing plan service providers and the support of the trade association representing brokerage firms.”)


382 To be accurate, Professor Doran’s statement referred to legislators who “favor or oppose integration” could use transition relief as political currency, but we are cautious optimists and hope that legislators will “favor” integration.

So it is appropriate to ask whether any of the original rationales for enacting the corporate income tax remain convincing today. Alternatively, even if those original rationales no longer seem convincing, is there any persuasive rationale based on new thinking that would support the continued imposition of the corporate income tax?

1. The Corporate Tax as Regulatory Tool

Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.

- President Taft (1909)

As noted above, one of the rationales for the enactment of the corporate income tax in 1894 and more so in 1909 was that corporations were large, getting larger, and were mostly unregulated. There was simply no information available to the government about what precisely they were doing. The Securities Exchange Commission did not yet exist. It would take another twenty-five (25) years and the Great Depression to jolt Congress into enacting the Securities Act of 1933 and the Securities and Exchange Act of 1934. The corporate income tax return provided a useful window into corporate investments. The importance of the return was magnified by the fact that the original intention at the time the Tariff Act was first being considered was that the corporate tax returns would be public - akin to the SEC reporting that we have today. So the imposition of the tax served not only to provide the government with a window onto corporate activities, but shareholders as well. There appears to have been broad based support for this transparency even by those that were not keen on the tax itself.

Corporations are heavily regulated today. Nevertheless, one could still make the argument, even today, that regulators do not have sufficient information about corporate activities. The OECD’s push for country-by-country reporting would be an example of additional demands by regulators for information about corporate activities to assess audit risk.

The compelling counterargument, of course, would be that the imposition of recordkeeping requirements and the imposition of double-taxation are two different things and a government can insist on one without necessarily insisting on another. After all, in the U.S., we collect copious amounts of information from S

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384 44 Cong. Rec. 3344 (1909) (statement of President Taft).
corporations and partnerships and tax exempt entities and yet they are not subject to income tax at the entity level. Thus, it is hard to see this as a legitimate rationale for continuing the corporate income tax as it exists today.

Professor Reuven Avi-Yonah has argued that the actual imposition of tax (not mere information reporting) does serve a necessary regulatory function. He argues that the imposition of tax and the provisions of exclusions from that tax allow the government to effectively regulate behavior. Imposing a tax and then providing a research and development credit is cited as an example. Yet, as Professor Avi-Yonah himself acknowledges, the government could (and often does) subsidize and penalize behavior outside of the Code. Moreover, as anyone who has been through an R&D credit audit would probably agree, the Service is perhaps not the best body to be making decisions about whether R&D spend is innovative or not.

In all events, however, even if one accepts that tax policy should be used to direct corporate behavior, that regulatory function can be achieved without imposing a tax at the corporate level. Investments in wind and solar projects are tax-favored and yet these are largely effected through partnerships, not corporations.

2. The Corporate Tax as Progressive Policy

The most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly, by successful stock jobbing, by skillful appropriation under the protection of the law of all the opportunities of life, and which have brought about a grossly inequitable distribution of the proceeds of human labor and of the values created by the activities of men.

- Senator Owen (1909)

... we shall confine our taxation to these great combinations of capital whose profits have been enormous, whose ability to bear is greater than that of any other class of the community, and whose abuses have awakened the attention of the country and demand legislative cure.

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389 Reuven S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193, 1249 (2004) (“Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify government in providing a subsidy via the tax code.”).
390 Reuven S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193, 1249 (2004) (“Now it is of course true that the government could subsidize these functions directly, rather than use tax expenditures, so that this cannot strictly be an argument for taxing corporations. That would require, however, setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the corporate tax is diminished.”).
392 See sections 45 and 48.
393 44 Cong. Rec. 3950 (statement of Sen. Owen). Professor Yonah cites this quote, among many, in support of his argument that there was a shift in attitude from the 1890s to the early 1900s regarding corporate wealth accumulation. See Reuven S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193, 1229 (2004). The quote, however, was specifically in response to the striking of an inheritance tax provision. Nevertheless, it accurately captures the concern over income and wealth inequality at the time and presents a good contrast with the sentiment today.
As Americans who are loyal to our communities and our country, we pay our taxes because it’s an investment in America and the next generation. Big corporations should do the same.

- Senator Newlands (1909)

As the foregoing suggests, the more things change, the more they stay the same. One of the most sympathetic arguments in favor of the corporate income tax has always been that it is simply an easy way to impose tax on wealthy people. The argument was in full force in 1909 and it captures the popular mood today. As Professor Yariv Brauner has noted, “My experience from participation in the debate in various fora is that both corporate income tax opponents and proponents avoid a sober analysis of the desirability of the tax, and tend to defend their respective positions based on their fundamental intuitions: the first group believes that the tax represents unfair, indirect redistribution from the more to the less successful in society, and the second that it represents some desirable redistribution from the rich to the poor. Note that the basic intuition is the same, only the rhetoric colors it differently.”

As noted in preceding sections, the debate over corporate incidence has been coextensive with the tax itself. The arguments have changed, however. In the 1890s and 1900s, it was argued that the corporate income tax would be regressive because the corporations that would likely bear the most significant burden were monopolies and could pass that cost on to their consumers, not labor.

So long as monopolies were regulated and investors largely invested within the country in which they lived, the argument in favor of progressivity got easier. Today, however, the debate largely revolves around the fact that consumers have more choices than they have ever had before and can purchase products over the Internet from companies that do not need to have a U.S. physical presence to sell to U.S. consumers, capital is highly (although not completely) mobile, and labor is decidedly less mobile. Thus, proponents of the progressivity of the corporate income tax have to confront the existence of an open economy where capital seeks the highest after-tax return possible regardless of international boundary.

A lot of trees have been felled to provide the paper for economic studies attempting to answer the question as to “who” precisely bears the burden of the corporate income tax. Despite the loss of foliage,

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397 44 Cong. Rec. 3995 (statement of Sen. Borah) (“That is the vice of this amendment. The small corporations, as I said last evening, in a competitive field, where they can not change their prices, made up of the small citizenship of the country in the humble walks of life, will have to meet this tax; but the great corporations will deal with prices as they will, they will raise prices when they desire, they will incorporate every dollar of this tax, and the consumers of the country will have to pay it.”)
there does not appear to be uniform agreement among economists as to the answer to this question.\textsuperscript{399} Even Professor Avi-Yonah acknowledges that the answer to the incidence debate is unresolved.\textsuperscript{400} A review of the literature suggests that there does appear to be some agreement that in order to argue that the tax falls on capital there has to be some deviation or further refinement of the original assumptions in the ZMW model that make that so. For example, it has been suggested that as the size of a jurisdiction’s economy increases relative to the size of the worldwide economy, capital bears a larger share of the corporate tax burden.\textsuperscript{401} Or, alternatively, it is possible that not all goods can be equally substituted for one another - a Ferrari made in Guatemala may not be easily substituted for a Ferrari made in Italy. It may lose its cache. This too could have the effect of pushing the corporate tax burden onto capital.\textsuperscript{402} Yet, the trend appears to be to acknowledge that at least some portion of the corporate income tax burden falls on workers.\textsuperscript{403}

In the end, the question as to whether labor or capital bears the tax and, if both do, what percentages are borne by each, may simply not be a question one can answer.\textsuperscript{404} One paper summed up the research in this area succinctly:

> Despite the complexity inherent in relevant general equilibrium models, the fundamental conclusions remain the same; if it is feasible and profitable for capital to avoid a tax by shifting to other sectors (and abroad in an open-economy model), the the burden will fall primarily on labor, assuming labor is immobile. The extent to which a shift is feasible and profitable depends on a variety of assumptions, which drive any conclusions about corporate tax incidence. Because there is no consensus on the size of the underlying behavioral responses, there is no consensus on tax incidence.\textsuperscript{405}

\textsuperscript{399} Yariv Brauner, \textit{The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy}, 59 Mich. St. L. Rev. 591, 629 (2008) ("It all goes back to the simple, yet central, question of who bears the burden of the tax. If the burden was spread in our society in a way that reflects the social consensus, then the tax may be perceived as fair; if not, then it could not be viewed in this way. Unfortunately, there is no clear answer to that question, and there probably could not be one that would satisfy a conclusion regarding the fairness of the tax. Economists have known this for a while now, but the legal literature is missing a non-technical explanation that could be used for tax policy-making purposes.")


\textsuperscript{402} Jane G. Gravelle and Kent Smetters, \textit{Who Bears the Corporate Tax in an Open Economy}, available at \url{http://www.nber.org/papers/w8280}.


\textsuperscript{405} Rosanne Altshuler, \textit{Capital Income Taxation} at 365. \textit{See also}, Alan C. Harberger, \textit{Corporation Tax Incidence: Reflections on What is Known, Unknown and Unknowable}, p. in \textit{Fundamental Tax Reform} Chapter 6 (electronic edition) (John W. Diamond and George R. Zodrow, eds.) ("The problem, of course, lies in the fact that we cannot handle the incidence of a tax in a general equilibrium setting without knowing (or making assumptions about) how the receipts of that tax are going to be spent, and what other distortions are deemed to be present in the economy. Since there are millions of different ways in which the receipts of the tax might be spent, and millions of combinations of other distortions that might be present when the tax is imposed, increased, decreased or removed, it looks as if one can get ‘millions squared’ different answers to the simple question, ‘What is the incidence of a single specific tax (or tax provision)?’").
The lack of a compelling economic case for progressivity is perhaps the reason that proponents of the corporate income tax have looked for other rationales for the corporate tax. Professor Avi-Yonah is one vocal supporter of retaining the corporate income tax. The logic of Professor Avi-Yonah’s argument appears to be that unbridled accumulation of assets by corporate managers is bad, the corporate income tax reduces the amount of assets that those managers have access to, and therefore the corporate income tax is good. Some have suggested, however, that even if one accepts the professor’s premise, his conclusion only holds water if you believe that labor is not bearing the burden of this tax. Regardless, if the goal is to take assets out of the hands of corporate managers, it would perhaps be wiser to incentivize those corporate managers to distribute earnings to shareholders who can then be taxed according to whatever progressive rates are preferred by Congress.

This section closes with two thoughts. The first thought relates to corporate tax incidence. The second thought relates to why, in the end, it really shouldn’t matter.

First, common sense suggests it is highly likely the corporate income tax falls at least in part, and will likely increasingly fall, on labor. Today, a consumer can purchase a wide variety of goods over the Internet from offshore suppliers who do not necessarily have to have a U.S. taxable presence. This is especially the case with respect to any good that is purchased via digital download. Thus, if a U.S. consumer can purchase these types of goods from Company A, a C corporation formed in the U.S. and subject to U.S. tax rules, or Company B, formed in a more favorable jurisdiction, the consumer is ambivalent whether they get the goods from Company A or Company B. This makes it very difficult for Company A to pass those costs onto the consumer. Similarly, if a shareholder has a choice between investing in Company A, formed in the U.S. and subject to the U.S.’s worldwide taxation system, and Company B, formed in a jurisdiction with a more favorable tax system, the costs associated with that shareholder investing in Company B are very low. Anyone with an Internet connection, a credit card number, and some money to spend can invest his or her money in a mutual fund that invests in non-U.S. entities. Thus, it is difficult to believe that Company A is able to pass the costs of its extra tax burden onto the shareholder through lower dividends or capital appreciation. The one group that is relatively immobile is labor - i.e., the American worker. In theory they can uproot themselves and move to another country to find a job. Yet, the recent recession has illustrated in stark relief that it is not easy for people to move from one State to another State within the same country much less to another country.

Second, in a sense, corporate tax incidence does not matter. Even if one believes that the entire corporate tax burden falls on capital, that belief should only inform an opinion as to how to pay for the elimination of corporate taxation. It should not influence “whether” to eliminate corporate taxation. After all, if the

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406 Reuvan S Avi-Yonah, Reinventing the Wheel: What we Can Learn from TRA 1986, 2015 TNT 56-6 (2015) (suggesting that the success of the tax reform act of 1986 implies that there is no need to integrate shareholder and corporate taxes, “In sum, it is unclear whether there are significant domestic efficiency gains associated with integration. The presumed gains depend on assumptions regarding the incidence of both the corporate tax and the dividend tax that most economists regard as unproven.”)


409 Our guess is that the interaction of 3-D printers and the Internet will only further this trend. When 3-D printers become as cheap and ubiquitous as home computers, foreign corporations will not even need to have distribution and sales facilities in the United States. U.S. residents will simply click the “agree” button the buy page of their website, the designs for a new dress, shoe, watch, etc... will be transmitted electronically over the Internet, and out will pop the product. Either the whole concept of nexus that has lasted for over 100 years will have to be seriously rethought, or you can assume the pressure on corporate management to avoid the imposition of corporate income tax will become irresistible at that point.

desire is to have a more progressive tax system, it would appear more logical to stop imposing a corporate tax that may or may not be progressive and start imposing that tax on wealthier individuals that is certainly progressive. Politicians who argue that they are in favor of a progressive system, and yet oppose eliminating our current system of corporate taxation, only lend support to the centrism view, which holds that the real objective is not to be progressive, but instead to appear to be progressive.

3. The Corporate Tax is a Fee for the Benefits Corporations Derive

According to the answer given yesterday by the Senator from California, it is a tax upon the privilege of doing business. You might just as well say that men should be taxed upon the privilege of breathing.

- Senator Cummins (1909)411

Remember that the corporate tax in 1909 was formulated as an excise tax on the privilege of doing business. The legislative history indicates that a prime rationale for phrasing it this way was simply to avoid a Constitutional challenge. Nevertheless, if one were to take the statements in the public record at face value it appears that there was some sentiment, however loosely grounded in fact,412 that Congress also thought there was some benefit that corporations (especially large corporations) were deriving from doing business in the country and they should have to pay for that.413

The argument was tenuous at the time. It should not even be raised now. Individuals do not need to operate in corporate form to derive limited liability or the other benefits generated by operating in corporate form.414

There has been some attempt to revive the “benefit” rationale for taxing corporations by arguing, at least in the case of publicly traded corporations, that the ability to access U.S. capital markets is a “privilege” that corporations should be required to pay for through the corporate income tax.415 Yet, entities do not


412 Professor Yonah makes the case that since the benefits of corporate form were bestowed by States and not the Federal government, the rationale for imposing a Federal corporate income tax in exchange for the benefits of corporate form were tenuous even at the time. Reuvan S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193 (2004). This sentiment was certainly expressed at the time. See 44 Cong. Rec. 4023 (statement of Senator Brandagee) (“If these corporations upon which we are imposing a tax are organized by States and draw their privileges and their existence from the States, how can we say that we are imposing a tax upon their right to transact business, which they get wholly and entirely from the State, and not from us?”).

413 See 44 Cong. Rec. 4024 (statement of Sen. Carter) (suggesting that the provision taxed the privilege of doing a business as a corporation without regard to who chartered the company); and 44 Cong. Rec. 4028 (statement of Sen. Rayner) (“The first proposition is that this is an excise tax. There can not be any doubt upon that proposition; No matter how this bill is worded the word "or" or the word "and" can not change the construction of what this, proposed, law is. It is an excise tax. It' is an excise tax, and not laid upon the profits of a: corporation. This is not a tax laid, upon the' net profits of a corporation. If it was a tax laid upon the net profits of a corporation, it might possibly come within the income-tax decision. It is a tax laid upon the business and privileges of a corporation, and the measure of the tax is the net profits of the corporation. That is about. as concisely stated as I, can state it, and it has been so stated, not once, but a, hundred times, in the different decisions upon kindred. propositions. When we get away from that proposition we indulge in what seems irrelevant and collateral matter that does not even illuminate the proposition we are discussing.”)

414 Anthony P. Polito, A Proposal for an Integrated Income Tax, 12 Harvard J. of L. & Pub. Policy 1009, 1014 (1989) (“To the extent that the benefits conferred argument assumes that the government is giving businesses a subsidy by permitting the corporate form, it proceeds from a false assumption. Centralized management, free transferability of interests, and legal personality can all be seen as merely reflecting the contract that investors would draw up among themselves were it not for the high bargaining costs among members of a disperse group. As such it represents not a subsidy, but a facilitation of the results that would occur in a frictionless market.”) (citations omitted)

even need to operate in corporate form in some cases to be listed on a public exchange as evidenced by the rise of master limited partnerships. There are also various corporate forms with one level of tax that can have their stock traded such as RICs and REITs. Moreover, foreign corporations can access the U.S. capital markets without negative effects to their share price as evidenced by the rise of inversions and the share price effects before and after the inversion. Thus, the “benefits” of U.S. corporate form are vastly reduced from what they were in 1894 or 1909 and they will be further reduced as time progresses.

4. **Ease of Administration**

It imposes a burden at the source of the income at a time when the corporation is well able to pay and when collection is easy.

- President Taft (1909)

Although the Sixteenth Amendment to the Constitution was ratified in 1913, the personal income tax was originally only imposed on very wealthy persons. It soon expanded, and it has been a pervasive aspect of American life since the 1940s. Thus, it is difficult for most of us to imagine a world without a personal income tax, wage withholding and the annual ritual of filing income tax returns. Yet, at the time the corporate income tax was enacted, there was no personal income tax at the federal level. Hence, if you were in favor of an income tax on wealthy people, and you believed that a tax on corporations was a good surrogate for that tax because the economic burden would fall on those shareholders anyway, then the corporate income tax was actually a superior approach. After all, why spend huge amounts of government resources chasing hundreds or thousands of shareholders when you could simply knock on the door of the large corporation they were investing in?

Yet, the ease of administering a corporate tax does not in any way militate in favor of double taxation. Indeed, as noted above, Congress assiduously avoided double-taxation of corporate profits from 1909 through 1935.

Moreover, as others have pointed out, there are ways to collect a tax on business income without imposing a corporate level tax. The passive foreign investment corporation (“PFIC”) rules represent one example of a regime that offers shareholders options as to how they wish to be taxed depending on whether their shares are publicly traded, and whether they have sufficient information to recognize income on a flow-through basis. Failing that, the taxpayers are charged for their deferral of corporate income until it is realized.

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416 See Amanda Athanasiou, *News Analysis: Looking Beyond Tax Policy to Curb Inversions*, 2015 WTD 114-2 (noting how the ability of foreign parented companies to continue to list on the U.S. exchanges, and be subject to U.S. securities laws and compliance rules, reduces the cost of inverting from a non-tax perspective).

417 44 Cong. Rec. 3344 (1909) (statement of President Taft).


420 Reuvan S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193, 1204-05 (2004) (“Thus, the most common rationale for retaining the corporate tax - that it is necessary from a deferral and administrability perspective as an indirect way of taxing shareholders - seems to rest on shaky ground. Both the deferral and the administrability issues can be resolved by other means, such as pass-through taxation of closely held corporations and mark-to-market taxation of shareholders in publicly traded corporations.”).

421 See section 1296 for mark to market treatment for stock that is traded on an exchange.

422 See section 1293 and the qualified electing fund election.

423 See section 1291.
It has to be acknowledged, however, that if integration is pursued, and the tax burden is placed on the Shareholder, instead of the corporation, there are distinct administrative challenges associated with public companies. These hurdles are addressed in detail in Part VI.

5. Corporations As Distinct Entities

This paper began by quoting two Senators with two different points of view regarding the nature of corporations during the Senate debate in 1894 over the introduction of the first entity-level corporate income tax. Senator Gray viewed corporations as merely aggregates of their shareholders, creditors, customers etc..., whereas Senator Vest viewed the corporation as a corporation, nothing more. The corporation was a distinct entity and, just like an individual, should pay its fair share of the federal income tax.

Depending on one's point of view, Professor Avi-Yonah has made a valiant (or quixotic) attempt to resurrect this basic argument that dates back to the initial creation of the corporate income tax. Professor Avi-Yonah notes that there was acceleration in the formation of large corporate groups between the 1890s and the early 1900s. He attributes this to New Jersey’s enactment in 1890 of a holding company provision in its corporate law which made it legal for one corporation to own another. He posits that this then lead to a distinct attitudinal shift between 1894 and 1909. The sheer size of corporations caused the public, and Congress, to begin to see corporations as distinct from their shareholders.

He argues that the corporations are distinct legal personalities managed by a group of corporate managers, the interests of corporations and their management are not necessarily aligned, and the corporate tax is a way of preventing corporate managers from diverting corporate profits. Stated differently, Professor Avi-Yonah argues the corporate tax is justified because it limits corporate (as opposed to shareholder) wealth accumulation.

The most persuasive part of Professor Yonah’s arguments is that there is support for this view in the legislative history. Stated differently and taking statements in the Congressional Record at face value, it is correct that a number of members of Congress really believed that corporations were distinct entities, not mere aggregates, and it was appropriate to tax corporations just like you would tax an individual. We would go further and say that this last argument - i.e., that corporations should be viewed as distinct entities, is the best argument that those who favor a retention of the current classical tax system have.

Moreover, for those inclined towards this view, this is the best time in history to make it. This is because the argument is much stronger now than it was in 1894 or 1909. There has been a tremendous shift in the way shares are held today vs. how they were held in the early part of the 20th Century. Specifically, equity interests in public companies can be held in either certificated form or dematerialized (book-entry)

424 Reuvan S. Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193, 1227 (2004)("In particular, although there were large-scale corporations before the Progressive Era, consolidation began only in the early 1890s and accelerated to a wave of consolidation by merger between 1898 and 1904.")

425 Id.

426 Id.


429 Carol Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 43 Am. U. L. Rev. 379, 383 (1994) (noting how in the first three decades of the 20th Century, over 90 percent of stock was held by individual shareholders).
form. Over time, the registered owner of shares became separated from the beneficial ownership of those shares as people began holding shares in “street name” to facilitate a higher volume of transactions. Today, the vast majority of equity interests of U.S. publicly traded companies is owned by beneficial owners who own their shares in dematerialized book-entry form through a securities intermediary (like a broker) or bank (i.e., in street name) who would typically deposit the shares with the Depository Trust Company who appears, through its nominee, Cede & Co. as the sole registered owner of the issuer’s equity interests. Thus, determining who precisely owns shares at any given moment in time when, for example, a proxy solicitation is sent, is a difficult exercise that even the Securities and Exchange Commission has acknowledged may lead to over-voting or undervoting. The fact that brokers typically hold all equity interests of the same class from the same issuer in “fungible bulk” for the clients coupled with the practice of loaning securities further complicates the process and can lead to two different “owners” voting the same share. Not only may there be some confusion about who precisely owns the shares of a company at any one given moment in time, but the number of objecting beneficial owners (OBOs) (individuals who object to having their contact information released to the issuer) has further decreased the connection between the individual shareholder and the issuer. Over the same period, there have been State and federal law changes which have decreased the ability of shareholders to directly manage publicly traded corporations. Not surprisingly, there has been a noted decrease in shareholder participation in corporate governance.

430 Securities and Exchange Commission, Concept Release on the U.S. Proxy System p. 13 (Jul. 14, 2010) (noting that “Most if not all equity securities not on deposit at DTC but trading publicly in the U.S. markets remain fully certificated.”)
432 Securities and Exchange Commission, Concept Release on the U.S. Proxy System p. 12-17 (Jul. 14, 2010) (noting that “Most if not all equity securities not on deposit at DTC but trading publicly in the U.S. markets remain fully certificated.”)
434 Securities and Exchange Commission, Concept Release on the U.S. Proxy System p. 29 (Jul. 14, 2010) (“Even though a broker-dealer has the ability to lend its customers’ margin securities pursuant to a stock loan agreement, because shares are held in fungible bulk, it may not be practical to inform a customer when an actual loan has been made and it may be unclear which lending investor has lost the right to vote. Therefore, a customer may expect to vote all of its securities because it does not necessarily know whether its securities have in fact been loaned.”); and Roberta S. Karmel, Voting Power without Responsibility or Risk, How Should Proxy Reform Address the Decoupling of Economic and Voting Rights, 55 Vill. L. Rev. 93, 102-03 (2010).
435 Securities and Exchange Commission, Concept Release on the U.S. Proxy System p. 29 (Jul. 14, 2010) (“According to one estimate, 70% to 80% of all public issuers’ shares are held in street name, and 75% of those shares, or 52% to 60% of all shares, are held by OBOs.”)
436 Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 Vand. L. Rev. 1129, 1137 (1993) (“The role of the shareholder as an owner of the corporation underwent a dramatic change in the first half of the twentieth century. Although shareholders originally had ultimate authority to control the corporation, this power was taken from them through a variety of means, such as disappearance of the common-law right of shareholders to remove directors at will, reduction of the number of transactions that required unanimous shareholder approval, increased judicial deference to directors’ business judgment and a refusal to permit shareholder challenges to the exercise of that judgment, and a growing view that shareholders had more or less permanently delegated managerial power over the corporation and could not exercise such power directly.”) (citations omitted).
437 Roberta S. Karmel, Voting Power without Responsibility or Risk, How Should Proxy Reform Address the Decoupling of Economic and Voting Rights, 55 Vill. L. Rev. 93, 103 fn. 63 (2010) (noting how individual investor participation had been declining before, but plummeted after the Securities and Exchange Commission allowed for Internet voting as a default regime); and Carol Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but not Too Late, 43 Am. U. L. Rev. 379 (1994).
So, the argument is that although corporations do not have souls, their shareholders are so diffuse and disconnected from the company, that the U.S. should tax them as if they do.\footnote{See Steven A. Bank, \textit{Entity Theory as Myth in the Origins of the Income Tax}, 43 Wm. & Mary L. Rev. 443, 473 (2001) (discussing the case of \textit{Amesbury Nail Factory Co. v. Weed}, 17 Mass. 53 (1820) where the court rejected the corporation’s argument that it should not be subject to a parish tax because it had no soul to save).} The benefit of making this argument is that the distortionary effects of the current U.S. system cease to be relevant. After all, there is no debate about who “bears” the individual tax.\footnote{Although, perhaps we should. See, Boris I. Bittker, \textit{Effective Tax Rates: Fact or Fancy?}, 122 U. Pa. L. Rev. 780, 799 (1974) (“This is not the place for a critical examination of the assumption, in discussions of vertical equity, that the income tax rests where it is imposed. But I wish to call attention to two puzzling aspects of the assumption, while leaving detailed examination of the issues to the economists. Some students of the corporate income tax assert, and a larger number accept the possibility, that the tax is shifted to some extent to the corporation's customers. 52 But if the classical axiom that income taxes cannot be shifted is to give way in this instance, it is difficult to exclude the possibility that the personal income tax is shifted to the same extent by unincorporated enterprises, such as sole proprietorships and partnerships, that compete with corporate businesses. And if this possibility is entertained, is it not also possible that there is some shifting by persons who are in the business of providing personal services, such as self-employed professionals and even wage-earners and salaried employees?”)} No one complains about the fact that a “profit” is taxed two times when it is passed from one individual to another individual.\footnote{If Joe earns $100 at his job, pays tax on that amount, and then pays the after tax-proceeds to Jim to mow Joe’s lawn, we don’t get agitated that Jim has to pay tax on his lawn-mowing profit even though Joe was not able to claim a deduction.} Thus, the best argument advocates of the classical tax system have is really the one first expressed back in 1894 - corporations should be treated as distinct persons for the purposes of taxation.

The problem is that no one sought double-taxation back in 1894. Moreover, even if one accepts Professor Yonah’s premise that corporate entities are distinct and it is a socially desirable outcome to reduce the amount of wealth under the control of corporate managers, it does not follow that imposing a corporate income tax is the way to accomplish that objective. It would seem logical to suggest the exact opposite - \textit{i.e.,} craft a tax system that encourages the distribution of corporate wealth to the shareholders and require corporations to subject any new capital raise to the pressures of the market, just like FDR’s administration sought to do in the 1930s.

6. Still Crazy After all these Years

So, the Civil War Era income tax did not impose a tax on corporations as entities. Even when Congress did begin to tax corporations as entities in 1894, Congress assiduously avoided double taxation of corporate profits. The U.S. did not adopt the present classical double-tax system until 1936, and even then, it was not the result of a progressive policy choice designed to tax wealthy shareholders, but was instead the result of active lobbying by corporate managers who wanted unfettered discretion over dividend policy. Most economists view our current system as distortive. There is a good argument that it is really workers (not shareholders or customers) who bear its financial burden. Even proponents of the corporate income tax, and it is pretty hard to find them,\footnote{Notable exceptions being Professors Avi-Yonah, Gravelle, and Edward Kleinbard. See Edward D. Kleinbard, \textit{An American Dual Income Tax: Nordic Precedents}, Northwestern Journal of Law and Social Policy, 41 (2010).} acknowledge the fact that workers bear at least some portion of the burden. The U.S. Treasury Department, entrusted with enforcing the tax, has repeatedly attempted to substantially overhaul the system. More recently, tax competition and the corresponding incentive to invert domestic corporations has made this more than a matter of intellectual purity. So, why does this system continue?

The centrism view provides one, albeit cynical, explanation. Politicians have no desire to disabuse the public of the notion that corporations (or wealthy shareholders) bear the burden of the corporate income tax, because the corporate tax allows politicians to raise revenue while claiming, in the words of Russell Long, to tax that “fellow behind the tree”. In this case, the corporation behind the tree has no, “self-aware,
heavily burdened person to complain about the legislators who enact it or raise its rates.”

In fact, some have advocated imposing a “hidden tax” on individuals through the corporate income tax as a valid policy, not merely the result of political expediency.

Some have argued, the corporate income tax creates a need for lobbying and a never ending source of campaign contributions to those Congress persons who favor a particular corporate tax preference. As Robert Stanley noted in his history of the income tax, the tax gives Congress significant flexibility to reward and punish different interest groups. This theory has been getting a new lease on life with the annual ritual whereby Congress passes so-called tax extenders.

A perhaps less cynical alternative answer to the question of why we continue to have the corporate income tax is that it remains quite popular. A lot of folks simply “believe” that it is morally right and economically just that corporations pay their “fair share”, although it is not as clear that individuals support double-taxation of corporate profits.

Thus, proponents of corporate income tax repeal have a lot of work to do in persuading the public that a substantial change is required. Nevertheless, even if the public support existed, the U.S. would still need to sort out, precisely, how to achieve some level of integration. That is what the subject of the next section.

VI. A TWO-PRONG APPROACH SHOULD BE USED TO ACHIEVE INTEGRATION

A two-prong approach is suggested below. Pure-flow would apply to non-publicly traded entities and an alternative integration approach would apply to publicly traded entities. Under this approach the current classical two-tier system would be abolished.

The following discussion proceeds in four parts. First, a common list of criteria is set forth against which integration approaches can be compared. Second, a line is drawn between those entities that can, and those entities that cannot, enjoy pure flow-through treatment. Third, companies entitled to flow-through status can either rely on subchapter K or an expanded subchapter S regime. Lastly, a primary and secondary integration approach for publicly traded companies (both PTPs and corporations) are analyzed and recommended.

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A. Common Criteria for Comparing Integration Approaches

Any meaningful comparison of integration approaches has to have a common criteria against which they should be judged. All of the following criteria have been addressed before in one forum or another. For the reasons articulated in Part III, however, this paper places more emphasis than other commentary on two criteria - taxpayer identity and Foreign Deferral. To be sure, there are other issues that are not referred to here, such as the extent to which share redemptions should be treated similarly with dividends, transition issues, etc... Nevertheless, the most significant issues are addressed below. The criteria are addressed in a logical progression and (except for taxpayer identity) not in terms of their importance.

1. Taxpayer Identity

For the reasons discussed in Part III, it is imperative, in the context of international tax competition, that corporate managers either cease to be responsible for the income tax imposed on corporate profits or that the importance of corporate income tax at least be lessened in order to have any positive impact on tax competition. A pragmatic test should be whether the corporate tax system has been modified such that corporate managers start to be compensated like private equity and hedge fund managers - i.e., on a pre-tax basis. If the integration approach achieves that objective, it will go a long way towards achieving acceptable tax competition, even if it falls short of true integration.

A traditional imputation approach (illustrated in Example 1 below) would leave the corporation as taxpayer. In contrast, a dividends paid deduction ("DPD") would leave both the corporation and Shareholder as taxpayer. A shareholder-level mark-to-market ("MTM") regime would impose tax solely on the Shareholder.

2. Common Base

If business income enjoys a "preference" (i.e., a slice of income is excluded from the tax base), the question is whether, and to what extent, this should be passed through to the shareholder. This is an incredibly challenging area for integration advocates, and is probably the prime reason why most serious analyses of this issue have concluded that pure integration is simply not achievable.

Before proceeding, it is important to define some terms. As Professor Charles E. McLure, Jr. pointed out almost 40 years ago, there are two different kinds of tax preferences and they present different challenges for integration approaches. McLure first defines “deductible preferences” as exclusions from the tax base (i.e., tax exempt municipal bond interest) or deductions in excess of those required to define economic income (i.e., the allowance for percentage depletion over cost depletion). He also defines

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449 Charles E. McLure, Jr., Must Corporations be Taxed Twice? p. 143 (1979) (“Once tax preferences are admitted, integration and dividend relief become much more complex administratively, especially if the integration or dividend relief is only partial. It becomes necessary to have arbitrary rules to specify the extent to which dividends are presumed to be from preference income and taxed income.”)

450 1992 Treasury Department Study (December) at p. 15 and 63-65 (concluding that corporate preferences should not pass through).


452 Charles E. McLure, Jr., Must Corporations be Taxed Twice? p. 93 (1979). McLure also identifies a separate type of preference involving preferential rates applied to certain types of corporate income. He notes that this preference is unique to a classical tax system and can be equated to an exclusion from the tax base. Hence, he collapses this type of preference into the first type, which he refers to as deductible preferences.
“creditable preferences” as preferences which reduce tax liability (i.e., the research and development credit would an important example today).453

McClure points out through numerous examples that creditable preferences have equal value to all shareholders,454 whereas deductible preferences have more value to those shareholders who are taxed at higher marginal rates. One question that any integration proposal has to confront is whether it will “pass through” all or any of the preferences or, instead, cause them to “washout” at the shareholder level. The difference between pass through and washout can be illustrated with the following example.

EXAMPLE 1: Jim is a U.S. citizen who owns all of the outstanding shares of USCO, a U.S. corporation. USCO earns 100 of economic income (what we would equate with E&P). Of that 100 income, 20 consists of municipal bond interest that is not subject to corporate tax. USCO is subject to a 35 percent corporate tax. USCO enjoys an R&D credit of 8. Assume Jim’s personal tax rate is 40%. Assume that USCO distributes 1/2 of its after tax profits in a given year to Jim.

<table>
<thead>
<tr>
<th></th>
<th>Retained Profit</th>
<th>Distributed Profit</th>
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<tbody>
<tr>
<td>1. Economic Income</td>
<td>50</td>
<td>50</td>
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<tr>
<td>2. Deductible Preference</td>
<td>(10)</td>
<td>(10)</td>
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<tr>
<td>3. Taxable Income</td>
<td>40</td>
<td>40</td>
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<tr>
<td>4. Tentative Corporate Tax</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>5. R&amp;D Credit</td>
<td>(4)</td>
<td>(4)</td>
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<tr>
<td>6. Corporate Tax Payable</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>7. Available Cash to Distribute (100 - 20)</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>8. Distribution</td>
<td></td>
<td>40</td>
</tr>
</tbody>
</table>

In order to achieve pure pass through, a number of things have to happen that require a lot more record keeping and thought than occurs in our current system. First, although Jim receives 40 of cash, he should not report 40 of cash in his gross income. If he were to do so, he would effectively lose the deductible preference associated with the municipal bond interest that USCO received. Thus, Jim should only report 30 of gross income. Second, Jim needs to gross up the 30 by the 10 of corporate taxes that were paid by the corporation on his behalf. Third, Jim needs to claim the 4 of R&D credit associated with the R&D credit. If Jim does all of that, he will include 40 in his income, compute a tentative tax of 16, and then claim a credit of 4, yielding 12 of tax liability. Even then, true integration has not been achieved. The tax base and tax rate imposed on corporate income has been aligned. After all, had Jim earned 50 of business income directly, he would have paid 12 of tax. But the Example does not solve for the timing issue, because Jim only pays tax when and if he receives a dividend.

Under current law, the corporation need only tell Jim that he received 40 of cash that is all out of the corporation’s E&P and therefore included in Jim’s taxable income. Under an integration approach where preferences are fully passed through, however, USCO has to tell Jim that he received 40. It also has to tell him that 10 of the 30 relates to deductible preferences. It also has to tell him that 10 of corporate tax is associated with his inclusion. Lastly, it has to tell Jim that 4 creditable preferences are associated with this inclusion.

454 This assumes that credits in excess of tax liability are refundable.
This may seem administratively difficult. Yet, this simple case does not address the myriad of other problems created by more complex facts addressed in the ensuing sections (i.e., loss carryovers, intra year share transfers, the foreign tax credit etc...).

If those administrative issues prove overly problematic, then the other approach is to allow the preferences to “washout”. If both deductible and creditable preferences are washed out, then Jim simply receives the 40 of cash dividend, is required to gross up his 40 inclusion by the 10 of tax paid. Jim has a tentative tax liability of 20 (40% x 50), and claims a credit of 10 for the tax that has already been paid at the corporate level, leaving Jim with a 10 check to cut to the federal government. Although this is certainly administratively easier, it is also one more step away from pure integration.

In addition to making a decision about whether preferences should be passed through or washed out, a decision must also be made about whether the preferences should be pro-rated or “stacked”. Example 1 assumes the preferences would be pro-rated between retained and distributed earnings. However, a different convention could be adopted whereby, for example, all distributions are considered to come from income that does not enjoy preferences first. If this stacking rule is adopted, corporations will always (or nearly always) be distributing income that is not subject to a preference, because corporations can rarely distribute all of their earnings.

The Australian and New Zealand models, which apply an imputation credit of the type used in the example, do not pass through all preferences. For example, New Zealand does not typically tax capital gains, and yet if a corporation recognizes a capital gain and does not pay corporate tax, the dividend, when passed through to the shareholder can be subject to tax. In essence, the capital gains preference “washes out”. An example of how these regimes operate with domestic individuals, corporations, and foreign shareholders is attached as Appendix III.

3. Common Rate

The tax rate is only aligned if the corporate profits are ultimately taxed at the shareholder's marginal rates. A dividend exemption system, such as the one proposed by the United States Treasury in 1992, would eliminate double-taxation, but the tax paid would be at the corporate tax rate. The inevitable result is that the dividend exemption is more valuable to those wealthier individuals who are taxed at higher rates. This is a very tough sell, politically. At the time Treasury suggested a dividend exclusion approach, corporate rates exceeded individual rates, and so this would not likely have offended those favoring more progressivity in the Code quite as much. Nevertheless, it would seem that given the history of individual and corporate rates in this country rising and falling, not necessarily in tandem, any integration approach has to assume that, at some point, individual rates will greatly exceed corporate rates, at which time a dividend exclusion system (or any system) that fails to tax corporate profits at the shareholder rate becomes very regressive.

3. Common Timing

456 Id. at 135-141 (1979).
457 1992 Treasury Report (December), Ch. 2.
458 1992 Treasury Report (December), p. 12 (“Under the current rate structure, in which the corporate rate is slightly higher than the maximum individual rate, there seems little reason to tax corporate income at shareholder rates. In contrast, an integration proposal developed in the mid 1970s, when the maximum individual rate on capital income of 70 percent exceeded the corporate rate of 46 percent, might well have required taxation at shareholder rates in order to prevent avoidance of the higher shareholder rates.”) (citations omitted).
Example 1 involved a situation where half of USCO’s earnings were distributed, and half were retained. The half that were retained would not be taxed currently to the shareholder. This violates one of the key features of pure integration, however, which is that the time at which the shareholder or corporation pays tax on business income must be aligned. The difficulty is that solving the timing problem with a publicly traded company is very complex indeed. A couple of approaches have been developed over the years to solve the timing problem.

The easiest approach from an administrative standpoint would be to force the shareholders to mark their stock to market. Corporate tax preferences become a nullity in this model, as no corporate tax is imposed. A significant downside is that it raises liquidity issues at the shareholder level, because the shareholder may be required either to borrow money or sell shares in order to raise the cash to pay the tax.

A far more complicated approach is to “allocate” the corporation’s earnings no less than annually to each shareholder. Given that public company shares are traded constantly, there is simply no way to allocate earnings in real time. Thus, the suggestion has been made that if an allocation approach is used, the only workable approach is to choose a “record date” and allocate the corporation’s earnings to the shareholders holding stock on that date. To prevent shareholders from using hindsight to purchase or sell stock immediately prior to the record date but after they know whether the corporation made or lost money during the year, the record date would have to be the first day of the company’s year (or quarter if quarterly allocations are made).

4. Reducing the Preference for Debt Financing

As noted above, the corporate income tax did not always create a strong incentive to finance corporations with interest bearing debt. That actually came later when interest deductibility limits were removed and double taxation was introduced. Nevertheless, there is a significant preference for debt financing over equity financing. An important objective for any integration approach should be to reduce the preference for debt financing over equity financing. In this regard, it is important to distinguish between reducing the incentive for debt financing and equalizing the treatment of debt and equity. These are very different goals, and the objective should be the former, not the latter. To illustrate, even if Congress were to choose to eliminate double-taxation through, for example, a dividends paid deduction, there would still be significant timing differences between the treatment of interest on debt and dividends on equity due to the application of the original issue discount rules with respect to debt instruments. Whereas holders of debt instruments will still be required to accrue interest as it is earned, there would not necessarily be a similar requirement for equity holders, depending on the integration approach that is chosen. Moreover, payments on debt can be made on interest and returned as tax-free payments of principal before maturity. In contrast, dividends on equity would presumably remain taxed on a cash basis at the time they are paid and come from earnings first. Lastly, if any integration approach changes the UBIT rules to prevent

459 Alvin C. Warren, Jr., American Law Institute, Federal Income Tax Project - Reporter’s Study of Corporate Tax Integration at Part 3.H. (1993) (electronic ed.) (“Another administrative problem is the timing of income reporting. For example, U.S. corporations cannot report taxable income and corporate level taxes to shareholders until they receive reports of the taxable income and credits of other U.S. corporations in which they own stock. We have been unable to devise a precise solution for these timing issues.”)


462 See generally, §§1271-1275.

463 Compare a pure flow-through or shareholder mark-to-market system, the shareholder would have to recognize income from equity as it is earned, with a shareholder imputation model or dividends paid deduction model where the shareholder does not recognize income unless or until he/she receives property from the corporation.
corporate dividends from escaping tax entirely (see below), tax exempts may still prefer holding interest-bearing debt rather than dividend paying equity.\footnote{This will be the case unless an even more radical approach is taken to impose tax on the receipt of interest by tax-exempts as well.}

5. \textbf{Foreign Tax Credit}

The foreign tax credit poses a different challenge than preferences. The foreign tax credit does have the result of decreasing U.S. tax liability, but that is only because the taxpayer paid income tax (or an in lieu of tax) to a foreign government.\footnote{Sections 901 and 903. See The American Law Institute, \textit{Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration}, at Part 7.3(b) (Alvin C. Warren reporter) (1993).} The foreign tax credit has been part of our U.S. tax system since 1918.\footnote{Revenue Act of 1918, ch. 18, §240(c), 40 Stat. 1082. P.L. 65-254.} Like most rules that have been around for a long time, our foreign tax credit regime has become somewhat sacrosanct, despite the fact that commentators have pointed out there is no particular reason why only provide a credit for taxes that resemble “income taxes” in the U.S. sense.\footnote{Harvey P. Dale, \textit{Creditability of Foreign Taxes}, in Chapter 4 of U.S. Taxation in Developing Countries 121, 122 fn. 9 (1980). Daniel N. Shaviro, \textit{The Case Against Foreign Tax Credits}, 3 J. Legal Analysis 65 (2011); and Kimberly Clausing and Daniel N. Shaviro, \textit{A Burden-Neutral Shift From Foreign Tax Creditability to Deductibility?} 64 N.Y.U. Tax L. Rev. 431 (2011).} In any event, the purpose of the income tax was to allow taxpayers to invest abroad without fear (or at least a reduced fear) of double taxation. As the U.S. Treasury put it in 1992, although there is no consensus among the international community about whether countries should foster capital import neutrality\footnote{The idea that all investments in a given country should bear the same tax burden regardless whether the investor is domestic or foreign.} or capital export neutrality,\footnote{The idea that all investors in a given country should be indifferent (from a tax perspective) whether they invest within or outside of the country.} and fostering both at the same time is not possible absent coordination among all countries, the U.S. has been fostering capital export neutrality unilaterally since 1918 through the use of the foreign tax credit.\footnote{1992 Treasury Report (December) at 75-76.}

Integration presents an opportunity to rethink the foreign tax credit, however. Treasury’s 1992 analysis posited a number of questions that needed to be answered with respect to the foreign tax credit.\footnote{1992 Treasury Report (December) at pp. 36-37.} First, should the foreign income taxes be treated just like U.S. corporate taxes? In other words, assume a domestic corporation’s sole source of income was $100 of pre-tax income subject to $19 of UK income taxes. Should the U.S. consider that $100 to have already borne $19 of “corporate tax” that should alleviate the shareholder’s individual tax burden? Should this be the case even though the U.S. government never received that $19? Second, what foreign tax credit limitation should apply? Some form of limitation must apply or else foreign taxes can be used as a credit against U.S. source income. Should the current overall foreign tax credit limitation with 2-baskets be retained?\footnote{Section 904(d). The number of foreign tax credit baskets has changed over the years, reflecting Congress’s preference for simplicity trumping over rules preventing cross-crediting.} Should we revert back to a per-country limitation?\footnote{The original foreign tax credit limitation was a per-country limitation. See P.L. 65-254, §222(a)(1), 40 Stat. 1073.} Third, should our current complicated structure for dealing with indirect credits (\textit{i.e.}, foreign taxes paid by first-tier and lower-tier foreign subsidiaries) be retained?
This question is obviously also impacted by the questions addressed above over territoriality vs. full-inclusion. For purposes of this paper, it is sufficient to point out that in a scenario where no corporate tax is imposed, but shareholders are required to mark their shares to market, no foreign tax credit could be granted. Foreign taxes (whether imposed on income or not) would simply be cash outflows from the company which reduce its dividend paying capacity (and perhaps its value). Hence, the “foreign tax credit problem” more or less takes care of itself and the whole territoriality vs. deferral debate ceases to be relevant in the MTM model.

The foreign tax credit issue is more challenging in a DPD model. In a DPD model, the existing foreign tax credit system would presumably be retained (assuming the U.S. does not move to a territorial system). Nevertheless, questions would have to be answered with respect to how the dividends paid deduction impacts the foreign tax credit limitation. Currently, interest expense is apportioned to U.S. and foreign source income, and thereby impacts the foreign tax credit limitation.\textsuperscript{474} If dividends are deductible, those expenses would presumably have to be apportioned in the same manner as interest expense.

The foreign tax credit issues become still more challenging in an imputation model. As a frame of reference, Australia and New Zealand have an imputation system. Although Australian and New Zealand companies can claim a foreign tax credit for foreign income taxes paid against their corporate tax liability,\textsuperscript{475} they cannot pass that credit along to their individual shareholders.

6. Complex Capital Structures

Complex capital structures pose a problem for any integration approach that requires an allocation of corporate earnings to a specific class of stock. It is precisely the reason why, for example, Congress mandates that S corporations have exceedingly simple capital structures. S corporations are not, for example, allowed to have preferred stock.\textsuperscript{476} If this were not the case, then rules would have to be devised for allocating S corporation earnings between and among different classes of stock with different economic terms. In the private (non-publicly traded) context where special allocations are not permitted, this should be a challenge Congress can overcome. Large partnerships with multiple classes of equity interests already do it. Moreover, the Code already addresses income allocation amongst different classes of stock in the U.S. anti-deferral regime context.\textsuperscript{477} Thus, in the private company context, where companies are widely held, but the shareholders are known and cannot transfer their shares without notifying the issuer, it should be possible to broaden the application of the S corporation rules to allow for multiple classes of stock.

Things get much more difficult in the publicly traded company context where the company simply does not know who its shareholders are at any one point in time. Moreover, a company’s earnings are distinct from a company’s decision as to when and how to distribute those earnings. Thus, imagine a corporation that has two classes of stock, Class A and Class B. The Class A shareholders (as a class) have an aggregate $1,000,000 preference on liquidation, and a non-cumulative preference on the first 10% of any dividends that are declared, but there is no requirement that the company distribute any dividends. Class A and Class B shareholders participate equally in any dividends in excess of the 10% dividend preference to the Class A and any liquidation proceeds in excess of $1,000,000. If the company makes $2,000,000 in

\textsuperscript{474} See generally, section 861 and 864 and Treas. Reg. §1.861-9T.

\textsuperscript{475} Although Australia and New Zealand have a territorial system, they still impose tax on certain investments in lower-tax jurisdictions. When tax is imposed on foreign investment, a credit is typically available.

\textsuperscript{476} §1361(b)(1)(D).

\textsuperscript{477} See Treas. Reg. §1.951-1(e) (allocating subpart F income to multiple classes of stock); and §1293 and proposed regulations issued pursuant thereto in the case of “qualified electing funds”.

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a given year, but does not distribute any of those earnings, how should the $2,000,000 be “allocated”? It is not clear.478

7. Shareholder Liquidity

Any approach that taxes a shareholder before the shareholder receives cash from the corporation raises liquidity concerns.479 S corporations and partnerships typically make cash annual cash distributions to enable their shareholders and partners to pay the tax due on their share of business income. Congress has sought to solve this in the subchapter M area with RICs and REITs by forcing them to pay dividends every year. Yet, these are special purpose companies and government intrusion on the dividend paying policy of corporate managers is what lead to the rise of double taxation in the first instance back in 1936. Congress has seen this movie before, and it did not end well. Thus, an imputation system or DPD approach, for example, are clearly superior in this regard to an MTM or flow through approach.

8. Subsequent Audits

Another challenging question is what happens when the corporation is audited and the Service makes a positive or negative adjustment to the corporation’s earnings. It is simply not practical to pass through the adjustment to thousands of shareholders who would then all have to amend their tax returns.

One suggestion has been to simply adjust the corporation’s earnings prospectively.480 As alluded to a number of times in this article, there is precedent for this in the electing large partnership rules. These rules had not yet been enacted at the time of the 1992 Treasury Report (December).481 They have now been outstanding for a number of years. Although there are efforts to reform the rules for large partnership audits generally, the concept of making adjustments prospective has been retained.482 Although this approach puts a premium on the corporation identifying and quantifying its tax exposures so that new purchasers are not surprised, FIN 48 is another development since 1992 which adds significant rigor to this analysis and should serve to reduce the severity of this concern.

An alternative suggestion has been that the tax on audit adjustments should be imposed on corporations at the entity level, thereby retaining (and perhaps enhancing) the significant incentive corporate managers

478 One commentator has suggested that corporations could either be forced to allocate their earnings annually and then “constrained to make distributions in accordance with those allocations.” Anthony P. Polito, A Proposal for an Integrated Income Tax, 12 Harvard J. of L. & Pub. Policy 1009, 1034 (1989) (“This would definitively settle each shareholder’s claim against the corporation’s earnings in the same year in which they were earned.”) The difficulty with this approach is that it would constrain companies from, for example, making share buy-backs on the market. There is no certainty, for example, that those shareholders who were allocated earnings are necessarily the people who would want to tender their shares.


480 1992 Treasury Report (December) p. 35 (“To avoid these problems, the shareholder allocation integration prototype would treat any audit or other adjustment to corporate income as a taxable event in the year of the adjustment. Under the prototype, it is unnecessary to adjust returns of prior year shareholders because adjustments to corporate income would be treated as an increase or decrease in the corporation’s current year taxes and income. The adjustments would be passed through to current year shareholders. The IRS would collect deficiencies directly from the corporation, and the corporation would pass through the credits for corporate taxes paid along with the additional income. Shareholders’ bases would be adjusted to reflect the additional income.”).


482 President’s Obama’s Greenbook proposals in 2015 would have modified the electing large partnership and TEFRA rules, but would have retained the concept of prospective audit adjustments, whereas the Greenbook proposal in 2016 would have required adjustments be made to the income of the partners in the year to which the adjustment relates.
have to accurately report corporate earnings on the initial return.\textsuperscript{483} This would, of course, be contrary to the goal of shifting the liability for corporate tax to the Shareholder.

9. **Domestic Deferral**

Any integration model that fails to allocate income to shareholders as it is earned and imposes tax at the shareholder rate, may potentially incentivize domestic deferral planning of the type that led to the enactment of the AET and PHC discussed above whenever shareholder rates exceed corporate tax rates. The AET has proven so completely incapable of policing domestic deferral one wonders why Congress retains it just to clutter up an already overly lengthy Code. Nevertheless, Domestic Deferral should not be a problem for an MTM or a partnership model. It is really only a problem for an imputation or DPD model, and, even then, only when shareholder rates are significantly higher than corporate rates.

10. **Foreign Deferral**

As noted previously, U.S. based multinationals are generally permitted to defer profits earned through foreign corporations unless or until they are remitted, subject to an exception for “subpart F income”\textsuperscript{484}. There appears to be a general consensus that this system needs to be changed, but the debate over “how” to change is not drastically different from the debate that President Kennedy had with Congress in 1961 and 1962.

At the risk of overgeneralizing, this debate boils down to whether the U.S. should: (i) move to a pure territorial system where all (or the vast majority) of foreign profits are permanently exempt from U.S. taxation; (ii) move to a full-inclusion system where foreign profits are currently taxed to U.S. multinationals and deferral is not permitted; or (iii) choose a middle-ground between these two points. People come down on different points of this continuum, but the trend appears to be in favor of (iii), choosing something less than a pure territorial system, but not adopting a full inclusion system.\textsuperscript{485}

There are pros and cons of each approach. It is sufficient for purposes of this paper to note a couple of key tensions. First, advocates of a territorial system stress the importance of competitiveness. Given that nearly all of the U.S.’s trading partners have moved to a territorial system, territoriality proponents argue that U.S. needs to move to a territorial system or else it will fail to compete and there will be increased pressure on U.S. multinationals to leave the U.S. The difficulty with a pure territorial system (or some partial territorial system) is that it increases the pressure that already exists in the current system to transfer intangible property, manufacturing and marketing activities earn profits overseas.\textsuperscript{486}

In contrast, Professor Edward Kleinbard and others\textsuperscript{487} have suggested a full-inclusion model would substantially alleviate pressures to move profit and activity overseas. Prof. Kleinbard notes that full

\textsuperscript{483} Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 Harvard J. of L. & Pub. Policy 1009, 1044 (1989) ("It would appear that the ideal of ignoring the corporate form should in this situation yield to administrative simplicity. Such adjustments after the fact, including interest and penalties, should be paid at the corporate level.") (citations omitted)

\textsuperscript{484} See generally, subpart F of the Code.

\textsuperscript{485} See e.g., Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises*, (July 21, 2014) reprinted in 2014 WTD 140-31 (discussing former Sen. Finance Committee Chairman Max Baucus’s partial full-inclusion approach whereby 60 percent of all “active foreign market income” would be included on a current basis, 40 percent would be excluded, but 100 percent of the income would then be considered to have been “previously taxed” and could be brought back to the U.S. without additional tax).

\textsuperscript{486} Edward D. Kleinbard, *Throw Territoriality from the Train*, 2007 WTD 66-5 (Apr. 5, 2007) (noting how a territorial system exacerbates the pressure on transfer pricing).

\textsuperscript{487} Jeffrey M. Kadet, *Worldwide Tax Reform: Reversing the Race to the Bottom*, 2013 TNT 49-8 (Mar. 13, 2013) (suggesting that full inclusion is the only way to prevent U.S. multinationals from shifting profits overseas).
inclusion also has the benefit of being a unilateral action that does not require coordination with other countries. He does acknowledge the negative impact that full inclusion would have on U.S. competitiveness as it focuses on the somewhat “meaningless” concept of corporate residence.  

In sum, the options are presented in the following table:

<table>
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<tr>
<th>(A)</th>
<th>(B)</th>
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<tbody>
<tr>
<td><strong>Full Inclusion</strong></td>
<td>*<em>Some Form of Territoriality</em></td>
</tr>
<tr>
<td>1. Retain Classical Tax System</td>
<td>Classical / Full Inclusion</td>
</tr>
<tr>
<td>2. Integration with Corporation as Taxpayer</td>
<td>Corporate Taxpayer / Full Inclusion</td>
</tr>
<tr>
<td>3. Integration with Shareholder as Taxpayer</td>
<td>Shareholder Taxpayer / Full Inclusion</td>
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* There are, as mentioned, various degrees of territoriality, but we assume for ease of illustration that territoriality is an absolute.

The difficulty with a full inclusion method while retaining the current system or, we would argue, an integrated system where the corporation remains a taxpayer, is that corporate managers will continue to be compensated on after-tax returns. Layering on a full-inclusion system will only further exacerbate the incentive to invert. The advantage of a system that taxes corporate profits once, but at the shareholder (not corporate) level, is that it should decrease the extent to which corporate managers are compensated on an after-tax basis and allow the U.S. to compete on a basis other than taxes. In this way, the U.S. can stop playing the traditional tax competition game. This also creates greater freedom to choose between the full inclusion and territorial approaches to Foreign Deferral, without enhancing the incentive to invert.

11. **U.S. Corporate Shareholders**

The treatment of U.S. corporate shareholders which receive dividends from a lower tier domestic corporations differs depending on the approach. In the imputation model, they would normally include distributed amounts just like individual taxpayers, gross those amounts up for corporate taxes already paid and then claim a credit. The challenge, of course, would be if Congress chooses to wash out preferences.

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488 Edward D. Kleinbard, *Stateless Incomes’s Challenge to Tax Policy, Part 2*, 2012 TNT 181-16 (“The United States today faces a Hobson's choice between the highly implausible (a territorial tax system with teeth) and the manifestly imperfect (worldwide tax consolidation). Because the former is so unrealistic, while the imperfections of the latter can be mitigated through the choice of tax rate, the worldwide tax consolidation solution, coupled with a much lower corporate income tax rate, is the more productive approach that the United States should take.”)

489 The interaction of the integration modality and the choice of full inclusion with a foreign tax credit, or some version of a territorial system can get very tricky. The Australian and New Zealand experience with triangular taxation (i.e., New Zealand residents owning Australia companies that invest in New Zealand) is illustrative. Australia has a territorial system and so the Australian parent company can receive the dividend free of Australian tax. Moreover, when the Australian company pays the dividend to the New Zealand shareholder, no Australian withholding tax is imposed. The difficulty arises, however, because the New Zealand individual shareholder of the Australian parent company has to pay tax even though New Zealand corporate tax has already been paid on the profits. Australia and New Zealand managed to resolve the issue through mutual agreement through the Trans-Tasman initiative. Carolyn Palmer, *The International Tax Consequences of New Zealand’s Imputation System, Past, Present and Future*, 14 New Zealand J. of Tax L. and Pol. 231 (2008); and Justin Dabner, *Responding to Globalization: Are Imputation Systems Up to the Challenge*, 10 New Zealand J. of Taxation L. and Policy 271 (2004).

490 Right now, the Code only partially relieves double-taxation in the case of domestic corporate shareholders who own at least 80 percent of corporate subsidiaries. Again, this is likely an historical anachronism rather than an intelligent policy choice. See e.g., Steven A. Bank, *When we Taxed the Pyramids*, 41 Fla. State Univ. L. Rev. 39 (2013). Nevertheless, to avoid overcomplicating an already complex topic, this paper does not spend significant time on corporate shareholders. It is sufficient to note that a decision has to be made about whether domestic corporate shareholders should be able to avoid double taxation regardless of their level of ownership, and then the technical provisions would flow from that decision.
for individuals. In that case, there may need to be different treatment for corporate shareholders, or else there will likely be many layers of corporate taxation. In the DPD model, the recipient would simply include the distributed amounts into its income and pay tax at that time. There would be no need for a dividends received deduction, because the paying corporation received a corresponding deduction. Lastly, in a MTM model, assuming the corporate shareholder is publicly traded, the shareholder would not be subject to tax. If the corporation were not public, but Congress adopted the above suggestion for substantially broadening the S corporation regime, then the mark-to-market gain or loss would simply flow through to the individual shareholders of the corporate shareholder.

12. Exempt Shareholders

Currently, dividends are not subject to the unrelated business income tax (“UBIT”) and, so, not subject to tax at the exempt shareholder level, provided the stock paying the dividends is not debt financed.\(^491\) If an integration approach were applied, however, it would only make sense that this rule should be changed so that corporate profits allocable to domestic tax-exempt shareholders does not escape corporate tax completely.\(^492\) The idea of expanding UBIT in this way is neither new nor novel. In 1985, when Congress flirted with the possibility of granting a partial dividends paid deduction, the proposals would have treated a portion of dividends received by tax exempts as UBIT.\(^493\) In this regard, a distinction should be made between those tax-exempt vehicles that receive a permanent exemption from tax (section 501(c) type entities) versus those vehicles which only receive a temporary tax-exemption (like 401(k) accounts). The owners of temporarily exempt accounts should presumably receive an inflation adjusted credit for any taxes that were paid on the receipt of dividends when the proceeds of the account are paid out and subject to tax.

13. Foreign Shareholders

The existence of foreign shareholders is perhaps the most complicated shareholder level issue. This is because the U.S. is already subject to a multiple bilateral tax treaties. These treaties are all based on the assumption that the U.S. has a classical tax system. None of these treaties will automatically change simply because the U.S. decides to move to an integrated system.\(^494\) In addition, foreign shareholders present a unique collection issue. The difficulties this poses for a DPD and MTM approach are relayed below.

14. Shareholder Windfall

Lastly, any integration proposal has to address the issue of windfall to existing shareholders who, presumably, purchased their stock at a price that reflected the anticipation of two levels of tax under our

\(^{491}\) §512(b)(4) (including income from certain debt financed property under section 514 in the computation of unrelated business taxable income).


current system. At least one commentator has noted, in connection politics of the Bush administration’s 2003 dividend exemption proposal, that the manner in which Congress handles windfalls can be used as political currency to get various interest groups on-side with respect to a given integration approach.

B. The Two-Prong Approach And Where to Draw the Line

As was noted at the outset of this paper, true integration aligns base, rate and timing of corporate and shareholder taxation of corporate profits. For this reason, the partnership or pure flow-through model has been considered the “theoretically ideal” model for taxing business profits. Under the partnership model, there is no tax imposed at the entity level. Instead, corporate profits (both distributed and retained) would be taxed immediately to the shareholders at their personal rate.

Yet, true integration for public companies is a very tough nut to crack. For this reason, other commentators have suggested a two-prong strategy for integration whereby a flow-through approach applies to simpler fact patterns and another regime addresses the complexities created by larger, more complex and widely held entities. Commentators have differed over what the criteria should be each regime, however. Some have argued that the distinction should be made based on the complexity of the capital structure, such that only those companies with a single class of stock qualify for flow-through status. Others distinguish between companies based on whether the company’s shares are publicly traded, either because traded shares are more liquid or because of their view that public companies derive a benefit that private companies do not.

This paper advocates that the dividing line should be based on ease of administration. The issue that creates excessive administrative complexity for taxpayers and the Service with respect to a partnership or flow-through model is the income allocation to partners/shareholders who transfer their equity interests without the knowledge of the issuer. This is because once equity interests can be transferred without the issuer's knowledge, taxpayers and the Service have to use some heuristic to allocate income as close as possible to owners for their holding period based on imperfect data. This results in an over-allocation or under-allocation of income. Thus, the dividing line should be drawn between those companies whose shares are transferred without the knowledge of the issuer and those whose shares are only transferred with the knowledge of the issuer.

495 The precise timing of that second shareholder level tax would be quite different from company to company, however. Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World? 39 Case Western L. Rev. 965, 971 fn. 8 (1988-1989) (addressing various views regarding windfall).


498 See e.g., Jeffrey Kwall, Taxing Private Enterprise in the New Millennium, 51 Tax Lawyer 229 (1998).

499 See Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate Shareholder Integration Proposal, 50 Tax L. Rev. 265 (1994-1995) (suggesting the distinction should be between illiquid companies who can be taxed on a flow-through basis, and liquid companies who cannot). See also, Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World? 39 Case Western L. Rev. 965 (1988-1989) (arguing in favor of a distinction between public and private companies, but suggesting that the former could be subject to double taxation).

500 As noted in a prior footnote, there are companies that will provide information about shareholders based on information provided by brokers, but this is not as accurate as having a shareholder register with shares that can only be transferred with notice to the issuer as evidenced by the discussion in Part V regarding the difficulty of issuing proxies.
The securities laws are instructive in this regard. Section 13(a) of the Securities Exchange Act of 1934 ("Exchange Act") requires a company to file periodic reports under certain conditions even if it has not registered a class of securities on an exchange under section 12(b) of the Exchange Act.\textsuperscript{501} Specifically, a company whose shares are not registered with an exchange must still file periodic reports with the SEC if it has assets exceeding $10 million and at least one class of equity securities held by 500 or more record holders as of the last day of the company’s fiscal year.\textsuperscript{502} As a practical matter, private companies attach restrictions on the sales of their shares prior to reaching that point in order to keep tabs on who their shareholders are, and how many they have.\textsuperscript{503} That does not mean that the shares are not liquid.\textsuperscript{504} It just means that the issuer should know who its shareholders are at any one point in time and be able to allocate income accordingly. Thus, a possible practical breakpoint between those companies that can, and those that cannot, enjoy flow-through would be companies with 500 or fewer shareholders. Once they reach that level, they will likely (although not certainly) be required to register their shares and will likely be motivated to list those shares on an exchange.

The test for applying an expanded Subchapter S should be whether the shareholders are prevented from transferring tax ownership of their shares without the corporate issuer's knowledge. The penalty for those corporations who purport to know who their shareholders are at any one point in time, but fail to have adequate safeguards in place, would be the imposition of any unallocated tax on the corporation itself on a prospective basis.

**C. First Prong: Subchapter K and an Expanded Subchapter S for Non-Publicly Traded Entities**

Under the two-prong approach, companies that are not publicly traded and that already enjoy flow-status through subchapter K or subchapter S could retain their status. An expanded subchapter S would be available, however, for those companies that do not currently qualify for subchapter S and do not have shares that are traded without the knowledge of the issuer.

The U.S. Treasury suggested a greatly expanded role for subchapter S in 1977, and other authors have also argued that subchapter S could be expanded to deal with certain corporations.\textsuperscript{505} This use of subchapter S begs a couple of key questions. First, why subchapter S? Why not allow subchapter K to apply to incorporated companies? Second, what modifications would have to be made to expand subchapter S?

1. **Subchapter S Possesses Certain Features that Make it a Better Choice for Private "C" Corporations That Want to Benefit from Integration**

One could argue that there is no need to alter or expand Subchapter S, because taxpayers already have the option of investing through partnerships if they can not, or do not want to, qualify under the S corporation rules. Those partnerships can provide limited liability for all partners. So, the argument goes, there is no need to spend a lot of time discussing the expansion of Subchapter S.

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\textsuperscript{502} Id.

\textsuperscript{503} Id. at 4 (noting that companies typically include rights of first refusal and other mechanisms to ensure their shares do not wind up in the hands of more than 500 record shareholders).

\textsuperscript{504} Id. at 5 (noting the secondary market platforms that exist for facilitating exchanges of private company shares).

\textsuperscript{505} Deborah H. Schenk, *Reforming Entity Taxation: A Role for Subchapter S*, 2015 TNT 46-4 (suggesting an expanded role for subchapter S).
The difficulty is that there are still a number of large private "C" corporations, many of which were formed years ago, that do not qualify for S corporation status. Nevertheless, their shares cannot be traded without the knowledge of the corporate issuer. Thus, horizontal equity would auger in favor of them being able to benefit from a pure integration or flow-through regime. Moreover, as a political matter they are unlikely to support an integration scheme that leaves them and their shareholders subject to double-taxation while public companies get integration treatment. The question then is whether it is easier to create a new set of rules to enable them to convert tax-free to partnership status, or instead simply expand subchapter S (which already contemplates "C" to "S" conversions) to accommodate these entities.

There is already settled law governing the tax-free conversion of "C" corporations to subchapter S status. There is also an anti-abuse rule that polices conversions followed by sales or dispositions of appreciated assets within ten years of conversion.

In addition, S corporations lack three distinct partnership features that enhance simplicity and decrease the possibility for abuse. Although these features also decrease taxpayer flexibility, that is a price taxpayers have to pay for obtaining one-level of taxation instead of two.

First, unlike partnerships, S corporations must allocate their net income or net loss. They are not permitted to specially allocate revenue or expense items. Thus, S corporations do not require the complexity of section 704(b) and the section 704(b) regulations.

Second, the shareholder is only permitted to claim losses in excess of basis equal to loans the shareholder has made to the corporation. There is no corollary to the complex section 752 rules in subchapter K.

Third, the opportunity for using contributions and distributions of property to shift income and loss is severely restricted in the S corporation context. This is because an S corporation's distribution of appreciated assets is taxable, not tax-free. If shareholder A contributes appreciated property to an S corporation, and the corporation distributes the property to another shareholder, the corporation immediately recognizes gain and that income is allocable to all of the shareholders. Alternatively, if loss property is distributed, no loss is permitted and the shareholder still takes a stepped down basis in the property. The shareholder also reduces his or her basis in the S corporation stock equal to the disallowed loss. Notwithstanding these features, for reasons that are discussed below, some additional guardrails may be needed to prevent income shifting if subchapter S is expanded in the manner suggested below.

2. What Changes Would Have to be Made to Expand Subchapter S?

A number of other changes would have to be made to make the S corporation regime a more realistic option for those private companies who have not yet elected to convert. The more significant expansions are noted below, together with caveats.

a) Number of Shareholders

See e.g., Andrea Murphy, America's Largest Private Companies 2014, Forbes (Nov. 5, 2014). Although a number of these large public companies have been able to elect S corporation status, many others with tens of billions in revenue have not.

Section 1374.

Section 1367(b)(2)(A).

Section 311(b).

Section 311(a).

For an illustration of these rules see Chief Counsel Advice 201421015 (Feb. 14, 2014).
A possible 500 shareholder limit was alluded to above. Ideally, there should not be any flat numerical limit on the number of shareholders unless one is desired as a surrogate for the real test - i.e., whether the company restricts the ability of its shareholders to transfer tax ownership of its shares without its knowledge. As the following discussion indicates, if S corporations are allowed to have entities as shareholders, a flat numerical limit becomes somewhat meaningless because taxpayers can use tiered structures to include as many shares as they want.

b) Types of Shareholders

The Code currently restricts S corporations to only having individuals, estates and certain trusts\(^\text{512}\) as shareholders. Domestic C corporations, partnerships and all foreign persons are forbidden from holding S corporation shares. The objection and response to having each type of shareholder is different.

The ban on domestic corporate and partnership shareholders serves as a backstop to the 100 shareholder limit. If partnerships can be shareholders of an S corporation, any flat upper limit on the number of shareholders becomes meaningless. Yet, if the limit itself were lifted, and the sole test was whether the S corporation's shares can be traded without the knowledge of the issuer, the need for the backstop goes away.

Instead, the S corporation would be tasked with ensuring that it knows how many of its shares are owned by that C corporation or partnership at any one point in time and allocating the appropriate amount of income to that shareholder. The C corporation or partnership would, in turn, either be entitled to flow treatment or the alternative treatment identified below in the second prong of the two-prong approach.

The issue with non-U.S. shareholders (be they individuals or entities) is that there needs to be a withholding regime to ensure they are paying their share of the one-level of tax on the business income generated by the S corporation. The Code already addresses this issue through section 1446 in the case of foreign owners of partnerships conducting business in the U.S. It should be possible to extend a section 1446-like regime to S corporations.\(^\text{513}\)

c) Complex Capital Structures

Another significant drawback of the current S corporation rules is that they do not allow for complex capital structures.\(^\text{514}\) Some have suggested that S corporation-like flow-through should not be permitted for companies with complex capital structures due to the potential for abuse.\(^\text{515}\) Others have suggested that complex capital structures can be accommodated, but only if capital accounts are created and maintained.\(^\text{516}\)

\(^{512}\) Section 1362(c)(2)(A).

\(^{513}\) See e.g., section 1446 in the case of partnerships. It does not automatically follow that the trade or business imputation rule in section 875 would have to be applied. Instead, each foreign investor's interest in an S corporation could be viewed as an isolated investment that does not necessarily cause the foreign shareholder to have a permanent establishment. The S corporation could even be given the right to prepare and file the return on behalf of the foreign shareholder so long as the items reflected on the return were limited to the S corporation's operation and not deemed to be part of a larger permanent establishment due to the application of the section 875 imputation rule. This would go a long way towards addressing the reluctance of foreign shareholders to file U.S. income tax returns, which is a significant motivation for the use of U.S. and foreign "blocker" companies.

\(^{514}\) Section 1361(b)(1)(D) limits small business corporations to corporations that have one class of stock. Although section 1364(c)(4) provides that non-voting stock is not considered a second class of stock, S corporations are prevented from issuing preferred stock, or convertible preferred stock and stock options etc....


Nevertheless, the Code accommodates flow through taxation with multiple classes of stock in other contexts, and it would certainly seem possible to do here.517 The key would be to mandate that income or loss be allocated, special allocations of revenue or expense items be prohibited,518 and that income not be allocated in a manner that is inconsistent with cash flows.519 Large complex partnerships that do not specially allocate revenue or expense use targeted allocations of income and loss every day right now, and do not require liquidations in accord with capital accounts. They force the income allocation to follow the cash, instead of the other way around. The key lies in not permitting cash to be distributed differently from income. It is difficult to see why this could not work for S corporations with complex capital structures.

Finally, the more widely held a flow-through becomes, the more complex its audit becomes, and the more administrative resources the IRS needs to spend chasing after what may be relatively small amounts of revenue. Yet, Congress has already taken a step towards simplified audit procedure for electing large partnerships that allow for prospective adjustments that do not require the filing of hundreds of amended returns.520

Thus, if the political will existed, the Code already contains approaches for eliminating the corporate income tax for private companies where there are a finite number of shareholders who can be identified and who cannot transfer their shares without notifying the company first.

D. Second Prong: Alternative Approaches for Publicly Traded Partnerships and Corporations

The second prong of the two-prong approach would impose a single integration regime on all domestic publicly traded companies (including PTPs). One could argue that PTPs already exist, PTPs pass through income and loss to their owners on a current basis, and if Congress amended section 7704, more companies could avail themselves of this regime. So why bother coming up with a new regime? The difficulty with this argument is it is precisely because Congress has limited the activities in which PTPs can be engaged that their asset base is less complicated than that of large multinationals.521 Imagine the

517 See e.g., Treas. Reg. §1.951-1(e) (addressing the determination of a shareholder’s pro rata share of a CFC’s subpart F income in the context of multiple classes of stock). The partnership rules are not a great example, because they allow for special allocations of “items” of income and expense, which would normally not be part of any corporate integration model.

518 Choices would have to be made in connection with how to treat liabilities. See e.g., Jeffrey Kwall, Taxing Private Enterprise in the New Millennium, 51 Tax Lawyer 229, 261 (1998) (noting that another complicating factor is the treatment of liabilities, deciding whether liabilities should be considered in determining the loss limits, and whether the more liberal and complex subchapter K model should be adopted or the simpler and more restrictive subchapter S model should be adopted).

519 The ALI report from 1993 used an example to illustrate the possibility for abuse but tellingly the example involved a situation where all of the income was allocated to one class of stock, but cash was paid out on both classes of stock. See The American Law Institute, Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes, Reporter’s Study of Corporate Tax Integration, at Part 3.F (Alvin C. Warren reporter) (1993).

520 See §§771-776. It is the case that FIN 48 would not necessarily apply to a private company that is not using generally accepted accounting principles. In that case, a prospective adjustment mechanism would very much place prospective purchasers of stock in the position of being exceedingly cautious about purchasing stock. Nevertheless, again, we are dealing with this same issue every day in the context of negotiating tax indemnities when C corporations are bought or sold. We would expect market practice to develop along the same lines with purchases and sales of partnerships whereby a new partner/shareholder would seek an indemnity for any post-closing adjustment that relates to a pre-closing period or, alternatively, they would build a discount into the purchase price.

521 Congress was clearly concerned about the administrative aspects of PTPs. See Staff of the Joint Committee on Taxation, Taxation of Master Limited Partnerships, pp. 35-36 (1987) ("Supporters of taxing master limited partnerships as corporations argue that trying to apply the partnership tax rules to the operations of a publicly traded entity is overwhelmingly complex. those rules were never designed for publicly traded entities, they argue.").
issues associated with doing 743 and 751 calculations for larger, more complex, publicly traded multinational partnerships. 522

One could argue that PTPs could be made simpler by modifying the partnership rules along the lines of those discussed above - i.e., eliminating the ability to specially allocate revenue and expense items, requiring that income allocations follow cash distributions, imposing a section 311(b) type recognition event on partnership distributions of appreciated property so as to eliminate section 704(c) and 737 concepts, eliminating basis adjustments for partnership debt, etc…. Nevertheless, even if every simplifying assumption that could be made was made, PTPs still present insurmountable income allocation issues. Unlike a corporation that only needs to deliver easily quantifiable information to shareholders that own stock at specific points in time (i.e., dividends on a Form 1099), partnerships are required to allocate income every day of the year. 523

There are a lot of alternatives to flow-through treatment, however. In this sense, it is best to think in terms of “degrees of integration” where integration should be considered a continuum with the U.S. classical tax system (two levels of tax) at one end and full pass through (partnership like) taxation at the other. 524 There are a lot of options in between these two extremes such as simply using rates to achieve integration, 525 providing deductions on equity capital, 526 letting shareholders exclude corporate dividends

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522 One example illustrates the point. The section 1248 amount with respect to foreign subsidiaries is an "unrealized receivable", also known as a "hot asset" within the meaning of section 751(c). A partner's sale of a partnership which has a section 1248 amount causes a gain that would otherwise be capital to be ordinary. Multinationals simply do not maintain these figures on an annual, much less daily, basis.

523 In practice PTPs attempt to send a customized Schedule K-1 to each beneficial owner of units. The question is how they go about identifying those owners and how much equity they own at any point in time. They attempt to do this by contracting with a 3rd party service provider to gather information from the various brokers to determine who the beneficial owners are as of a given point of time during a given month. The PTPs divide their pre-depreciation income for the entire year by 12, and then adjust those amounts for depreciation using an interim closing of the books approach. The PTP then allocates the income for each month based on the ownership of its units on the first day of that month. For the reasons discussed in Part V in connection with the difficulty of determining ownership of public companies at any given moment, this information is not going to be entirely accurate and so could lead to over allocation or under allocation of income/loss. It can also result in persons who owned equity for a period to not be allocated any income. Specifically, if a person bought and sold an equity interest within a month, then presumably the equity holder would never receive an allocation of income. As a safeguard, we understand that PTPs attach an ownership schedule to the Schedule K-1s that are issued and equity-holders are instructed to review their schedule. They are often provided a number to contact if their schedule is incorrect. If they notice a correction, a new Schedule K-1 can be generated.


525 One approach, suggested in the mid-1990s, was to simply revert to the system as it existed in the early part of this century where dividends were excluded from the “normal” tax base but included in the shareholder’s “surtax” base. Specifically, rather than engaging in complicated machinations to achieve one level of tax, proceed on the assumption that Congress has the will to set rates at the right level and the willpower to keep the rates there. If corporate profits were taxed at the lowest tax rate available for individuals, and dividends were excluded from gross income up to the top end of that lowest bracket, but included in gross income for purposes of computing liability under each successive bracket (i.e., like the situation that existed the surtax at the beginning of the 20th Century). The biggest advantage of this approach is that it would be simple. It would not impinge on corporate dividend policy. The fact that the rate would have to be set and kept quite low would also decrease the existing incentive for businesses to migrate out of the United States. This approach puts a lot of faith in Congress’s willpower, however. It also ignores the differences between shareholder and corporate tax bases, which existed back in 1894, and has only grown since then. One author has suggested that a credit mechanism for low income shareholders could alleviate the challenges posed by differences in tax base. See generally, John K. McNulty, Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects, 12 Int’l Tax & Bus. L. 211 (1994). Nevertheless, commentators have suggested that the potentially “fatal flaw” in this approach is that so long as the Code has a progressive set of income tax brackets, higher income shareholders will have the incentive to defer the receipt of corporate dividends. See generally, George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431 (1992).]
from the tax base,527 providing shareholders an imputation credit for taxes paid by the corporation,528 imposing a corporate tax but providing for a dividends paid deduction,529 and taxing shareholders on a mark-to-market basis while exempting corporations from tax.530

Variations of an imputation model were popular in Western Europe in the aftermath of World War II.531 An imputation model was also adopted outside of Europe in, most notably, Australia and New Zealand. The challenge for the European countries was that the European Court of Justice, an EU court of last resort, ruled that countries with an imputation system could not fail to give the imputation credit to those shareholders who were resident outside of the dividend payor’s country, but yet within the EU. As a result, EU countries started phasing out their shareholder credit.532 Australia and New Zealand have retained their imputation systems, however, and represent good examples of how an imputation can work even with large, publicly traded multinationals. For a basic side-by-side comparison of how the Australian and New Zealand systems work using a simple example of a public company, see Appendix III.

The thesis of this paper, however, is that the corporate tax burden must be shifted to the Shareholder to the limits of administrative ability. The imputation model does not achieve that objective. Thus, if the U.S. were to adopt such a model, the same debates that have prevailed over whether to move to a territorial or full inclusion system would continue, as corporate managers will continue to insist on a system that facilitates Foreign Deferral.

Two models that could shift the tax liability onto Shareholders of public companies and deserve significant consideration are the MTM and DPD models. The following subsections explore those two approaches. As will become evident below, non-U.S. shareholders present the biggest administrative challenge for each approach.

1. Tax Share Appreciation on a Mark to Market Basis

If Shareholders were forced to mark their corporate shares (U.S. and foreign) to market no less than annually, then double-taxation could be avoided.533 This approach relaxes the assumption that Shareholders should only be taxed on a realization basis in order to achieve integration.534 Probably one

520 A number of countries have provided for deductions on equity capital investments in order to reduce the incentive for debt financing such as Belgium, Brazil, Italy, etc....

527 This is the approach employed by the 1864 Act, the 1894 Act and, for lower income shareholders, from 1913 through 1935. A dividend exclusion or exemption approach accords with the 1992 Treasury Study (December). In this modality, shareholders exclude corporate dividends from their gross income altogether. A variant of this proposal was proffered by the George W. Bush administration in 2003, but was not enacted. An analysis of the politics surrounding the Bush proposal can be found in Michael Doran, Managers, Shareholders, and the Corporate Double Tax, 95 Va. L. Rev. 517 (2009).

528 This is the approach still in use in Afghanistan, and was in use for over twenty years in Mauritius.


530 Michael J. Graetz and Alvin C. Warren, Jr., Unlocking Business Tax Reform, Tax Notes 707, 709 (Nov. 10, 2014).

531 Id. at 709-710.


of the most thoroughly considered MTM integration proposals was put forward by Professor Joseph M. Dodge.\textsuperscript{535}

In this approach, the shareholder marks his or her shares to market no less than annually. The corporation would not be subject to tax at the entity level, but would instead withhold tax from any cash or property distributions made to the shareholder. The shareholder could then credit the withholding tax against their individual tax liability or claim a refund for the amount withheld if it exceeds their tax liability. Choices would have to be made about the character of gains and losses,\textsuperscript{536} the tax rate, whether losses could only offset previously recognized gains or whether a more liberal loss utilization regime would be allowed.

\textit{a. Advantages}

The primary advantage of this approach is that corporate managers would, presumably, cease to be compensated on an after-U.S. tax basis. They may still retain the incentive to reduce foreign taxes, but there should not be any U.S. tax-inducement to move functions or profits overseas. Inbound and outbound corporate transfer pricing audits would effectively disappear. Another advantage is that the full inclusion vs. territoriality debate becomes moot. Effectively all enhancements to a U.S.-based multinational’s income, whether earned here or abroad, would be subject to tax as realized at the Shareholder level. The third advantage would be that the model would completely eliminate the tax preference for debt financing. The fourth advantage is that treaty partners may be more willing to renegotiate existing tax treaties to accept the imposition of withholding tax on corporate property distributions, as the withholding would simply be a surrogate for the corporate income tax that is no longer being paid.

\textit{b. Disadvantages}

The primary disadvantage is, of course, the shareholder liquidity concern. Absent cash distributions from their subsidiaries to pay the tax, shareholders would have to potentially borrow or sell stock to pay their taxes each year.

Another significant disadvantage is that some companies have certain classes of their shares which are listed and traded on an exchange while other classes are not. Thus, for those companies that have a class of shares that is not traded on an exchange, an interest charge regime akin the section 1291 in the passive foreign investment company ("PFIC") rules would have to be applied to prevent the shareholders from simply deferring shareholder-level taxation and paying no tax in the process.

The most significant disadvantage is an administrative one, however. The tax would likely be impossible to collect from foreign shareholders on a mark-to-market basis. At best, the tax could only be collected when foreign shareholders received dividends or sold their shares.\textsuperscript{537} The severity of this challenge warrants additional exploration.


\textsuperscript{536} We have mark-to-market regimes in the Code right now. The section 475 mark-to-market regime applies to inventory and so gains and losses as “ordinary”, whereas the section 1256 regime allows for partial short-term capital and partial long-term capital treatment. See §§1256(a)(3). Contracts such as foreign currency contracts described in section 1256(g)(2) are treated entirely as ordinary under subpart J of the Code governing foreign currency transactions.

\textsuperscript{537} Joseph M. Dodge, \textit{A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal}, 50 Tax L. Rev. 265, 289 (1995) ("Although the exemption for gains on stock of U.S. corporations could be repealed, it probably would be difficult to directly enforce a tax on U.S. stock gains of nonresident alien individuals.").
1) How to Collect Tax on a Realization Basis From Non-U.S. Shareholders

There are three (3) key obstacles to overcome in order to impose tax on foreign shareholders of public companies: (i) imposing substantive liability; (ii) overcoming treaties; and (iii) cash collection. Each is addressed below.

a. Imposing Substantive Liability

Normally, gains on sales of stock are sourced by reference to the seller’s tax residence, which in this case would be foreign. The Code can be redrafted to provide a special U.S. sourcing rule for mark-to-market gains on U.S. publicly listed companies, however. There is precedent, for example, in the FIRPTA regime where Congress deemed sales of land-rich companies to be income that was effectively connected with the conduct of a U.S. trade or business. The same rationale could apply here.


The second hurdle would be to overcome treaty provisions. U.S. treaties typically contain a paragraph which provides that unless there is an exception to the contrary, gains on sales of property that is not considered real property and not used in the conduct of a business forming part of a permanent establishment can only be taxed in the country of residence.

When the United States enacted FIRPTA in 1980. The U.S. had already signed treaties that ceded tax jurisdiction on gains to the residence country. In recognition of that fact, the statute provided a grace period whereby the treaties would continue to apply until December 31, 1984. After that, if the treaty had not yet been renegotiated, the FIRPTA provisions would override the treaty. A few years later, Congress confronted another treaty override problem in a slightly different context when it enacted the branch-profits tax now found in section 884. This time, rather than providing a grace period, Congress and Treasury subordinated the tax to the treaty, provided the taxpayer satisfied an anti-treaty shopping

538 Section 865(a).
539 Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265, 342 (1995) (“Because mark-to-market gains of foreign individual shareholders are a tempting revenue source - given the abolition of the U.S. corporate income tax - it is worthwhile to explore the issue of whether taxing such gains is feasible. It would be easy enough to broaden the language of §871 so as to make foreign individuals taxable on mark-to-market gains, but, to be effective, that move would require defining U.S. source in this context. The Code is silent about sourcing mark-to-market gains. Section 865(a), perhaps the closest analogy, looks to the residence of the shareholder but only applies to income from sales. Application of that approach would defeat the purpose of trying to tax mark-to-market gains of foreign shareholders.”)
540 Section 871(m), is another example where Congress was concerned about foreign taxpayers using different arrangements to avoid dividend withholding tax and so Congress crafted the concept of a “dividend-equivalent amount” to ensure that dividend withholding tax could not be avoided through sales and other types of transactions that were economically equivalent to a dividend.
541 See Article 13 of the United States Model which provides a specific carve-out in paragraphs 1 and 2(c) for companies that are or were U.S. real property holding companies. Paragraph 6, however, relinquishes all other taxing rights to the state of residence.
542 P.L. 96-499, section 1122(a).
543 This period was extended by 2 years for treaties that were negotiated but not ratified by 1985.
544 A few years after FIRPTA, Congress was confronted with a somewhat similar problem when it enacted the branch profits tax in section 884 in 1986. Congress provided that the tax would not be applied if imposition of the tax violated an existing treaty (i.e., the non-discrimination clauses of the treaty). Had that been all, then there would not have been a treaty override problem. The treaty override problem was presented by the fact that the U.S. sought to unilaterally impose a “limitations on benefits” provision into the treaties such that a taxpayer could not apply the treaty unless the taxpayer satisfied the U.S.-imposed treaty-shopping rules which appeared nowhere in the treaty. See generally, Richard L. Doernberg, Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority, 42 Tax Lawyer 173 (1989).
provision that did not appear in the treaty. One of the reasons Congress presumably believes it can override treaties without significant blow-back is because it is very difficult for the aggrieved party to successfully pursue remedies.545

A similar approach could work here. In fact, it was almost attempted. As fate would have it, with the FIRPTA and branch profits tax treaty overrides under its belt, Congress seriously considered imposing a tax on the gains generated by non-resident shareholders with respect to shares of a U.S. Company in 1989546 and again in 1990.547 The 1990 bill was referred to as the Foreign Tax Equity Bill of 1990. Importantly, this tax was not “in lieu of” a U.S. corporate tax and so, not surprisingly, both bills faced significant opposition from foreign investors and governments.548

Both bills would have created a new section 899 of the Code that would impose substantive U.S. tax liability on gains generated by non-resident persons who owned 10 percent or more of U.S. companies. Section 899(a) of the Foreign Equity Tax Bill would have deemed any gain by a non-resident 10 percent shareholder of a U.S. company to have effectively connected income from U.S. sources. To prevent avoidance, the bill would have treated options and convertible debt as stock.549 It would also have used attribution rules to determine if the 10 percent ownership level was met.550

The bill did not deem the shareholder to have a permanent establishment, however. Thus, it was unclear whether the provision could have applied without overriding a treaty where the applicable treaty only allowed source based taxation for gains from property used in a U.S. permanent establishment. To address treaty override concerns, the bill followed the path Congress used in connection with the branch profits tax (i.e., it subordinated the law to the treaties, but imposed a new qualified residency requirement that did not appear in the treaty).551

The grace period approach used with FIRPTA would likely prove the better path, however. A grace period is likely to lead to less opposition because taxpayers are free to rearrange their affairs, and it also provides time for U.S. treaty partners to negotiate in good faith rather than simply have their treaties overridden.

545 See generally, Richard L. Doernberg, Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority, 42 Tax Lawyer 173 (1989) (noting the pushback received in response to unilaterally engrafting new provisions on existing treaties, but noting how various remedies such as competent authority, international court of justice proceedings, interstate arbitration, unilateral remedies, suing in courts of the resident state, and suing in a U.S. court, would not likely be successful).

546 H.R. 3299.


548 See e.g., John Turro, British Ambassador Issues Warning Over Proposed 'Tax Equity' Act, 90 TNI 26-3. Interestingly, one of the more compelling arguments against imposing tax on stock gains is that foreign governments would be inclined to retaliate and the U.S. would wind up losing tax revenue given its status as a capital exporting nation. See Testimony of Leonard S. Schneiderman before the House Ways and Means Committee on Jan. 25, 1990, 90 TNT 40-28. It is unlikely countries would feel the need to retaliate when the shareholder level tax is the only tax imposed. Moreover, even if they did retaliate, the retaliation would only impose a “cost” on the U.S. if it retained a foreign tax credit regime and shareholders had sufficient foreign source income to claim the credits.

549 Section 899(d).

550 Section 899(b)(3).

551 Section 201(f)(3) of the Foreign Tax Equity Act.
c. Collection

The last problem is collection. Collection will prove a very difficult problem.\(^ {552} \) Even if Congress can impose substantive liability, the Service needs to be able to collect the tax. Right now, outside of the FIRPTA rules for real property holding companies, the Code doesn’t tax foreign shareholders on the sale of stock in domestic companies. It doesn’t even tax less than 5 percent shareholders of U.S. real property holding companies whose stock is regularly traded on an exchange.\(^ {553} \)

The only solution to that problem would be to enact a regime similar to the FIRPTA which requires a buyer (whether U.S. or non-U.S.) of domestic stock to withhold tax from any foreign seller.\(^ {554} \) The regime would have to go further, however, as FIRPTA imposes the withholding tax liability on the buyer of the stock, not the brokers effecting the trade.\(^ {555} \)

The Foreign Equity Tax Bill provides a precedent in what would have been section 1447. Specifically, section 1447(a) would have imposed a 10 percent gross basis withholding tax on the withholding agent for payment for the shares. There was an exception provided for non-publicly traded shares where the seller provided an affidavit that the seller was either not a foreign person, or not a 10 percent shareholder.\(^ {556} \) With respect to regularly traded shares, the withholding agent did not have to withhold if the agent did not know or have reason to know that withholding applied and the transaction involved a disposition of less than one percent of the U.S. company’s stock.\(^ {557} \) If the disposition involved one percent or more of the U.S. company’s stock, then the withholding agent would either be required to withhold or receive an affidavit from the seller that the requirements for withholding were not satisfied.\(^ {558} \) In the event no withholding was made, but tax was in fact due, the seller’s basis would be deemed to be zero for purposes of assessing the seller.\(^ {559} \) Importantly, for our purposes, the act would have defined the withholding agent as the last person to have receipt or custody of the amount realized on the disposition.\(^ {560} \) As commentators noted at the time, a number of different people could become liable for withholding and although this could increase compliance with the regime, the approach could backfire as every individual in the transaction thinks someone else is doing the withholding.\(^ {561} \)

This is further complicated by the fact that shares of a U.S. company may be listed on a foreign exchange. Hence, two foreign brokers with foreign customers may clear a share sale transaction through a foreign

\(^ {552} \) As a workaround, Professor Dodge had suggested requiring corporations to withhold 30% of the mark-to-market gain, which would then be a credit for each shareholder. In that case, foreign shareholders may file a refund, if they are over-withheld. If they don’t, then the U.S. just keeps the money. The difficulty with this approach is that shares are traded daily, and so it would be a difficult matter indeed to allocate the earnings and credit to the appropriate shareholder. This intra-year share transfer problem is the primary administrative hurdle to making a true pass-through integration approach work. Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265, 345 (1995)

\(^ {553} \) Section 897.

\(^ {554} \) See generally, §§897 and 1445.

\(^ {555} \) The FIRPTA rules narrowly construe the universe of persons who could be considered “agents” for the purchaser. See Treas. Reg. §1.1445-4(f). Moreover, the regulations do not impose a withholding duty on the agent. They only impose a duty to notify the purchaser of statements they know to be false. Section 1445(d)(1) and Treas. Reg. §1.1445-4(a).

\(^ {556} \) Section 1447(b)(1).

\(^ {557} \) Section 1447(b)(2)(A) and (B).

\(^ {558} \) Section 1447(b)(2)(B) (flush language).

\(^ {559} \) Section 1447(c) (flush language).

\(^ {560} \) Section 1447(d)(1).

clearinghouse on a non-U.S. exchange. Yet, we would be expecting the buyer to withhold tax on the transaction.

This is, admittedly, a very daunting task. In this regard, it is useful to consider some precedents. Many countries impose a non-resident capital gains tax, but few impose it on shares of publicly traded companies. Three examples of countries that do impose non-resident capital gains tax on public companies include Brazil, China and India.

Brazil imposes its non-resident capital gains tax on sales of public Brazilian companies traded on a Brazilian exchange if they are subject to a low rate of tax 17% in their country of residence and that country is also listed in Normative Ruling No. 1,037/2010 as a "low-tax" jurisdiction. The current rate of tax is 15%.562 Foreign investors are required to appoint a representative who can pay any applicable taxes.563 Moreover, brokers and financial intermediaries have an obligation to withhold the appropriate amount of tax.564 Importantly, if the shares are traded on a non-Brazilian exchange (i.e., they are traded on the NYSE through American Depositary Receipts), then the transfer of those receipts is not treated as the transfer of a Brazilian asset subject to non-resident capital gains.

China also imposes a non-resident capital gains tax on certain foreign sellers of Chinese companies. Specifically, capital gains derived by individuals (including foreign individuals) from transfer of shares issued by listed companies are exempted from tax. Thus, only gains derived by a non-resident enterprise from transfer of shares issued by listed companies is subject to Chinese tax at the rate of 10%.565 China imposes limitations on foreign investors investing in shares traded on China’s domestic exchange markets, however. Typically, foreign investors are only allowed to buy so-called "B shares". The investment in A shares is not allowed, with exceptions for the Qualified Foreign Institutional Investors (the “QFIIs”) , the RMB Qualified Foreign Institutional Investors (the “RQFIIs”) and the Pilot Program of Shanghai-Hong Kong Stock Connect (the “Pilot”). In November 2014, China exempted capital gains derived by a QFII and a RQFII from the sales of shares in a Chinese resident enterprise from income tax. Another exception is for the Pilot, under which capital gains derived by foreign investors from transfer of A shares are exempted from income tax.566 As of yet, China has not issued any specific measures regarding the collection of such tax (except for capital gains derived by QFIIs). Technically, foreign investors who sell shares of a Chinese listed company and who are not exempt from tax should self-assess and file a tax return. There is no withholding regime. Historically, China in practice has not enforced capital gains tax on the sale of stock of companies through the exchange markets (except against the QFIIs prior to 2014).

India also imposes a non-resident capital gains tax of 15% on the transfer of shares of stock of an Indian company listed on an Indian exchange if the gain is short-term.567 If the shares are traded over an Indian exchange, brokers are obligated to withhold payments to foreign direct investors and non-resident Indian investors. There is an exception, however, for transfers of Global Depositary Receipts transferred between one non-resident to another non-resident.568 Thus, if the shares are traded through depositary

562 As per Article 57 and 99 of Normative Ruling No. 1,585/2015. This is the rate that is in force as of October 2015.
563 Article 85, paragraph 2, of Normative Ruling No. 1,585/2015.
564 Article 100, paragraph 3, of Normative Ruling No. 1,585/2015.
565 If the income is effectively connected with an establishment in China, the applicable tax rate is 25%.
566 The exemption applies to transactions on or after 17 November 2014 and is subject to the condition that the income is not effectively connected with an establishment in China. See generally, Baker & McKenzie LLP Client Alert dated November 2014 entitled Breaking News: China Confirms Capital Gains Tax Exemptions for QFIIs, RQFIIs and the Shanghai-Hong Kong Stock Connect Scheme available at www.bakermckenzie.com.
receipts on a non-Indian exchange between non-Indian shareholders, there is no tax. Although this appears to be a major exception, it is only relatively recently that Indian companies have been allowed (as a regulatory matter) to list on a non-U.S. exchange without being first listed on an Indian exchange.

These precedents suggest it will be very difficult to capture the tax on trades effected over a non-U.S. exchange. Nevertheless, that is a hurdle that needs to be overcome. Failure to tax sales of domestic corporation stock (or depositary receipts evidencing that stock) simply because it occurs on another exchange will create an entirely new distortionary impulse to trade shares of domestic companies on foreign exchanges.

Yet, despite these difficulties, Congress has effectively already forced the Service to solve for this collection issue. Specifically, section 1473(1)(ii) of the FATCA regime imposes a withholding obligation (if adequate documentation is not provided) on "gross proceeds" from sales of stock of U.S. publicly traded companies. Although the effective date has been repeatedly delayed due to the complexity of actually enforcing such a system, this burden will have to be overcome if this provision is going to ever come into force.

An analogous problem is presented by Section 871(m) where Congress has directed Treasury to collect the appropriate amount of withholding on dividend-equivalent payments between two possibly foreign persons subject to withholding tax. Not surprisingly, Treasury determined that the only way it was going to collect the tax was to deviate from the FIRPTA model and impose a withholding tax obligation on the financial intermediaries (including the clearinghouse used to clear transactions over the exchange) who facilitate these transactions. A similar approach would have to be taken here. A withholding obligation would have to be imposed on brokers and financial intermediaries who facilitate transfers of domestic stock, even if the trade is effected over a non-U.S. exchange.

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570 The regulations impose an obligation on the broker (if there is only one involved) or the short party’s broker (if two broker’s are involved) or the short-party (if no broker is involved) to ascertain whether they are participating in a section 871(m) transaction Treas. Reg. §1.871-15(o).

571 See Treas. Reg. §1.871-15(p) and Treas. Reg. §1.1441-7(a)(3) Example 7 (addressing an option traded over an exchange that is also a dividend equivalent transaction and noting that the exchange itself may have a withholding obligation).
B. Market Reaction If U.S. and Foreign Shareholders Tax Differently

It is always difficult to anticipate how the market will react to new tax rules. Nevertheless, one could expect that tax planners will seek to exploit any difference between the way U.S. and non-U.S. Shareholders are taxed. The Code already taxes U.S. and foreign investors in domestic corporations differently. The MTM approach would exacerbate that difference. As noted above, it does not appear to be possible to tax foreign shareholders on a MTM basis. Thus, absent a counterbalance, there would be a significant incentive for U.S. individuals to invest in U.S. publicly traded corporations through foreign investment vehicles. The most likely counterbalance would be double-taxation and the inability to tax-effect losses against MTM gains. Specifically, U.S. individual investors that own foreign corporations (even more than 50 percent of a foreign corporation) that invest in U.S. publicly traded companies and incur U.S. dividend withholding tax or non-resident capital gains tax (on a deferred, not MTM basis) would not receive any "credit" for the U.S. taxes already paid. Moreover, any loss on the shares of the foreign company could not be used to offset MTM gains with respect to domestic shares.

2. Dividends Paid Deduction Model

In this model, tax is imposed at the entity level. Tax is also imposed at the shareholder level. However, if as and when the corporation chooses to distribute a dividend, the corporation claims a deduction for dividends paid. This model may or may not involve the corporation withholding tax on dividends which the shareholder then claims as a credit or uses to pursue a tax refund. Some have suggested that this approach will run into the same political opposition that plagued the split-rate system in place during 1936-1938. Yet, one would hope that since the deduction would be based on dividends voluntarily paid, there would be a greater willingness to see this as Congress’s attempt to better align the treatment of debt and equity. An illustration is below.

**EXAMPLE 2:**

<table>
<thead>
<tr>
<th>Retained Profit</th>
<th>Distributed Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Economic Income (Before Considering Foreign or U.S. Taxes)</td>
<td>50</td>
</tr>
<tr>
<td>2. Deductible Preference</td>
<td>(10)</td>
</tr>
<tr>
<td>3. Taxable Income Before Considering Dividends Paid Deduction</td>
<td>40</td>
</tr>
<tr>
<td>4. Dividends Paid Deduction</td>
<td>(40)</td>
</tr>
<tr>
<td>5. Tentative Corporate Tax</td>
<td>14</td>
</tr>
<tr>
<td>6. R&amp;D Credit</td>
<td>(4)</td>
</tr>
<tr>
<td>7. Foreign Tax Credit</td>
<td>(5)</td>
</tr>
<tr>
<td>8. Corporate Tax Payable</td>
<td>5</td>
</tr>
<tr>
<td>9. Available Cash to Distribute (100 - 10 Foreign Tax - 10 US Tax)</td>
<td>85</td>
</tr>
<tr>
<td>10. Distribution</td>
<td>40</td>
</tr>
</tbody>
</table>

At first blush, it would seem that, apart from simply exempting dividends, the dividends paid deduction model is the most straightforward of the integration approaches. That is deceptive, however, as illustrated by Example 2. The issue of “stacking” discussed above in the context of corporate preferences and shareholder imputation applies here as well. After all 20 of USCO’s economic income has not been subjected to tax, and will not be subjected to tax. USCO should not receive a deduction for distributions of economic profit that have not been subject to tax. So, should the first 40 distributed be deductible from corporate profits and included in shareholder income? In other words, should the preference income be...

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“stacked” last? Example 2 assumes a pro ration approach where one-half of the preference income is associated with the distribution. This need not be the case, however.

The other question is what happens to the R&D credit and foreign tax credit associated with the distributed earnings. Should USCO be able to claim the credits associated with its distributed earnings such that, on a net basis, USCO is entitled to a corporate tax refund of 4? Or should the R&D credit and foreign tax credit be associated with the dividend and claimed (or not claimed) by the shareholder? Or, alternatively, should they be translated into deductible preference income and treated in the same way as other deductible preference income?

How should foreign tax credits be treated? There is at least a mechanic for permitting Shareholders of USCO an indirect foreign tax credit. The simpler, and perhaps better, approach would be to simply retain all of the foreign tax credits at the USCO level. To reflect the reality that the foreign income which generated the foreign tax credit was not fully taxed in the U.S., the dividends paid deduction could be “apportioned” to foreign sources just like interest expense is currently. Thus, USCO retains the entire credit, but its foreign tax credit limitation is substantially reduced and may (if large enough) prevent USCO from actually using the credit within the carryover period.

a. Advantages

The DPD more closely aligns (but does not completely align) the tax treatment of debt and equity. It is also unlikely that any special rules would be needed to deal with tax audits under this model. There is no shareholder liquidity issue and the model can easily accommodate complex capital structures.

b. Disadvantages

The model presents a number of challenges as well, however. The first difficulty is that the approach retains a corporate level tax and the corresponding incentive for corporate managers to reduce the effective tax on undistributed profits. This incentive is certainly reduced given that managers have the power to distribute dividends to reduce or eliminate their tax liability. Thus, this approach better aligns government priorities with shareholder and management incentives, but the alignment is not complete.

Moreover, FDR's experience in 1936 suggests that corporate managers are unlikely to immediately start paying out dividends simply because the corporation can claim a deduction.

The second difficulty is that the DPD would either require an override of existing treaties, or Congress would have to accept the temporary revenue loss from low dividend withholding tax rates. Eventually treaties could be renegotiated to reflect provisions like those that Mauritius managed to get in its treaties

573 The U.S. currently grants an indirect foreign tax credit to domestic corporations that own 10 percent or more of the foreign corporation to avoid double-taxation. In theory this could be “pushed out” to the shareholders of the domestic corporation. This would require keeping treating a U.S. company like we currently treat foreign companies under sections 902 and 960. USCO would have to maintain a pools of U.S. source earnings, foreign source general basket earnings, and foreign source passive basket earnings, and other baskets as required. See e.g., the foreign oil related income (“FORT”) and foreign oil and gas extraction income (“FOGET”) rules. USCO would have to specify the pool of earnings out of which the dividend was distributed and relay to the shareholder the amount of foreign source income and taxes in each foreign tax credit basket that is associated with the dividend. The shareholder would either have sufficient limitation or not, and would either be able to claim a credit or not. A decision would also have to be made about ownership limitations. Under current law, an indirect foreign tax credit is only permitted to corporate shareholders who own 10 percent or more of the voting stock of a foreign corporation. If a decision were made to push the credit out to the shareholder, a corollary decision would have to be made whether any ownership threshold would be retained.

574 Treas. Reg. §1.861-9T.

575 This is, of course, only the case so long as the percentage of earnings paid out each year is not so large that shareholders are constantly being forced to amend their returns.
to preserve source based taxation on dividends.\textsuperscript{576} In the case of cooperatives, RICs and REITs, Congress appears to have chosen the latter direction. The cost here would likely be much larger. Some estimate of this potential revenue loss can be made from information published by the Service’s Statistics of Income Division.\textsuperscript{577} As an illustration, over $135 billion of “dividends” were paid in 2012 alone. Of that figure, $12.7 billion was paid to corporations resident in the UK and over $6 billion was paid to corporations resident in each of Canada and Japan. All three of these countries are countries to which the U.S. has already ceded significant source based taxation rights under applicable treaties.

It is possible that structures could be devised to circumvent the problem whereby, for example, the corporation was not permitted to claim a deduction for dividends to foreign shareholders. Alternatively, the foreign shareholders could be given the option of receiving dividends without withholding tax (in which case the corporation does not receive a deduction) or subject to withholding tax (in which case the corporation does receive a deduction). These approaches suffer from a couple of defects. First, the non-discrimination provisions of the U.S. model convention\textsuperscript{578} and most U.S. treaties explicitly provide that disbursements made by a resident of one contracting state (i.e., a U.S. corporation) to a resident of another contracting state (i.e., an individual resident in the UK) must be deductible under the same conditions as if they had been paid to a resident of the first mentioned state (i.e., the U.S.). Second, these approaches create a new economic distortion. Specifically, U.S. shareholders, as a general rule, will likely favor investments in corporations that do not have a large foreign shareholder base.\textsuperscript{579}

Alternatively, the U.S. could simply argue that the withholding is a new type of withholding not covered by our treaties, like the U.S. did with Chapter 4 of the Code implementing FATCA. There is already precedent for this type of spin in the post-BEPS world, as the UK has taken the position that its diverted profits tax is a “new” kind of tax that is not subject to existing treaty provisions.\textsuperscript{580}

The third difficulty is that the approach does not achieve common timing. The shareholder is not taxed when the income is earned. Thus, like the imputation model, the approach is subject to Domestic Deferral concerns whenever shareholder rates exceed corporate rates. The fourth difficulty is that the approach is unlikely to achieve a common tax base for the reasons stated.

\textsuperscript{576} An analogy here could be drawn to the section 884 branch profits tax regulations where the U.S. imposed the tax, but grandfathered pre-existing treaties that did not allow for the imposition of the tax. Over time, as treaties were renegotiated, the ability to impose the branch profits tax was explicitly inserted into the treaty.


\textsuperscript{578} See Article 24(4) of the U.S. Model Income Tax Convention (2006).

\textsuperscript{579} Assume a single U.S. corporation (USCO 1) that has two shareholders, John and Peter, who each own 50 percent of USCO 1’s stock. John is a U.S. citizen, and Peter is a non-resident alien who chooses to receive his dividend on a gross basis without withholding. USCO 1 generates 100 of pre-tax profit and, in this example, profit equals cash. Stated differently, USCO 1 does not claim any non-cash deductions. Absent any dividends, USCO 1 would be subject to 40 of tax (federal and state). Under U.S. corporate law, USCO 1 has to pay dividends equally to John and Peter. If USCO 1 wants to maximize its dividend payout, it has two separate equations and two unknowns to solve for. Specifically, we know USCO 1’s tax liability (T) equals profit minus one-half of the dividend distributed (D), or T = (100 - .5 D) \times .40. We also know that the profits minus the dividend paid minus the tax has to be greater than or equal to zero, or 100 - D - T \geq 0. Thus, 100 - D - (100 - .5 D) \times .40 and so D has to be less than or equal to 75. So, USCO 1 distributes 75 of dividends. USCO 1 can only deduct one-half of that dividend, so pays 25 of tax, leaving it with no cash. That would be fine, except that USCO 2 is a separate U.S. corporation that also generated 100 of taxable profit all of which was cash. USCO 2 is owned equally by John and Pat, and Pat is a U.S. citizen. USCO 2 could pay out 100 of dividends, and incur no corporate level tax. In the latter case, John gets more dividends from USCO 2 than he gets from USCO 1, and would be inclined, all other things being equal, to divest his USCO 1 shares and invest in USCO 2 shares.

3. **Summary Table**

Given the number of criteria and the fact that each integration approach has pros and cons, it is easy to get lost in the weeds. The purpose of the table below is to rank the criteria and then compare three (3) integration approaches: (i) imputation; (ii) DPD and (iii) MTM. As the table below illustrates, all three models have significant advantages and disadvantages. Thus, the only way to make a decision amongst the approaches is to rank the criteria.

The thesis of this paper is that, in the current environment, the taxpayer identity and Foreign Deferral criteria are the most important. The other criteria are ranked accordingly. If the reader agrees with the ranking, then the MTM approach is clearly superior. If the reader disagrees with the ranking and, for example, views shareholder liquidity as more important, then MTM looks far less promising.
<table>
<thead>
<tr>
<th>No.</th>
<th>Common Criteria</th>
<th>Imputation System</th>
<th>Dividends Paid Deduction</th>
<th>Mark-to-Market at Shareholder Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Taxpayer Identity: Does the shareholder bear the tax?</td>
<td>No, the shareholder does not bear any tax when corporate rates equal or exceed individual rates.</td>
<td>Eventually, yes, but corporate managers are still incentivized to reduce corporate tax on earnings before they are distributed.</td>
<td>Yes</td>
</tr>
<tr>
<td>2.</td>
<td>Foreign Deferral: Does the approach create greater flexibility in dealing with lockout and foreign deferral?</td>
<td>No. Corporate managers will still have a significant incentive to defer profits or advocate for a territorial system.</td>
<td>May reduce the lockout effect in that corporate managers can selectively bring back earnings when needed to pay dividends to shareholders without fear of increased corporate taxation. The model does not reduce the incentive to defer profits offshore or advocate for territorial system, however.</td>
<td>Should eliminate both the lockout effect and incentive to defer profits or advocate for a territorial system. Corporate managers will presumably be compensated on a pre-tax basis.</td>
</tr>
<tr>
<td>4.</td>
<td>Complex Capital Structures: Can the approach accommodate complex capital structures?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>5.</td>
<td>Are foreign shareholders taxed as they are now?</td>
<td>They can be.</td>
<td>Foreign shareholders in non-treaty countries could continue to be taxed as they are now. Foreign shareholders in treaty countries, however, would escape most or potentially all U.S. tax on corporate earnings absent renegotiation of dividend withholding tax provisions of U.S. treaties.</td>
<td>Not unless Congress is willing to allow earnings attributable to foreign investors to escape taxation. Even if Congress were to impose a tax liability on foreign shareholders of U.S. companies together with a withholding tax regime, it is unlikely the U.S. will collect that tax on a mark-to-market basis.</td>
</tr>
<tr>
<td>6.</td>
<td>Subsequent Audit Adjustments:</td>
<td>Prospective adjustments can be made in a manner akin to the electing large partnership regime.</td>
<td>Prospective adjustments can be made in a manner akin to the electing large partnership regime.</td>
<td>Should not be an issue, given than there is no corporate level tax.</td>
</tr>
<tr>
<td>7.</td>
<td>Common Rate: Is the income ultimately subject to individual rates such that wealthier persons pay more tax?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>8.</td>
<td>Domestic Deferral: Is there an incentive to defer dividends when shareholder rates exceed corporate rates?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>9.</td>
<td>Common Timing: Is the income subject to tax at the shareholder level when earned?</td>
<td>No</td>
<td>No</td>
<td>Yes in the sense the sense that corporate earnings are presumably influencing the price of the stock.</td>
</tr>
<tr>
<td>10.</td>
<td>Common Base: Is there a single tax “base” of business income that is subject to tax?</td>
<td>Potentially, but unlikely given the difficulty of passing through preferences.</td>
<td>Potentially, but unlikely given the difficulty of passing through preferences.</td>
<td>Yes. There is only one “base” and it is the base applied at the shareholder level.</td>
</tr>
<tr>
<td>11.</td>
<td>Shareholder Liquidity:</td>
<td>Not an issue.</td>
<td>Not an issue.</td>
<td>Shareholder liquidity is a concern and one the primary difficulties with adopting a shareholder mark-to-market approach.</td>
</tr>
<tr>
<td>12.</td>
<td>Foreign Tax Credit: If credit retained, how would policy issues be addressed?</td>
<td>Policy decisions would have to be made regarding whether foreign income taxes should be treated like U.S. corporate income taxes vis-à-vis the imputation credit.</td>
<td>Policy decisions would have to be made both at the corporate level and the shareholder level. At the corporate level, decisions would have to be made about whether dividends paid deduction should be apportioned like interest expense and reduce the corporate foreign tax credit limitation. A further decision would need to be made as to whether the corporation’s foreign taxes passed through to shareholders.</td>
<td>Foreign tax credits no relevant in this structure as corporation does not pay tax, and shareholder’s gain or loss is measured solely by reference to mark-to-market regime.</td>
</tr>
<tr>
<td>13.</td>
<td>U.S. Corporate Shareholders: How does the approach accommodate domestic corporate shareholders?</td>
<td>A policy decision would have to be made as to whether the benefits of integration would be limited to significant corporate shareholders, or</td>
<td>There should not be any significant policy issue, because the distributing corporation would deduct dividends, and the recipient corporate shareholder</td>
<td>Not an issue.</td>
</tr>
</tbody>
</table>

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|   | whether it would be extended to all shareholders.  
|   | would include dividends in its base. If the recipient 
|   | fails to further distribute dividends, it would bear tax 
|   | until such time as it chooses to distribute the amount 
|   | to its shareholder.  
| 15. | **Are domestic tax-exempt shareholders taxed as they are now?** | No, UBIT rules would have to change to ensure at least one level of tax is imposed.  
|   | No, UBIT rules would have to change to ensure at least one level of tax is imposed.  
|   | No, UBIT rules would have to change to ensure at least one level of tax is imposed.  
| 16. | **Windfall Issues** | If there were a desire to prevent any windfall, a mechanism would likely have to be considered that would retain historic earnings and provide that they could not be paid out without a second layer of tax. The question would be whether those earnings are stacked first, stacked last, or required to be paid out on a pro rata basis.  
|   | If there were a desire to prevent any windfall, a mechanism would likely have to be considered that would provide that no deductions for dividends could be claimed up to the amount of those earnings. Only dividends in excess of those earnings could be deducted.  
|   | Unlikely any mechanism would be required because any increased value associated with the company would be reflected in the stock price and taxed.  
|   |   |   |
CONCLUSIONS, RECOMMENDATIONS AND THE END OF OUR TAXING HISTORY

It is easy to be cynical about the system but cynicism hits marginal returns fairly early in the game.

- Harley H. Hinrichs 581

In 1992, Francis Fukuyama published *The End of History and the Last Man* in which he posited that the fall of the Soviet Union and the corresponding collapse of other totalitarian regimes around the world may not simply be a passage of history, but may portend the end of historical development of modes of government. Stated differently, mankind had “arrived” and, but for some outliers who would eventually fall into line, Western principles of liberal democracy represented “the” way that mankind would choose to govern itself going forward. This was an easier position to defend in 1992, shortly after the fall of the Berlin wall and the emergence of the U.S. as the sole superpower. Events since then have either disproven Fukayama’s theory or they simply illustrate one of those temporary setbacks that Fukayama suggested may occur on the road to universal acceptance of liberal democracy.

It is always a dicey business to predict the future. Yet, doing nothing, or simply retaining the current classical tax system with some form of territorial system is unlikely to prevent the next wave of inversions or incentivize corporate managers to arrange business structures on a pre-tax basis. Tax competition will continue. There will always be a country that offers a better tax regime and, in this multilateral world, that country will likely offer other compelling non-tax benefits as well. On the other hand, shifting the burden of the corporate tax to the Shareholder may allow the U.S. to extract itself from the tax competition game altogether.

Integrating corporate and shareholder taxation of corporate profits is admittedly a very difficult task, no matter what method is chosen. Nevertheless, an integration approach that shifts the tax burden away from the corporation and onto the Shareholder and reduces the extent to which corporate managers are compensated on after-tax returns is worth the effort. If achieved, the U.S. corporate tax regime would be coming full circle. It would be ending where it began, back in 1864, by recognizing the individual as taxpayer. Perhaps then, the U.S. would reach the end of its taxing history.
Appendix I

As we noted in the text, the tax competition models assume that there are $N$ regions, $n_1, n_2, \ldots, n_N$. Within each region there is a firm and these firms compete to produce a single output, which has only two factors of production: capital, $k$, and labor, $l$. 582 There are two assumptions of these models that are important to our discussion of international taxation. First, capital is perfectly mobile across regions and labor is not. In other words, capital from region 1 may be invested in region 2, but labor from region 1 may not be employed in region 2. Capital is only taxed in the region in which it is employed on a source basis. In other words, if capital from region 1 is invested in region 2, the capital is only taxed in region 2.

The economic literature often refers to types of function without specifying the exact functional form, making it difficult for the layman to wade through it. In an effort to demystify these models, we express the explicit functional form of these functions algebraically solely for illustrative purposes. They are meant to illustrate how the models work and easy-to-interpret graphs. Nothing more.

We begin our discussion of the ZMW model by introducing the government of country $i$, which only provides public good $g_i$ valued as the product of the taxed amount of the capital employed in their country. Algebraically, this is expressed as:

$$g_i = \tau_i \cdot k_i$$

Next we consider what every firm within country $i$ does. The models assume that firms seek to maximize profit subject to a budget constraint. A firm’s profit is the revenue in excess of its costs. The firm is assumed to operate in a perfectly competitive market, which means that it earns $p$ per unit of product it sells and that it cannot engage in any transaction sufficiently large to change this price. 583 The number of units it has to sell is determined by its production. The firm’s objective is to pick the inputs of capital $k_i$ with marginal cost $r$ and labor $l_i$ with marginal cost $w$ to produce a total of $q$ units, which it will sell at $p$/unit, to maximize its profit. Algebraically, this is expressed as

$$\max_{k_i,l_i} \pi_i = p \cdot q_i - r \cdot k_i - w \cdot l_i$$

The marginal cost of capital, $r$, can be thought of as the rate of return on any financial asset. Readily accessible examples of $r$ are the interest one could earn on a fixed deposit account, the asset being cash, and the return on an investment portfolio, the asset being the stocks in the portfolio. As we mentioned before, the assumption of this model is that capital is perfectly mobile across regions. Finally, it is also assumed that the marginal cost of capital is exogenous to the firm. This means that the firm is a price taker with respect to capital, and that market forces for capital determine the marginal cost of capital. 584

The marginal cost of labor, $w$, is the per unit cost of units of labor. For example, if labor is measured in hours, then $w$ is the hourly wage of labor. Similarly, recall that an assumption of this model is that labor is perfectly immobile across regions. Here too, we assume that the marginal cost of labor is exogenous to the firm.

582 An arbitrary region is typically referred to as region $i$ and the associated inputs to production in that region will be referred to as $k_i$ and $l_i$ respectively.

583 In the literature, such a firm is referred to as a price taker. This is to distinguish such a firm from a monopolist, who is referred to as a price setter.

584 From an economic point of view, this is the opportunity cost of capital. In other words, this is the highest forgone opportunity for the use of this money. This is why we use a company’s weighted average cost of capital is valuing it as an enterprise.
The foregoing provides a computation of profit, but we cannot compute profit without knowing how many products \( (q) \) we will produce. This is where the production function comes in. Conceptually, the production function embodies the technology that the company will use to convert inputs into output. Recall that our firm takes only capital and labor as its inputs and turns these into units, which it then takes to market. A number of different production functions could be used, and often the literature does not specify what production function is being used which, again, makes the literature somewhat difficult for a layman to follow. We will discuss a very common form of the production function because a complete discussion of the universe of production functions is beyond the scope of this paper.

The Cobb-Douglas production function is a commonly used form of a production function in such models, and has the general form:

\[
F(k_i, l_i) = A \cdot k_i^\alpha \cdot l_i^\beta
\]

\( A \), referred to as the total factor multiplier, accounts for the synergies due to combining the inputs in the right way. It could represent know-how or some other form of technology.

\( \alpha \) and \( \beta \) are output elasticities, which measure the percentage change in the output due to a percentage change of the corresponding input. These parameters describe the state of the firm’s technology as far as converting inputs into output. In particular, we consider the following three scenarios:

1. **Increasing Returns to Scale:** \( \alpha + \beta > 1 \)

   The increase in the inputs is accompanied by a greater increase in output. For example, doubling the inputs results in more than doubling the quantity of the product produced.

2. **Constant Returns to Scale:** \( \alpha + \beta = 1 \)

   The increase in the inputs and the increase in the output move in lockstep. For example, doubling the inputs results in doubling quantity of products produced.

3. **Decreasing Returns to Scale:** \( \alpha + \beta < 1 \)

   The increase in the inputs is accompanied by a lesser increase in output. For example, doubling the inputs results in less than double the quantity of products produced.

The third case is often referred to as “diminishing marginal returns.” Most real firms face this constraint. They derive benefits by expanding up to a certain point, but at some point they hit a point where simply pouring more capital into the firm does not increase the output by a corresponding amount. Thus, we will assume decreasing returns to scale in our example. For ease of illustration, going forward, let us assume our firm has the following parameter values: \( A = 1 \), \( \alpha = \frac{1}{2} \) and \( \beta = \frac{1}{8} \). Therefore, our firm’s production function is expressed as:

\[
F(k_i, l_i) = k_i^{\frac{1}{2}} \cdot l_i^{\frac{1}{8}}
\]
As the foregoing graph illustrates, if capital is increased while labor remains constant, the quantity increases as additional capital is employed, but at a decreasing rate.

**Profit Maximization**

Now that we have inserted the production function into the profit function, we can determine what level of output a given firm will pursue to maximize profit. Here, we will employ simple methods in calculus. But before we go down that route, let us develop some intuition for what we will be doing algebraically with calculus. Conceptually, we can think of this problem as akin to walking up a hill and wanting to know when we have reached the top as illustrated in the following graph.

In our firm’s problem, the profit function is the hill and calculus will tell us how to determine where we are on the “hill.” Specifically, the first derivatives tell us the slope of the function at any particular point. If the slope is 0, then function is either at a maximum or a minimum. What distinguishes the maximum
from the minimum is the nature of the determinant of the Hessian Matrix. The Hessian Matrix, or a just Hessian, is a square $n \times n$ matrix of second derivatives. The determinant is an operation in matrix algebra that turns a square matrix into a scalar. The nature of the scalar is the traditional trichotomy in mathematics: (i) $> 0$, (ii) $< 0$, or (iii) $= 0$. Instead of a general discussion of Hessians and determinants, we will focus on our specific bivariate problem, and in particular our specific bivariate convex problem.\textsuperscript{585} The following table summarizes the results:

<table>
<thead>
<tr>
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<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Derivative</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Determinant of Hessian</td>
<td>$&lt;0$</td>
<td>$&gt;0$</td>
</tr>
</tbody>
</table>

We will discuss the determinant of the Hessian in greater detail when we solve the problem explicitly.

**Marginal Products of Capital and Labor**

The economic literature gives special names to the first partial derivatives of the production function with respect to capital and labor. By “partial derivative”, we mean that we take the derivative of the production function with respect to capital, assuming labor remains constant or we take the derivative of the production function assuming capital remains constant. The first derivatives of the production function with respect to capital and labor are called the Marginal Product (“MP”) of Capital and of Labor, respectively.

Recall that our firm’s production function has the form $F(k_i, l_i) = \frac{1}{2} k_i \cdot \frac{1}{8} l_i$. The MP of Capital and of Labor are given as follows:

$$MP_k = \frac{\partial F}{\partial k} = \frac{1}{2} \cdot \frac{1}{8} k_i \cdot \frac{1}{8} l_i$$

$$MP_l = \frac{\partial F}{\partial l} = \frac{1}{8} \cdot \frac{1}{2} k_i \cdot \frac{7}{8} l_i$$

We can use these equations to identify the point where additional capital (or additional labor) begins to produce diminishing marginal quantities of output.\textsuperscript{586}

To determine the point where profit is maximized we refer to our profit function:

$$\max_{k_i, l_i} \pi_i = p \cdot \frac{1}{2} k_i \cdot \frac{1}{8} l_i - r \cdot k_i - w \cdot l_i$$

Our first step then is to take first partial derivatives of the foregoing equation.

$$\frac{\partial \pi_i}{\partial k_i} = \frac{p}{2} \cdot \frac{1}{8} k_i \cdot \frac{7}{8} l_i - r$$

\textsuperscript{585} Functions can be concave or convex. Concavity and convexity, in some sense, describes the curvature of a function relative to its origin. The technical definitions of concavity and convexity are beyond the scope of our discussion here.

\textsuperscript{586} There are a couple of things to note here. First, we treat as constant everything we are not differentiating. For example, when differentiating with respect to k, we treat l as if it were a number like 2 or 5. Second, when differentiating polynomials, we multiply the expression by the exponent and reduce the exponent by 1.
\[ \frac{\partial \pi_i}{\partial k_i} = \frac{1}{8} \cdot p \cdot k_i^{\frac{3}{2}} \cdot l_i^{\frac{7}{8}} - w \]

We may rewrite the first-order conditions as:

\[ \frac{\partial \pi_i}{\partial k_i} = p \cdot MP_k - r \]

\[ \frac{\partial \pi_i}{\partial l_i} = p \cdot MP_l - w \]

A further simplification can be made. If we multiply \( MP_k \) (or \( MP_l \)) by price, we get a term referred to as the “marginal revenue product” with respect to capital \( MRP_k \) or labor \( MRP_l \) - the additional dollars of revenue generated at that given level of capital or labor. Thus, the foregoing equations suggest that profit is maximized with respect to capital when \( MRP_k \) equals \( r \) and profit is maximized with respect to labor when \( MRP_l \) equals \( w \). Stated differently, when an additional unit of capital only generates enough revenue to cover the cost of that additional unit of capital, we know that we have either maximized profit with respect to capital or minimized profit with respect to capital.

To determine whether we are at a maximum or a minimum, we look at the determinant of the Hessian. Let us start with our Hessian. Our Hessian is a (symmetric) square 2 \( \times \) 2 matrix with the following form:

\[ H = \begin{bmatrix} \frac{\partial^2 \pi_i}{\partial k_i^2} & \frac{\partial^2 \pi_i}{\partial k_i \partial l_i} \\ \frac{\partial^2 \pi_i}{\partial k_i \partial l_i} & \frac{\partial^2 \pi_i}{\partial l_i^2} \end{bmatrix} \]

Let us now take these derivatives:

\[ \frac{\partial^2 \pi_i}{\partial k_i^2} = -\frac{p}{4} \cdot k_i^{\frac{3}{2}} \cdot l_i^{\frac{7}{8}} \]

\[ \frac{\partial^2 \pi_i}{\partial l_i^2} = -\frac{7p}{64} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{15}{8}} \]

\[ \frac{\partial^2 \pi_i}{\partial k_i \partial l_i} = \frac{p}{16} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{7}{8}} = \frac{\partial^2 \pi_i}{\partial l_i \partial k_i} \]

The determinant of \( H \) is given by:

\[ |H| = \frac{\partial^2 \pi_i}{\partial k_i^2} \cdot \frac{\partial^2 \pi_i}{\partial l_i^2} - \left( \frac{\partial^2 \pi_i}{\partial k_i \partial l_i} \right)^2 \]

\[ = \left( -\frac{p}{4} \cdot k_i^{\frac{3}{2}} \cdot l_i^{\frac{7}{8}} \right) \left( -\frac{7p}{64} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{15}{8}} \right) - \left( \frac{p}{16} \cdot k_i^{\frac{7}{2}} \cdot l_i^{\frac{7}{8}} \right)^2 \]

\[ = \frac{7p^2}{256} \cdot k_i^{-1} \cdot l_i^{\frac{14}{8}} - \frac{p^2}{256} \cdot k_i^{-1} \cdot l_i^{\frac{14}{8}} \]

\[ = \frac{6p^2}{256} \cdot k_i^{-1} \cdot l_i^{\frac{14}{8}} > 0 \]
Therefore, we have proved that the turning point is a maximum. These specific values of \( k \) and \( l \) which will achieve this maximum are referred to as the demand of capital and of labor, denoted by \( k^* \) and \( l^* \) respectively. Let us solve for these.

Recall that the firm’s objective is to pick the quantum of capital \( k_i \) with marginal cost \( r \) and labor \( l_i \) with marginal cost \( w \) to produce a total of \( q \) units, which it will sell at \( p/\text{unit} \), to maximize its profit. We know that capital and labor are consumed in positive quantities. In other words, it doesn’t make sense for a firm to invest -$5.00 in a project or contract with an employee for negative hours of work. Furthermore, any number raised to an exponent, positive or negative, is still a positive number. Therefore, we see that the second derivatives are negative and so it should be the case that when \( \text{MRP}_k = r \) and \( \text{MRP}_l = w \) we are indeed maximizing profit, not minimizing profit.

Now, we return to the all-important question of what combination of capital and labor maximizes our firm’s profit, i.e. \( k^* \) and \( l^* \). For this, we must solve our first order conditions simultaneously. Let us start with our first-order conditions

\[
\frac{\partial \pi_i}{\partial k_i} = p \cdot MP_k - r = 0
\]
\[
\frac{\partial \pi_i}{\partial l_i} = p \cdot MP_l - w = 0
\]

Therefore, the profit maximizing ratio of capital to labor at any given point can be expressed as:

\[
\frac{p \cdot MP_k}{p \cdot MP_l} = \frac{MP_k}{MP_l} = \frac{r}{w}
\]

This is the first important result. A firm’s profits are maximized when the ratio of the marginal products of the inputs equal the ratio of the marginal costs of their inputs. This outcome is also Pareto optimal. In other words, profit is maximized when the incremental benefit matches the incremental cost exactly.

We return to our first-order conditions again.

\[
\text{MRP}_k = \frac{p}{2} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{1}{8}} = r
\]
\[
\text{MRP}_l = \frac{p}{8} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{7}{8}} = w
\]

We have two equations and two unknowns, so we can use algebra to solve for the demand for capital \( k^* \) or labor \( l^* \) as follows:

\[
\left( \frac{p}{2} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{1}{8}} \right) \left( \frac{p}{8} \cdot k_i^{\frac{1}{2}} \cdot l_i^{\frac{7}{8}} \right) = r \cdot w
\]
\[
\therefore l^* = \left( \frac{p^2}{16rw} \right)^{\frac{4}{3}}
\]
\[
\therefore k^* = \frac{4w}{r} \cdot \left( \frac{p^2}{16rw} \right)^{\frac{4}{3}}
\]
The \( k^* \) and \( l^* \) represent the demand functions of capital and labor, respectively.

The foregoing is all lead up to the punch line. The important point to recognize is that the demand for capital decreases as the cost of capital increases, \( i.e. \) as \( r \) increases \( k^* \) decreases. Moreover, the models assume that the return on capital is constant across jurisdictions and exogenous to the models. Therefore if a jurisdiction imposes taxes on capital then a firm in that jurisdiction no longer demands \( r \), but will instead demand a return on its capital of \( r + x \) where \( x \) is the extra amount of return they require in order to achieve an after-tax return of \( r \). This has the effect of increasing the denominator of demand for capital function, and, hence, \textit{decreasing the demand for capital in that jurisdiction}.\(^{587}\)

One can (and some do) disagree about the assumptions - \( i.e. \), whether capital is truly mobile or whether there are refinements to the model that would decrease the outflow of capital, but the point of the foregoing is just to illustrate how the models reach the conclusions they do and how their assumptions impact those conclusions.

\footnotesize{\textsuperscript{587} In particular, }\( \frac{\partial k^*}{\partial r} = -\frac{3}{2} \left( \frac{p^{8-10}}{1024w} \right)^{\frac{3}{2}} < 0. \)
Appendix II

Below we relay some of the interesting backstories of the individuals who worked on the successive PAS missions for ICA and USAID in Kabul which lead to the enactment of the Afghan income tax law.

Mr. Mangerich’s Backstory

PAS had a contract to provide financial and economic assistance to ICA with the first contract running from 1957 to 1959. The Chief of Party was Donald Nemetz, a World War II veteran, who, after the war, was hired by PAS and worked for them in a number of countries over the years. He arrived in Afghanistan in April 1, 1957.588 One of the advisors working under Mr. Nemetz was a gentleman named Harry L. Mangerich, also a World War II veteran who had worked for the Internal Revenue Service after the war.589 At the time, Afghanistan was struggling to cover its budget deficit and having difficulty in raising revenues from more traditional sources.590 Not surprisingly, then, Mr. Mangerich was tasked with assisting the Afghan government’s Ministry of Finance with drafting an income tax law and updating their existing tax laws.

Harry Leo Mangerich (a.k.a. “HLM” to his kids) was born in Illinois in 1914.591 He graduated from Northwestern with a degree in Commerce in 1941. He served in the Armed services and it is believed he was first posted to Labrador. He got married to Lieutenant Agnes (“Jens”) Jensen in November 1945. Jens also served in the Armed Forces during World War II. One event during Mrs. Mangerich’s service was documented in four (4) separate books.592 Specifically, Mrs. Mangerich was a nurse on a plane with a team of twenty-nine (29) other nurses and personnel which took off from Sicily on November 8, 1943, and was headed for Bari Italy. Her airplane got lost in the fog and crash landed in Nazi-occupied Albania.

589 The other members of the PAS team were Katherine Hudson, administrative secretary; Michael Nightingale, statistics; Charles Winter, accounting; and Ream Lazaro, budget.
590 “An extraordinary increase in the tax levied upon merchants, artisans, and other shopkeepers, has resulted in such widespread and determined opposition among this class of taxpayer that the Afghan Government has been forced to rescind the increase and restore the tax rate to roughly the level it had before the introduction of the increase. While firm conclusions cannot yet be drawn as to the effects of this development, the following tentative judgments seem justified. (1) Financing of the Afghan Five-Year Plan has gotten off to a very bad psychological start, since the sharp increase in the small-businesses tax has created the impression that the Government wishes to finance the plan by draconic levies upon the small entrepreneur, while leaving the Afghan aristocracy and large-landholder class more or less untouched. A preview has been provided of the difficulties which will confront the Government at every turn in its attempt to find domestic resources with which to finance the Five-Year Plan.... According to reports reaching Kabul, the details of which are conflicting and vague, application of the tax at Mazar-e-Sharif resulted in violence. Merchants attempted to march to the Governor’s residence to protest the tax, and were dispersed by police, not without some casualties (some reports speak of two deaths). The Commandant of Security... who, in answer to the merchants’ protests, had threatened to collect the tax, if need be, at bayonet point, is reported to have been mauled during the Mazar disturbances.” Foreign Service Despatch, from Embassy, Kabul to The Department of State, Washington, dated December 31, 1956. Available at the National Archives, College Park, Maryland.
591 The following is derived from phone, e-mail and in-person interviews with Mr. Mangerich’s two children, Jon Mangerich and Karen Mangerich Curtis, and phone and e-mail interviews with Don Nemetz’s son, Brad Nemetz. We also conducted telephone interviews with Harley H. Hinrichs on July 14, 2015, who served as an economic advisor in Afghanistan in the late 1950s and again in the late 1960s. Mr. Hinrich’s wrote an article about tax administration in Afghanistan which is cited in the main body of the article. The second tour in Afghanistan was pursuant to a contract with the Robert R. Nathan & Associates consulting firm for USAID. The text is also based on research of cases to which Mr. Mangerich was a party, information on the USAID Development Exchange Clearinghouse and records available on the Internet.
The group managed to escape with no loss of life, but it required an 800 mile journey around enemy positions and lasted from November 8, 1943 to March 18, 1944.

The Mangerich’s first daughter, Karen, was born on August 1946, at what was then called Mitchell Air Force Base, but is now the location of Hofstra University in Long Island, New York. Harry was subsequently stationed in Japan as part of the occupation forces from 1949-1951.

He joined the Internal Revenue Service after discharge from the Army. HLM and Jens were adventurous people and liked to travel. His children recall that Harry and his wife spent some time at various postings within the United States but then Harry was posted to Taipei from May 1952 to June 1953. There is evidence that Harry worked for the Mutual Security Agency in Taipei during this period. We know that he then served as the Commissioner of Revenue and Taxation for the Government of Guam during the 1950s. His precise tenure is unknown, but is known that the Mangerich’s first son, Jon, was born in Guam on April 4, 1955.

At some point Harry met Don Nemetz, who was then working for PAS and, as noted in the text, served as Chief of Party on the first PAS contract in Afghanistan for the International Cooperation Agency. The Mangerichs moved to Kabul and lived there from 1958-1959. To that end. Mr. Mangerich’s first task when he arrived in 1957 as part of the PAS contract was to develop an income tax system for Afghanistan. We know that Mr. Mangerich left Afghanistan in 1959. We also know that when he departed, “a” tax law had been drafted but not yet been enacted. Mr. Mangerich’s subsequent work does not provide any clues as to whether he advocated or did not advocate a dividends paid deduction regime.

593 Interviews with Karen and Jon Mangerich. Portions of the timeline provided by Karen Mangerich.
594 Harry and Jens’s children recall a posting to Taipei from 1952-1953, a time in Portland, OR (1953-54) and a time as Commissioner of Revenue and Taxation for the Government of Guam (July 1954 – Aug. 1956), where their son, Jon was born in 1955. Also, they recall a year spent in Sacramento CA prior to his posting to Kabul.
595 Guam is a U.S. Territory which was acquired from Spain pursuant to the Treaty of Paris after the Spanish-American War in 1898. President McKinley granted the U.S. Navy the authority to administer the island. After World War II, President Truman transferred oversight responsibility from the U.S. Navy to the U.S. Department of the Interior. The Organic Act of 1950 imposed U.S. income taxing jurisdiction over Guam, but directed that the revenues would be delivered to Guam. See generally, Bruce Liserowitz, Coordination of Taxation Between the United States and Guam, 1 Berkeley J. of Int. L. 218 (1983). A number of lawsuits were raised challenging the imposition of the tax and Harry Mangerich was noted as the defendant in some of the cases as the Commissioner of Revenue. See Pacific Wholesalers v. Mangerich, 147 F. Supp. 867 (1957) (refusing to allow a loss carryforward from 1950 when the income tax law did not tax effect until 1951); and Phelan v. Taitano, 233 F.2d 117 (9th Cir. 1956); Holbrook v. Taitano, 125 F. Supp. 14 (1954). In 1958, Congress enacted a mirror system for Guam much like it had for other U.S. territories. Liserowitz, Coordination, at 220.
596 Pacific Wholesalers v. Mangerich, 147 F. Supp. 867 (D. Guam 1957) (noting that Harry Leo Mangerich was the Commissioner during the year at issue - 1950).
597 It is unclear exactly how Harry Mangerich found out about PAS, but it is possible he managed to find out about the opportunity by linking up with other World War II veterans who had joined PAS.
598 Final PAS Report p. 7.
599 We believe that from 1957 to 1959, the original draft of what ultimately was enacted as the income tax law in 1965 was created. See Memorandum from Mr. Wade Jones to Public Administration Service entitled “Resume of PAS Activities by Year - 1957-1961” and dated October 10, 1961 (“REVENUE. All principal laws translated and report codifying present revenue laws presented together with plan of reorganization for Revenue Department. Recommendation for creation of Tax Advisory Committee approved and first draft of Codified Income Tax Law completed. Special report submitted on adverse revenue effects resulting from freeze on postage stamp sales.”)
600 After Kabul, the family moved to Arlington, VA where Mr. Mangerich worked at the Treasury Department. The family moved to Managua, Nicaragua during the mid-1960s where Mr. Mangerich again worked in the tax office there trying to update and codify their taxation system. We have thus far been unable to identify any precise linkage between Mr. Mangerich and the
Ben Eaton and Alden Slattengren

Mr. Ben Eaton was an economist who joined the PAS team in Kabul beginning in September 1959. We know that two revised drafts of the income tax law were prepared in 1959. We know that another three drafts were prepared in 1960 and that ultimately the sixth draft was submitted to the Cabinet of Ministers for review in that year. The Minister of Finance at the time was His Excellency Abdullah Malikyar. Mr. Eaton anticipated that the income tax law would be enacted by 1 Hamal, 1340 (March 21, 1961). We know that the Prime Minister had established a “Revenue Advisory Committee” that had largely been, “lifted from the Internal Revenue Code”, which presumably referenced the establishment of the Joint Committee on Taxation established in Subtitle G of the Internal Revenue Code of 1954.

Had the law been enacted on schedule, the plan was to roll out an implementation plan including training, preparation of income tax returns, etc. during 1961. It was not enacted, however. It appears that another economist named Alden Slattengren arrived in Kabul in July 1961. The Minister of Finance, Ben Eaton and Alden Slattengren met with an economist advisor named Dr. Peacock in February 1962 to discuss Afghanistan’s precarious budget situation given the absence of income tax revenues and increasing expenditures.

In February 1962, Ben Eaton’s contract ended, and he left the country. In the same month, Alden Slattengren suffered a heart issue and was evacuated from Kabul in March 1962. Given the failure to

reforms enacted in Nicaragua. We have not discovered any provision similar to the deductible dividends provisions in Afghanistan or Mauritius. However, it is relevant to point out that an amendment was made to the income tax law in November 5, 1974, which was published in La Gaceta, official journal number 270 of November 26, 1974, which allowed for the possibility to deduct re-investments of profits generated by the company. We have not found evidence that this provision originated with Mr. Mangerich, however. Specifically, Article 16(a) of permitted a deduction of, “Up to 50% of taxable profits, that any tax payer invests in any year in real estate property, in the clearing or grubbing of new land for crops or pasture, soil conservation, irrigation works or other new fixed investments aimed exclusively to increase agricultural production. It is also allowed the reinvestment of profits to make the factory to grow, which shall be properly planned and approved, to increase the production of the goods that are manufactured and originated in the factory. Provided that the previous re-investments mentioned, there are no depreciation quotes authorized or expenses accepted to replace them, up to the total amount for reparations be accepted. Also it is considered as reinvestment of profits, investments in buildings made by the taxpayer to provide housing and services to their employees at no cost.”

601 We believe that he is the “second revenue advisor” referred to in the 1959 section in Memorandum from Mr. Wade Jones to Public Administration Service entitled “Resume of PAS Activities by Year - 1957-1961” and dated October 10, 1961.

602 Id. (“Three income tax drafts considered, hearings on tax completed, and act (including Income Tax, License and Gross Receipts Tax, and Procedure and Administration) submitted to Cabinet.”).

603 Memorandum from R.D. Stover to H.E. Abdullah Malikyar, Minister of Finance dated June 27, 1960.

604 Memorandum from Ben Eaton to Mr. R.D. Stover, Chief of Party, entitled “Tax Program for Five Year Plan, 1340-1344 Inclusive” dated June 27, 1960. See also, Memorandum from R.D. Stover to H.E. Abdullah Malikyar, Minister of Finance dated June 27, 1960 at p. 6; and Memorandum from Ben Eaton to R.D. Stover, entitled “Quarterly Report - April 1, 1960 to June 30 1960 Inclusive” and dated July 9, 1960 (noting the expectation that a graduated rate schedule had been agreed to in lieu of a normal tax and surtax for individuals and a single rate had been agreed for corporations).

605 Memorandum from Ben Eaton to R.D. Stover, entitled “Quarterly Report - April 1, 1960 to June 30 1960 Inclusive” and dated July 9, 1960 at p.2.

606 Memorandum from Mr. Wade Jones to Public Administration Service entitled “Resume of PAS Activities by Year - 1957-1961” and dated October 10, 1961.


608 Id. at 4. It was unclear what the nature of the issue was. One document referred to it as a heart attack, but a later letter from MacDonald Salter to Fred Crawford dated April 27, 1962 referred to the medical condition as a “heart issue” and noted that Mr. Slattengren had been cleared for future work after his return to the United States. A telephone interview with his son, Judge Linn
enact the income tax law, the PAS position was that the Royal Government of Afghanistan had received the work product that PAS had contracted for, there would be no additional revenue advisors and, to the extent it was needed, other PAS personnel would fill in to advise on income tax matters as and when the government decided to move forward to enact the law.\footnote{Memorandum from Fred Crawford entitled “Technical Service Report Public Administration Reports Control No. U-239” and dated April 30, 1962 at pp. 3-4.} We know that the new PAS Chief of Party in Kabul, Julian Orr, in 1963, requested copies of the income tax laws from Pakistan, Iran, India and Turkey from the PAS main office and continued liaising with the Ministry of Finance in his capacity as Chief of Party.\footnote{Memorandum from Julian Orr to Mr. Fred Crawford entitled “Requests for Publications and Information Pertaining to Revenue” dated May 6, 1963.} 609 610

Irving Olson

As noted above, the income tax law underwent six successive drafts between 1957 and 1960.\footnote{Final PAS Report p. 7. \textit{See also}, Kabul Times, p. 4 (May 13, 1965) (“At a meeting of the Council of Ministers held under the chairmanship of Prime Minister Dr. Mohammed Yousuf yesterday morning the draft of Income Tax Law was studied and finalized. The draft had already been discussed at the previous meetings of the Council. A Ministry of Finance source said that the draft law provides greater facilities for taxpayers. The collection of income tax will regulated on the basis of social justice. The draft which contains 12 chapters will be put into effect under a royal decree after it has been approved by His Majesty the King.”)} After Alden Slattengren left in March 1962, PAS had no dedicated revenue advisor in Kabul. Alden had grown up in Taylors Falls, Minnesota, however. As fate would have it, one of Alden’s schoolmates from Taylors Falls was Irving Olson.

Irving Olson was born in 1915 in Minnesota.\footnote{The information for Mr. Olson’s backstory is taken from http://www.taylorsfallsschoolfoundation.org/2013AlumniAwards and interviews with Rod Olson on July 24, 2015.} He attended the University of Minnesota in the Fall of 1932 and had wanted to study journalism, but had to drop out due to the death of his father when he was required to take over the family farm. Despite failing to complete his studies, Irving became self-educated. In the early 1950s he worked for the Minnesota Department of Revenue, and in 1955, he became City Assessor for Duluth, MN. Three years later, as Messrs. Mangerich and Nemetz were working on the first PAS contract for the Ministry of Finance in Afghanistan, Mr. Olson became Minnesota Property Tax Director in the U.S..

Upon returning to the U.S., Alden convinced Irving to take a job with PAS and Irving traveled with his family to Kabul in 1963 on a two year contract from 1963 to 1965. He and his wife, Mary, and two young children, Kathleen and Rod, arrived on February 25, 1963.\footnote{Memorandum from Fred Crawford entitled “Technical Service Report - Public Administration Reports Control No. U-239” and dated April 4, 1963.} We know that as soon as he arrived, he began work on a revision to the sixth draft of the income tax law. This effort was apparently initiated by fears that the government would object to the latest draft of the income tax law.\footnote{\textit{Id.}} We also know that the revised version was designed for “simplicity of administration, convenience of payment and collection procedures and certainty of application.”\footnote{\textit{Id.}}
Irving’s subsequent assignment after having left Afghanistan was Bangkok, Thailand, but after his family had already moved, he was recalled temporarily to Afghanistan for three months to help with finalization of the Income Tax Law of 1965. Irving Olson was very well liked by the Afghans and was able to work with the Afghans to get the law passed by the council of ministers and published in the month of Sunbola, 1344 (or August, 1965).\textsuperscript{616} Not surprisingly, the income tax was very difficult to actually collect in practice.\textsuperscript{617}

Over the following years Mr. Olson worked in Thailand, Iran, Grenada, and the Philippines. Irving and Mary returned to Afghanistan in 1970, but had to leave in 1973 when Mohammed Daoud Khan deposed King Zahir Shah in a coup while the King was away in Italy.

In the late 1970’s, Irving and Mary retired to Minnesota, where Irving continued his passion for researching his family history and his Swedish heritage.

\textsuperscript{616} Final PAS Report p. 7 (“The advisor who ultimately succeeded in developing an acceptable law has stated that the USAID objective was the enactment of a progressive global income tax law while the main purpose of the Afghans was the incorporation of their existing taxes and a workable income tax in a general tax law. The law as approved attempts to include both objectives.”).

\textsuperscript{617} Harley H. Hinrichs, \textit{Certainty as Criterion: Taxation of Foreign Investment in Afghanistan}, National Tax Journal, vol. XV, 139 (noting how even prior to the enactment of the revised income tax law in 1965, foreign and domestically owned businesses were, in theory, subject to a tax on “net income” but that since records were spotty and computing “net income” is difficult to do even in more developed countries, the Afghan officials would simply impose a four percent (4%) tax on imports and two percent (2%) on exports, effectively converting the income tax into a tariff.); Kabul Times p. 2 (Jul. 29, 1968) (“The ministry of finance in the past year has advertised in the newspapers and over the radio on the legal consequences of paying taxes. It has repeatedly called on the public to cooperate in the payment of taxes.”); Kabul Times p. 2 (Sep. 12, 1971) (“The income tax is the most delicate aspect of the issue. At present, the civil servants are the ones who pay their obligations in meeting the income tax dues. From their salaries the state revenue is directly deducted and deposited in the state account. But what about the businessmen, the commercial firms, etc? It is here that a better account keeping system is needed.”).
Appendix III

The following example is used to illustrate some of the salient points regarding the application of the Australian and New Zealand tax systems.

EXAMPLE: A publicly traded company ("ANZCO") has 4 shareholders, Amy, ANZSH, Jeff, and USCO, who each own 25% of the stock of ANZCO. ANZCO can be either an Australian company or a New Zealand company. Amy is an individual and either an Australian tax resident or a New Zealand tax resident depending on the fact pattern below. ANZSH is either an Australian tax resident company or a New Zealand tax resident company depending on the fact pattern below. Jeff is always U.S. citizen. USCO is always U.S. corporation entitled to full U.S. treaty benefits. ANZCO only earns 2 types of income: (i) 100 of income from conducting active operations in the country it is tax resident in and on which it paid federal tax; and (ii) 100 of income from dividends paid by subsidiaries located outside of its country of residence which is not taxed in either Australia or New Zealand under their territorial systems. Assume ANZCO makes a cash distribution of 100, with 25 going to each shareholder.

(a) Consequences assuming ANZCO is Australian and Amy is Australian.

ANZCO is required to maintain a “franking account balance” equal to the Australian tax paid on Australian source income. The fact that ANZCO has earned 100 of income from conducting active operations in Australia on which it paid Australian federal tax of 30% would typically be reflected by a franking account balance of 30 (assuming no other credits or debits). ANZCO’s after tax cash balance from those earnings is 70. The other 100 of earnings attributable to dividends from non-Australian subsidiaries is considered “conduit foreign income” or “cfi” and does not increase ANZCO’s franking account balance.

This means ANZCO could (if it chose to) frank 70% of the 100 distribution to its shareholders. It need not do this, however. Instead, it may elect to pay a lesser portion out of franked earnings and the other portion out of cfi.619 We assume, for purposes of illustration, that that is what ANZCO chooses to do.620

Amy

In this case, Amy, an Australian resident, receives 25. Of that amount, 12.50 represents cfi, which is included in Amy’s taxable income without any gross up and without any credit or offset. Amy just has to pay tax on that amount at her marginal rate. The other 12.50 is a distribution of “franked” earnings. The Australian dividend imputation system uses a gross-up and tax offset mechanism to remove the impact of double taxation for Amy on the franked dividend.621 Amy would thus include in her taxable income the 12.50 plus 5.36, with the 5.36 representing the share of the 30 of taxes that ANZCO paid that were

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618 In either case, it is assumed that they have relevant taxpayer identification numbers in the country they are resident of.

619 Even after subtracting for the 30 of tax, ANZCO has 70 of franked earnings, such that 1/2 of the 100 dividend or 50 could be considered to come from franked earnings.

620 For this purpose it is important to note that Australia does not have tax concept of corporate “earnings” like the U.S. has a concept of “earnings and profits” to determine whether a cash distribution is considered a “dividend” or a return of the shareholder’s investment. Instead, Australia defers to its corporate law which in turn defers to its Australian accounting principles to determine whether a company has sufficient “earnings” out of which a distribution may be paid. For our purposes, we assume ANZCO has sufficient “earnings” as that term is understood in Australia out which a dividend may be paid.


associated with the 12.50 distributed.\textsuperscript{623} Thus, Amy recognizes 17.86 of income and calculates a notional tax liability against which she can claim a 5.36 credit. Note that Amy does not get to increase her tax basis in the shares of ANZCO for the undistributed earnings of ANZCO. Thus, if Amy were to sell her shares, she would pay tax on any gain. If the shares had been held by Amy for longer than 12 months, a discount may be available in respect of any capital gain made upon disposal. Double tax is not explicitly avoided. Notwithstanding that, the acquiring shareholder can benefit from the franking credits remaining in the company upon eventual payment of a dividend.

\textbf{ANSH}

The distribution to ANZSH of 25 is similarly comprised of 12.5 of “franked” income and 12.5 of “conduit foreign income” or cfi. ANZSH would include the 12.50 of franked income together with 5.35 of credits. With respect to the cfi, unless ANZSH pays the cfi out to its shareholders before it files its tax return, ANZSH would have to pay tax on the receipt of the cfi. We assume ANZSH does not distribute the cfi before it files its tax return. ANZSH would then calculate a tentative tax liability equal to 30\% of 30.35 (25 + 5.53). ANZSH would then be able to claim a credit against that liability equal to the 5.35 of franking credits.

\textbf{Jeff}

Importantly, the distribution of 25 to Jeff is not subject to withholding even though 12.5 of the amount distributed to Jeff has never been subjected to Australian tax. Effectively, Australia has chosen, by virtue of having a territorial system and an imputation system, to cede taxing jurisdiction on any non-Australian profits paid to non-resident shareholders. This treatment is not treaty-specific. Jeff would get the same treatment if he were resident in a country with which Australia does not have a treaty.

Again, Jeff does not get to step up his basis in ANZCO for undistributed earnings. Normally, this is not relevant, but Australia does impose a non-resident capital gains tax on dispositions of Australian companies that are “land rich” (more than 50\% real property investments in Australia) and in that case, a basis step up would be relevant. Nevertheless, none is offered under the Australian system.

\textbf{USCO}

As with Jeff, the distribution of 25 to USCO is not subject to withholding even though 12.5 of the amount distributed to USCO has never been subjected to Australian tax.

\textbf{\textit{(b) Consequences assuming ANZCO is New Zealand Resident and Amy is New Zealand Resident.}}

ANZCO is required to maintain a “imputation credit balance” equal to the New Zealand tax paid on New Zealand source income. The fact that ANZCO has earned 100 of income from conducting active operations in New Zealand on which it paid New Zealand corporate income tax of 28\% would typically be reflected by an imputation credit account balance of 28 (assuming no other credits or debits). ANZCO’s after tax cash balance from those earnings would be 72. As ANZCO is exempt from tax on the other 100 of earnings attributable to dividends from non-New Zealand subsidiaries, ANZCO will not have paid any New Zealand corporate income tax on such dividends so as to generate any credit in ANZCO’s imputation credit account.

This means ANZCO could (if it chose to) fully impute the 100 distribution to its shareholders if it had imputation credits from another source. If ANZCO wishes to fully impute the distribution, it would

\textsuperscript{623} 12.50 distributed divided by franked earnings of 70 x 30 of taxes paid.
attach imputation credit of 28 to gross dividend of 100 (made up of cash dividend of 72 and imputation credit attached of 28). New Zealand withholding tax may also be required to be deducted from the cash dividend depending on the residency of the shareholder and the ratio at which imputation credits are attached.

In general, ANZCO is allowed to attach imputation credits to a dividend at any ratio so long as the ratio does not exceed the maximum ratio (as discussed above when making a fully imputed distribution), and is higher than the ratio at which ANZCO had attached imputation credits at in respect of an earlier distribution made by ANZCO during the same imputation year.

If ANZCO elects (and is permitted to do so) to only attach half of the imputation credits (being 14) available to the 100 distribution. We assume, for purposes of illustration, that that is what ANZCO chooses to do.

Amy

In this case, Amy, a New Zealand resident, receives 25. Imputation credits of 3.50 (representing Amy's share of the 14 imputation credits attached) would be attached to the distribution. Resident withholding tax of 4.75 would also be required to be deducted from the cash dividend.

The amount of resident withholding tax to be deducted will depend on the ratio at which imputation credits are attached. In broad terms, regardless of the ratio at which imputation credits are attached, the combined value of the imputation credits attached and the resident withholding tax required to be deducted from a distribution must not exceed 33 for every 100 of distribution.

The current top personal marginal tax rate in New Zealand is currently 33%. The regime is therefore designed to ensure that for every 100 of income earned by ANZCO, tax of 33 (whether in the form of corporate tax paid by ANZCO or resident withholding tax attached) would have been accounted for before that income is distributed and reaches the hands of Amy. The New Zealand dividend imputation system uses the above mechanism to remove the impact of double taxation for Amy on the partially imputed dividend.

If Amy is subject to a lower personal marginal tax rate, Amy may be able to claim a refund of the resident withholding tax deducted or to apply any excess imputation credits towards satisfaction of other taxable income of hers.

Note that Amy does not get to increase her tax basis in the shares of ANZCO for the undistributed earnings of ANZCO. Thus, if Amy were to sell her shares, she is not ordinarily expected to pay tax on the proceeds from the sale if the shares are held on capital account. However, under a specific avoidance rule relating to dividend stripping she could be taxed on the gain if the shares are held by Amy on capital account and Amy has disposed of her shares to avoid being taxed on the undistributed gain accumulated in ANZCO.

ANSH

The distribution to ANZSH of 25 is similarly comprised of imputation credits of 3.50 (representing ANSH's share of the 14 imputation credits attached). Resident withholding tax of 4.75 would again be required to be deducted from the cash dividend as the dividend is paid to a New Zealand resident company (assuming that ANSH does not hold an exemption certificate from resident withholding tax).
The resident withholding tax deducted together with the imputation credits of 3.50 would increase the imputation credit balance of ANSH by 8.25. These imputation credits will be available to be used by ANSH when distributing its income to its shareholder.

Jeff

Importantly, the distribution of 25 to Jeff is not subject to withholding to the extent that the distribution is fully imputed (i.e. the distribution of 12.5) on the basis that Jeff's shareholding in ANZCO is at least 10%. The balance of the distribution which is not imputed is subject to non-resident withholding tax in New Zealand at the rate of 30 percent. However, under the US-New Zealand Double Tax Agreement, the non-resident withholding tax can be reduced to 5 percent. Effectively, New Zealand has chosen to partially cede taxing jurisdiction on any New Zealand profits paid to non-resident shareholders of a jurisdiction that New Zealand has a double tax agreement with.

Again, Jeff does not get to step up his basis in ANZCO for undistributed earnings. Normally, this is not relevant, but New Zealand can impose tax on gains from disposal of shares in a New Zealand company where those shares are not held on capital account. Depending on the jurisdiction of the non-resident shareholder, treaty relief may not be available to alleviate the New Zealand tax on dispositions of New Zealand companies that are “land rich” (more than 50% real property investments in New Zealand) and in that case, a basis step up would be relevant. Nevertheless, none is offered under the Australian system.

USCO

The same analysis discussed above in relation to Jeff also applies to USCO.