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Corporate Tax Reform: The Key to International Competitiveness

Ann L. Hardman

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Corporate Tax Reform: The Key to International Competitiveness

ABSTRACT

This Note responds to "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once," a study the United States Department of the Treasury released on January 6, 1992. This Note explores some of the issues and concerns of integration and considers arguments in support of and against the United States system of taxation. The latter portion of this Note addresses the relationship between international economics and integration, focusing on the potential for international competitive disadvantage under the classical tax system. The author concludes that Congress should read the Treasury's study as a legislative proposal and act upon it to bolster the United States economic competitiveness.

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I. INTRODUCTION

In 1977, the United States Department of Treasury (the Treasury) urged integration of the corporate and individual tax structures.¹ Nine years later, the Tax Reform Act of 1986 directed the United States Secretary of the Treasury to study reforms of corporate income taxation.² Originally targeting January 1988 for completion of its study,³ the Treasury released it in January 1992.⁴ Fifteen years after the Treasury first recommended integration, this study reaches the same conclusion.⁵

The stated purpose of the report⁶ is to initiate debate on the merits of integration.⁷ Although the Treasury did not intend its report to be a legislative proposal,⁸ one might read it as one.⁹ Given the prevalence of integrated tax systems among the United States trading partners¹⁰ and

1. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977).

2. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

3. *Id.*

4. DEPARTMENT OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992) [hereinafter INTEGRATION].

5. *Id.* at v.

6. The report is a comprehensive study of the potential issues arising out of an integration of the corporate and individual tax systems.

7. INTEGRATION, *supra* note 4, at ix.

8. *Id.*

9. Although the Treasury professed neutrality, its preference for one particular method of integration, the dividend exclusion prototype, is evident. The Treasury believes "[t]he dividend exclusive prototype . . . would, with few changes in current law, implement many of this Reports' key policy recommendations. The principal advantage of the dividend exclusion prototype is its simplicity and relative ease of implementation." *Id.* at 17.

10. Integration is becoming quite popular in other nations. Seven of the European

the potential for international competitive disadvantage if the United States tax system remains unintegrated, Congress should treat this report as a legislative proposal and act on it.

This Note illuminates and discusses some of the issues and concerns that led the Treasury to recommend adoption of a plan to integrate the individual and corporate tax systems in the United States. This Note synthesizes the principal arguments for and against the current system in the United States, outlines various models of integration, and addresses selected topics concerning international economics and tax policy in an increasingly interconnected, global economy. The last section addresses the most serious consequence of the classical system, the overuse of debt.

II. THE CURRENT SYSTEM

A. *The Classical System*

Current United States tax law imposes taxes on corporations as separate entities, apart from the tax imposed upon their owners.¹¹ One effect of this system is that income earned at the corporate level is taxed twice—first at the corporate level, and again at the individual shareholder level when it is distributed as dividends.¹² There are methods to circumvent this double tax. Structuring distributions to shareholders as deductible payments rather than as dividends is one method of circumventing the double tax.¹³ One example is the use of debt instead of equity to finance corporations.¹⁴ Although the double tax burden may seem

Community (EC) member states and four non-EC states use the imputation system of integration. Sijbren Cnossen, *Overview*, in *WORLD TAX REFORM: A PROGRESS REPORT* 261, 262 (Joseph A. Pechman ed., 1988). Seven of the member states of the Organization for Economic Cooperation and Development (OECD) use a dividend deduction or split-rate system. *Id.* The remaining five OECD member states (Luxembourg, the Netherlands, Spain, Switzerland, and the United States) still use the classical system. *Id.* at 262-63.

11. INTEGRATION, *supra* note 4, at v.

12. *Id.* at 1. To illustrate, suppose a corporation has \$1,000,000 of taxable income. Because this corporation has taxable income in excess of \$335,000, this corporation would be taxed at a flat rate of 34%, I.R.C. § 11(b)(1) (1992), and owe taxes of \$340,000. Having thus paid its taxes, if the corporation were to distribute the remaining \$660,000 in dividends, that \$660,000 would be taxed again at the shareholder level. To simplify the calculation, assume the entire amount goes to shareholders in the top marginal rate, 31%. Under these assumptions, the shareholders would owe \$204,600 in taxes on the \$660,000 received as dividends. The effective tax rate on this \$1,000,000, thus, is 54.46% ($\$340,000 + \$204,600 = \$544,600$ total tax paid, or 54.46% of \$1,000,000).

13. See, e.g., STEPHEN A. LIND ET AL., *FUNDAMENTALS OF CORPORATE TAXATION* 5 (3d ed. 1991).

14. See, e.g. Peter C. Canellos, *Corporate Tax Integration: By Design or By De-*

inequitable, there are some arguments supporting taxing the corporation and its shareholders separately.

B. *Arguments for the Classical System*

If one ascribes to the view that a corporation is a separate being,¹⁵ then it follows that the corporation is an appropriate subject of taxation; there is no double tax because the corporation is an entity separate from its shareholders.¹⁶ A C corporation is typically a large, publicly held organization in which shareholders are not active participants but rather distant investors.¹⁷ It is reasonable to tax a shareholder's income from corporate investments as well as income from the shareholder's primary taxable activity because the shareholder is not involved in the operation of the corporation's business activities. However, the more active the shareholder becomes in corporate operations the less reasonable the double tax imposed by the classical system becomes.¹⁸

Equity urges the taxation of corporations as separate entities. The increase in economic power derived from adopting the corporate form is an advantage for which a corporation should pay.¹⁹ Moreover, in an era of budget deficits, the need for a broad tax base necessitates the taxation of corporations as separate entities.²⁰

fault?, in CORPORATE TAX REFORM: A REPORT OF THE INVITATIONAL CONFERENCE ON SUBCHAPTER C, 129, 136 (George K. Yin ed., 1988). When a corporation is financed with debt, the same \$1,000,000 of corporate income distributed as interest to bondholders bears no tax at the corporate level. Income is thus subject to a total federal tax of 31% if distributed to the highest marginal bracket individual, and no tax at all if distributed to a tax-exempt investor.

15. The Supreme Court declared corporations to be "persons" within the meaning of the Equal Protection Clause of the Fourteenth Amendment, *Santa Clara County v. Southern Pacific R.R. Co.*, 118 U.S. 394, 396 (1886), and protected by the Due Process Clause, *Minneapolis & St. Louis R.R. Co. v. Beckwith*, 129 U.S. 26, 28 (1888).

16. Canellos, *supra* note 14, at 130.

17. The public, or C corporation, is "an association of individuals, organized to further a common purpose, and possessing a combination of attributes (e.g., continuity of existence, limited liability, separate legal entity, centralized management and transferability of interests) which distinguishes [it] from other forms of association." LEWIS D. SOLOMON ET AL., *CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS* 1 (2d ed. 1988).

18. This is especially true in the context of closely held corporations, in which the shareholders are often employees of the corporation. *See, e.g.*, Canellos, *supra* note 14, at 130. Under the classical system, this shareholder would be taxed twice on the same activity.

19. *Id.* at 130.

20. *See, e.g.*, LIND, *supra* note 13, at 21.

An interesting argument in favor of the classical system is that the double tax burden really does not present a competitive disadvantage because C corporations primarily compete against other C corporations.²¹ Thus, the argument goes, the playing field is not so uneven as critics of the classical system suggest, especially because the corporation presumably passes the burden of the double tax on to consumers.²² Classical system advocates also question the success rate of the various integration schemes currently used by some of the United States trading partners.²³

C. *Criticisms of the Classical System*

The most fundamental criticism of the classical system is that the double tax is actually an indirect tax on shareholders.²⁴ Instead of the corporation treating the tax as a cost of doing business and passing it on to customers, the classical system allegedly passes the cost of the tax on to shareholders in the form of decreased dividend payments.²⁵ The fact that the law treats a corporation as a distinct legal entity, apart "from that of its managers, shareholders, and employees cannot change the fact that a tax can . . . affect the well-being of those who work for or own the [corporation], or consume its products."²⁶ From this perspective, the double tax appears to be patently unfair. It violates vertical equity²⁷ by subjecting income earned indirectly by shareholders in different tax brackets to the same corporate tax rate.²⁸ The double tax also violates horizontal equity²⁹ by subjecting income an individual earns from corpo-

21. Canellos, *supra* note 14, at 130-31.

22. *Id.* This argument is flawed, however, because some C corporations, especially smaller ones unable to qualify for S corporation treatment, may compete primarily with partnerships and S corporations. In addition, C corporations must increasingly compete in the international arena, in which many of the participants operate under integrated tax systems. See Cnossen, *supra* note 10, at 262.

23. Canellos, *supra* note 14, at 132.

24. *Id.* at 131.

25. *See id.*

26. JOHN A. KAY & MERVYN A. KING, *THE BRITISH TAX SYSTEM* 153 (5th ed. 1990).

27. Vertical equity refers to the distributive and redistributive implications of taxation, that is, how tax liabilities are assigned to people at different income levels. *Id.* at 141. For example, the Internal Revenue Code imposes different tax rates on people at different income levels. *See* I.R.C. § 1 (1992).

28. KAY & KING, *supra* note 26, at 153. Even if the individual shareholder is in the lowest tax bracket or is exempt from paying income tax altogether, that shareholder effectively pays a tax rate of 34% on the corporation's taxable income prior to its distribution of dividends. *See supra* note 14.

29. Horizontal equity refers to the practice of imposing the same tax rate on all

rate dividends to a different effective tax rate than income the same individual earns directly or through a partnership or S corporation.³⁰

The classical system also distorts the decision-making process.³¹ Perhaps the most publicized effect of the classical system on the decision-making process is its encouragement of the use of debt rather than equity for financing,³² which creates leverage problems.³³ Over-reliance on debt results in reduced investment in the corporate sector and increased corporate vulnerability to bankruptcy.³⁴ Over-reliance on debt also has a substantial negative impact on corporate tax revenues.³⁵ By permitting the relatively unrestricted use of debt, the classical system has created, in effect, a dividends-paid deduction without assuring that the ultimate recipient is a taxpayer rather than a tax-exempt entity.³⁶ Rules to combat the "evasion" of the double tax are difficult to draft, and there seems to be an inclination to facilitate transactions that ease the double tax burden.³⁷

income a person receives. KAY & KING, *supra* note 26, at 41.

30. *Id.* If an individual taxpayer must use the C corporation form instead of the S corporation form, or if the nontax benefits of the corporate form more closely fit the taxpayer's needs than does the partnership form, that taxpayer will be subjected to a much higher tax rate. *See id.*

31. The Treasury specifically identified three inherent distortions in decision-making: (1) an incentive to invest in noncorporate rather than corporate businesses, (2) an incentive to finance corporate investments with debt rather than equity, and (3) an incentive to retain earnings or to structure the distribution of earnings so as to avoid the double tax. INTEGRATION, *supra* note 4, at vii.

32. The preferential tax treatment of debt arises from the fact that interest payments, unlike dividends, are deductible business expenses under section 163 of the Internal Revenue Code. *See* I.R.C. § 163 (1992); *see also* Canellos, *supra* note 14.

33. *See* Canellos, *supra* note 14, at 131.

34. CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 26 (1979).

35. *See* Michael J. Graetz, *The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions*, 42 TAX NOTES 721, 722 (1989). Current estimates suggest that for every dollar of equity financing a corporation replaces with debt financing, the United States loses 40¢ of income tax revenue. *Id.* The principal reason for this loss of revenue lies in the composition of corporate investors. Graetz estimates that only half of the corporate stock and five percent of the corporate bonds in the United States are owned by individuals, while the remainder is owned by tax-exempt investors. *Id.* When one considers that 100 billion dollars of equity has been replaced annually by debt in recent years, it is no wonder the United States has a revenue problem.

36. Canellos, *supra* note 14, at 138-39. A kind of unofficial integration system thus exists, allowing corporate income to be attributable to corporate investors who are holders of debt instruments. *Id.*

37. *Id.* at 139.

The classical system also distorts the decision-making process with respect to the distribution of corporate earnings.³⁸ This is of particular concern to free market economists, who lament the effect that the disincentive to distribute corporate earnings has on the market.³⁹ Artificially high retention rates permit corporations to reinvest funds without passing the test of the marketplace, resulting in investment in projects that may not yield the highest social rate of return.⁴⁰ Critics also assert that the classical system is responsible for depressing the rate of economic growth,⁴¹ reducing the level of investment,⁴² and interfering with the efficient allocation of resources.⁴³

An often overlooked problem with the classical system is its growing obsolescence in the world economy.⁴⁴ If the United States continues to adhere to the classical system while its trading partners and the rest of the world convert to integrated tax systems, the United States could find itself at a tremendous competitive disadvantage.⁴⁵ Moreover, the more burdensome the classical system becomes, the more methods corporations will find to circumvent the double tax.⁴⁶ The result will be a less rational tax structure, lost tax revenues, and increased compliance burdens.⁴⁷

38. *Id.* at 131.

39. *See id.* at 131-41. When a corporation retains earnings, its shareholders are deprived of the opportunity to make their own choices with respect to how those earnings will be reinvested because corporate management makes the decision instead. *Id.*

40. McLURE, *supra* note 34, at 25.

41. *Id.* at 7.

42. INTEGRATION, *supra* note 4, at 1.

43. *Id.*

44. *See supra* note 10.

45. The EC poses a particular challenge because most of its member states have integrated tax systems. *Id.* The EC is poised to become a serious competitor with the United States, and it is quite possible that the United States will lose investors and corporations to EC member states.

46. The Internal Revenue Code is rife with sections mitigating the tax burden. Most important, perhaps, is the opportunity for closely held businesses to operate as S corporations, allowing them to obtain pass-through treatment and be subject to a single level of tax. LIND, *supra* note 13, at 21. If the organization cannot qualify for S corporation treatment, there are a number of self-help integration techniques available. For example, a corporation might pay its shareholders deductible compensation, I.R.C. § 162(a)(1) (1992) or interest, I.R.C. § 163 (1992). The corporation might also pay for shareholders' food and lodging expenses, I.R.C. § 119 (1992), travel expenses, I.R.C. § 162(a)(2) (1992), provide life insurance, I.R.C. § 79 (1992), or medical and accident insurance, I.R.C. §§ 105(a)-(b) (1992).

47. Canellos, *supra* note 14, at 147.

III. INTEGRATION - A SOLUTION TO THE PROBLEMS?

A. *An Introduction to Integration*

Adopting an integrated system of taxation would produce several benefits. Integration would eliminate, or at least reduce, the double taxation of corporate income.⁴⁸ In the case of the United States, integration would move the tax system "in the direction of more neutral taxation of corporate income"⁴⁹ and reduce the distortions in decision-making caused by the double tax regime.⁵⁰ The United States could realize other benefits from an integrated system, such as reducing the cost of capital for corporate investment, encouraging the use of "capital structures less vulnerable to instability in times of economic downturn,"⁵¹ increasing the capital stock in the corporate sector by 125 billion to 500 billion dollars, decreasing the debt-asset ratio in the corporate sector by 1 to 7 percentage points, and producing an annual gain to the economy of 2.5 billion to 25 billion dollars.⁵²

1. Basic Models of Integration

There are two broad categories of integration models: full integration and partial integration.⁵³ Full, or complete, integration eliminates the tax on corporate income and applies pass-through treatment to C corporations and their shareholders, the same treatment currently reserved for S corporations, partnerships, and sole proprietorships.⁵⁴ Under the full integration scheme, income earned at the corporate level, whether or not it is distributed, is treated as shareholder income and taxed at the rate applicable to the individual shareholder.⁵⁵

Partial integration affords tax relief for dividends paid by a corporation.⁵⁶ There are three basic variations of the partial integration model. Under one variation, shareholders would receive a tax credit equal to some percentage of dividends received from the corporation.⁵⁷ This

48. MCLURE, *supra* note 34, at 2.

49. INTEGRATION, *supra* note 4, at 15.

50. See *supra* notes 31-43 and accompanying text.

51. INTEGRATION, *supra* note 4, at vii.

52. *Id.* at vii-viii.

53. LIND, *supra* note 13, at 22.

54. *Id.*

55. MCLURE, *supra* note 34, at 3. This is the purest form of integration and arguably the most equitable. By affording pass-through treatment, both horizontal and vertical equity are achieved. See *supra* notes 27, 29.

56. See LIND, *supra* note 13, at 22.

57. *Id.*

would effectively treat corporate income tax as a type of withholding tax with respect to income distributed to the shareholders.⁵⁸ In another variation, the Treasury might allow shareholders to exclude all or a portion of the dividends they receive from their gross income.⁵⁹ A third variation would allow corporations to deduct some or all of the dividends paid to shareholders, similar to the deduction currently allowed for interest payments.⁶⁰

2. Policy Issues

Several policy concerns influenced the Treasury's evaluation of the prototypes it examined. First, the Treasury does not want to extend the benefit of corporate level tax preferences to shareholders.⁶¹ Second, the Treasury does not want to reduce the total tax collected on corporate income that is distributed to tax-exempt investors.⁶² These policies reflect a recognition of the need to maintain tax revenues. Third, the Treasury is concerned about the effect that integration could have on foreign investors and the foreign taxes paid by domestic corporations.⁶³ Consequently, the Treasury recommends that integration benefits be denied to foreign shareholders.⁶⁴ It also recommends that taxes which domestic corporations pay to foreign states receive different treatment from taxes paid to the United States.⁶⁵

58. INTEGRATION, *supra* note 4, at 15. This is the imputation credit model. *Id.*

59. *Id.* This is the dividend exclusion model favored by the Treasury. Corporate shareholders already may do this in certain circumstances under section 243 of the Internal Revenue Code. *Id.*

60. MCLURE, *supra* note 34, at 3. This is the dividend-paid deduction model. *Id.*

61. INTEGRATION, *supra* note 4, at 15. While tax preferences may reduce the corporate level tax, current law does not extend the preference to shareholders, instead taxing all income distributed to shareholders as ordinary income. *Id.*

62. *Id.* Under current law, tax-exempt investors are not completely exempt from tax because corporate income is still subject to tax at the corporate level, at a maximum rate of 34%, regardless of the tax-exempt status of the dividend recipient. *Id.* at 15-16; *see also supra* note 28.

63. INTEGRATION, *supra* note 4, at 16.

64. *Id.* The Treasury concluded that this issue would be handled better through treaty negotiations so as to achieve reciprocity. *Id.*

65. *Id.* Again, the Treasury concluded that treaty negotiations would be a more appropriate forum in which to decide the proper allocation of tax revenues between the source state and the taxpayer's state of residence. *Id.*

B. *The Treasury's Prototypes*

1. Dividend Exclusion Prototype

The dividend exclusion prototype is the model the Treasury favors.⁶⁶ Under this prototype, corporations would calculate their income under current rules and continue to pay tax at a rate of thirty-four percent.⁶⁷ Shareholders, however, generally would exclude dividends from their gross income.⁶⁸ Although distributed and retained income would be taxed at the thirty-four percent rate, the shareholder level tax on dividends would be eliminated.⁶⁹ All other distributions would receive the same tax treatment rendered under current law.⁷⁰

The dividend exclusion model would retain the corporate tax preferences available under current law.⁷¹ By allowing shareholders to exclude only those dividends on which the corporation has paid the full tax, however, the Treasury would not extend these tax preferences to the shareholders.⁷² To avoid extending tax preferences to shareholders and exempting foreign source income from any United States tax, the Treasury would place strict limits on the amount of excludable dividends.⁷³

Implementation of the dividend exclusion model would require adding a new account to the corporate books to aid in determining whether fully taxed income is the source of corporate distributions.⁷⁴ The Excludable Distributions Account (EDA) would measure the corporation's supply of fully-taxed income; from the EDA, the corporation would be able to pay excludable dividends.⁷⁵ The EDA would monitor the actual corporate taxes paid and convert that amount into an equivalent amount of after-tax income that the corporation could then distribute to its shareholders.⁷⁶ The dividend exclusion model would ensure that the distributed

66. *See id.* at 17. The Treasury determined that this model could accomplish most of its policy recommendations and at the same time offer simplicity. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* This would retain the current system whereby tax-exempt shareholders are subjected to tax at the corporate level. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* This would retain the current system whereby income that benefits from a tax preference is not taxed at the corporate level but is taxed at the individual shareholder level. *Id.*

73. *Id.* at 19. The corporate alternative minimum tax, which curbs the excessive use of tax preferences at the corporate level, therefore, would be retained. *Id.*

74. *Id.*

75. *See id.*

76. *Id.* [$\text{Annual additions to EDA} = (\text{U.S. tax paid}/0.34) - (\text{U.S. tax paid}) +$

income would be taxed at the full corporate rate regardless of the tax bracket or exemption status of the dividend recipient.⁷⁷

The EDA would not complicate significantly the existing tax reporting system. Corporations would have to report to shareholders and the Internal Revenue Service the excludable and taxable portions of dividends paid,⁷⁸ and shareholders would include taxable dividends just as they do under the current regime.⁷⁹ The Treasury recommends making adjustments to the EDA in the current year to avoid recharacterizing dividends paid in prior years at both the corporate and shareholder levels.⁸⁰

The Treasury does not maintain that the dividend exclusion model would be ideal, or that it would, by itself, reverse the tax system's bias toward debt financing.⁸¹ In fact, this prototype would not change significantly the treatment of debt and, therefore, would not alter the ability of those who invest in corporate debt to receive income free from tax at the corporate level.⁸² Another problem with the dividend exclusion model is that it would compromise vertical equity.⁸³ The Treasury's response to this argument is simplicity: the dividend exclusion prototype would reduce the transition burden, and if policymakers later desired to tax distributed income at individual shareholder rates, they could devise a system to refund excess tax collections.⁸⁴

2. Shareholder Allocation Prototype

The shareholder allocation model would extend integration to retained earnings by attributing income to the shareholders as the income is

(*excludable dividends received*)] *Id.* Thus, for each \$34 of taxes paid, the corporation could pay \$66 of excludable dividends (assume for simplicity that no dividends were received by this corporation). Each \$1.00 of corporate taxes paid would support \$1.94 of excludable dividends, or in the inverse, each \$1.00 of excludable dividends must be supported by at least \$0.52 of corporate taxes paid. *Id.*

77. *Id.* at 19-20.

78. *Id.* at 20.

79. *Id.*

80. *Id.*

81. *See id.* at 21.

82. *See id.*

83. *See id.* at 22. Shareholders whose individual marginal tax rates are lower than the corporate rate still would be (indirectly) taxed at the 34% corporate rate. The Treasury counters this argument with data indicating that approximately two-thirds of corporate dividends are paid to taxpayers with marginal tax rates of more than 25%. *Id.* at 22. Moreover, since lower bracket shareholders obviously own some property (the shares in question), it is not clear that their lower bracket indicates less ability to pay. *Id.*

84. *See id.*

earned.⁸⁵ Shareholders would report this income and receive a tax credit for taxes paid by the corporation.⁸⁶ Retained and distributed earnings would thereby receive equal treatment.⁸⁷ The Treasury does not endorse this prototype because of its complexity and its policy implications.⁸⁸ Despite its drawbacks, however, it is the model that full integration advocates endorse.⁸⁹

The Treasury condemns this model's administrative complexity.⁹⁰ The shareholder allocation model would require corporations and shareholders to amend instruments governing outstanding corporate stock.⁹¹ Corporations also would have to maintain capital accounts similar to those required of partnerships.⁹² The reporting requirements would create chaos if a shareholder sold or acquired stock in the middle of the year.⁹³ Accounting requirements would be more complicated even for shareholders paying lower marginal rates.⁹⁴ Maintaining the corporate level taxation does assure, however, the taxation of income distributed to tax-exempt and foreign shareholders.⁹⁵ Shareholders would be required to make adjustments to the basis in their stock, increasing the basis by the amount of taxable income allocated to them, less their share of any distributions to the shareholders, tax-exempt income, or corporate taxes paid.⁹⁶

85. *Id.* at 27.

86. *Id.*

87. *Id.*

88. *See id.* *See infra* text accompanying notes 91-96.

89. *Id.* Note that this model does differ from the pass-through ideal: (1) losses are not passed through to shareholders, (2) the corporate level tax is retained, (3) only an aggregate income is reported to shareholders, and (4) integration benefits are not extended to tax-exempt shareholders or to foreign shareholders unless done so by treaty. *Id.* at 27.

90. *Id.*

91. *Id.*

92. *Id.*

93. *See id.*

94. *See id.* at 27-28. To insure compliance and mitigate cash flow problems for shareholders, the system would require the corporation to pay income tax at the corporate rate and then allow shareholders a tax credit, similar to the operation of withholding taxes. *Id.* at 27. Shareholders with marginal rates less than the corporate rate could use this tax credit against other income but would not be entitled to a refund. *Id.* at 27-28. The administrative complexity arises from the additional reports and forms that corporations would have to make available to shareholders, the trouble of dividing income and tax credits between shareholders who may have held stock for less than a year, and the presence of varying classes of stock within each corporation. *See id.*

95. *Id.* at 30.

96. *Id.* at 28.

The shareholder allocation model significantly deviates from the Treasury's policy goals concerning its treatment of tax preferences. Unlike the dividend exclusion model, the shareholder allocation prototype extends tax preferences to shareholders.⁹⁷ The Treasury determined that modifying the basic model to avoid such treatment would be too difficult and would result in a system inconsistent with the pass-through nature of this prototype.⁹⁸

The difficulties with tax preferences were not the Treasury's primary reason for rejecting the shareholder allocation model.⁹⁹ The primary reasons for rejecting this model were administrative concerns¹⁰⁰ and the extreme difficulty in allocating income to shareholders who held shares for less than a year.¹⁰¹

3. Comprehensive Business Income Tax Prototype

The Comprehensive Business Income Tax (CBIT) model is the most comprehensive of the integration prototypes.¹⁰² The major drawback to this system is the Treasury's estimate of the length of time necessary to implement it.¹⁰³ CBIT represents the ideal: a very long-term, comprehensive method designed to equalize the tax treatment of debt and equity.¹⁰⁴

CBIT would promote economic efficiency by equalizing the treatment of debt and equity,¹⁰⁵ by decreasing the difference between corporate and noncorporate forms of business,¹⁰⁶ and by reducing the tax distortions

97. *Id.* at 30. For example, if a corporation earned tax-exempt income, such as interest on a municipal bond, this income would not be included in its taxable income. Thus tax-exempt income would not be allocated to shareholders. *Id.* at 31.

98. *Id.* at 30. Doing so would convert the shareholder allocation prototype into distribution-related integration. The dividend exclusion prototype could accomplish this more simply. *Id.*

99. Future legislation could restrict or even eliminate tax preferences. *See id.*

100. *See id.* at 27. An important consideration would be the increased reporting burdens for corporations and shareholders. *Id.*

101. *Id.* at 35.

102. *Id.* at 39.

103. The Treasury estimates that full implementation would require a phase-in period of at least ten years. *Id.*

104. *See id.* Because the Treasury believes that it is unlikely that CBIT will be implemented in the near future, its technicalities will be omitted. *See id.*

105. *Id.* Equal treatment of debt and equity would reduce or eliminate the current tax regime's bias toward debt. *Id.*

106. *Id.* Equal treatment of corporate and noncorporate forms would presumably eliminate the current bias against the corporate form, an anomalous condition for a capitalist state.

between retained and distributed earnings.¹⁰⁷ CBIT would not allow deductions for dividends or interest paid by the corporation, but would include in income any dividends or interest that shareholders or debt holders receive.¹⁰⁸ Furthermore, CBIT would apply to all but the smallest businesses, regardless of the form in which they were conducted.¹⁰⁹ The result would be a single level of tax on all capital income businesses earn.¹¹⁰ Interest and dividend income would be subject to a uniform level of tax, equal to the top individual rate of thirty-one percent, regardless of a taxpayer's marginal tax rate or tax-exempt status.¹¹¹ Although tax preferences would pass through to shareholders under CBIT, this disadvantage would be easily corrected through legislation.¹¹²

In addition to facilitating many of the Treasury's policy goals, CBIT could provide another major advantage: simplification of the Internal Revenue Code.¹¹³ Provisions relating to the prevention of excessive and mismatched interest deductions would become unnecessary, as would provisions seeking to uncover the true character of a corporation's capital structure.

IV. INTEGRATION AND INTERNATIONAL ECONOMICS

A. *The Cost of Capital*

1. Theory

A state's tax system, whether it is classical or integrated, affects corporate decision-making. One area of impact is the cost of capital, which is simply the pre-tax rate of return sufficient to cover items such as operating expenses, taxes, economic depreciation, inflation, and investors' required rate of return.¹¹⁴ The following is an example of the decision process under the classical system.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

112. *See id.* at 43.

113. *Id.* at 52.

114. *Id.* at 3.

2. Illustration

Assume a potential investor, "A," desires to earn a ten percent after-tax return on investment.¹¹⁵ In order to accomplish this goal, A's investment must earn a return high enough to yield a ten percent return after paying tax at A's marginal tax rate of thirty-one percent¹¹⁶ If A invests in a corporation, that investment must earn a return high enough to pay the corporate tax of thirty-four percent and A's individual tax of thirty-one percent. The high cost of capital thus discourages investment in the corporate sector because it is inefficient for A to invest in a corporation when A can invest in a noncorporate venture and earn a higher rate of return. Assuming all of the other components of the cost of capital are equal, the differences are set forth below:

Effect of the Classical System on Investment Decisions

	<u>Noncorporate Investment</u>	<u>Corporate Investment</u>
A's desired rate of return	10%	10%
Required rate of return	14.49% ¹¹⁷	21.96% ¹¹⁸

Under an integrated tax system, the bias would not be as great and the nontax advantages of using the corporate form might outweigh any difference in the rate of return between corporate and noncorporate investments.¹¹⁹ Assume investor A again has the same desire to earn a ten percent return on investment. This time, however, A is investing under a

115. Ten percent is an arbitrary number, chosen for simplicity.

116. Assume that A is in the top marginal rate bracket and that all income A earns on this investment will be taxed at a flat rate of 31%.

117. The formula for determining the rate of return that a noncorporate investment must earn given A's tax rate is as follows: $rate\ of\ return = (A's\ required\ rate\ of\ return) / (1 - A's\ individual\ tax\ rate)$. Thus, the rate of return is 14.49% [$rate\ of\ return = (0.10) / (1 - 0.31) = 0.1449$, or 14.49%].

118. The formula for determining the rate of return that a corporate investment must earn given A's tax rate and the corporate tax rate is as follows: $rate\ of\ return = (A's\ required\ rate\ or\ return) / ((1 - A's\ individual\ tax\ rate) * (1 - corporate\ tax\ rate))$. Thus, the rate of return is 21.96% [$rate\ of\ return = (0.10) / ((1 - 0.31) * (1 - 0.34)) = 0.2196$, or 21.96%].

119. See *supra* note 17. For example, A may be willing to give up 1% each year in return for the protection afforded by the limited liability aspect of the corporate form.

tax system that has a dividend exclusion method of integration.¹²⁰ If A wants to invest in a corporation, that investment must earn only enough to cover the corporate tax rate.¹²¹ Again, assuming all of the other components of the cost of capital are equal, the differences are as follows:

Effect of an Integrated System on Investment Decisions

	<u>Noncorporate Investment</u>	<u>Corporate Investment</u>
B's desired rate of return	10%	10%
Required rate of return	14.49% ¹²²	15.15% ¹²³

Although a difference in the rate of return still exists, the magnitude of the difference is considerably less and other advantages of using the corporate form may mitigate that difference. Taking into account the non-tax advantages of the corporate form, investment in a corporation might actually yield a higher return for A.¹²⁴

3. International Implications: Corporate Location

The tax system affects decisions regarding the location of corporate operations. For example, if corporate operations will earn a fifteen percent pre-tax rate of return anywhere in the world, where should the investor locate the corporation? For simplicity, assume that the investor, A, has a choice between State X and State Y. State X uses the dividend exclusion model of integration; State Y uses the classical system. Assume that both State X and State Y have the same tax rates for individuals,

120. See *supra* section III(B)(1).

121. See *id.* Under the dividend exclusion model, the corporation pays tax at the corporate rate and the shareholders exclude dividends paid from fully taxed corporate income. *Id.*

122. The formula for determining the rate of return that a noncorporate investment must earn given A's tax rate is as follows: *Rate of return* = *(A's required rate of return)/(1 - A's individual tax rate)*. Thus, the rate of return is 14.49% [*rate of return* = $(0.10)/(1 - 0.31) = 0.1449$, or 14.49%].

123. The formula for determining the rate of return that a corporate investment must earn under the dividend exclusion model given the corporate tax rate is as follows: *Rate of return* = *(A's required rate of return)/(1 - corporate tax rate)*. See INTEGRATION, *supra* note 4, at 18. Thus, the rate of return is 15.15% [*rate of return* = $(0.10)/(1 - 0.34) = 0.1515$, or 15.15%].

124. See *supra* note 119.

thirty-one percent, and for corporations, thirty-four percent, and that all else is equal. The differences are as follows:

Effect of Integrated System on Investment Decisions

	Investment in <u>State X</u>	Investment in <u>State Y</u>
Corporate rate of return	15%	15%
A's rate of return	9.99% ¹²⁵	6.83% ¹²⁶

Given these assumptions, it is highly improbable that A would choose to establish the corporation in State Y if A were free to choose the corporate location.¹²⁷

A consideration of the macroeconomic affects of a nation's investment decisions illustrates the impact of the classical system on international investment decisions.¹²⁸ One measure is the ratio of corporate investment to the total noncorporate sector investment in areas such as housing and unincorporated business.¹²⁹ Comparing Australia, France, Japan, the United Kingdom, and the United States, the Treasury noted that the United States has had the lowest ratio of corporate to noncorporate investment during the latest three years for which data is available.¹³⁰

125. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment under the dividend exclusion model is as follows: *A's actual rate of return* = (corporate rate of return)*(1 - corporate tax rate). See INTEGRATION, *supra* note 4, at 18. Thus, A's actual rate of return is 9.9% [*A's actual rate of return* = $(0.15)*(1 - 0.34) = 0.099$, or 9.9%].

126. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment under the classical system is as follows: *A's actual rate of return* = (corporate rate of return)*(1 - corporate tax rate)*(1 - A's individual tax rate). Thus, A's actual rate of return is 6.83% [*A's actual rate of return* = $(0.15)*(1 - 0.34)*(1 - 0.31) = 0.0683$, or 6.83%].

127. These assumptions disregard the possibility that A may have ties to a particular state which A may be unwilling to relinquish, despite the economic costs.

128. INTEGRATION, *supra* note 4, at 5.

129. See *id.*

130. *Id.* The United States is the only state in this group that does not use some form of an integrated tax system. See *supra* note 10.

B. *The Corporate Tax Wedge*

1. Theory

The corporate tax wedge is the difference between the pre-tax return on corporate investment and the cost of funds used to generate this return.¹³¹ When all else is equal, capital tends to flow from states with higher tax wedges to states with lower tax wedges.¹³² This may not result in the efficient allocation of capital.¹³³ For example, if the tax wedges between the two states differ, equal after-tax returns on an investment will fail to yield the equal pre-tax returns required for the efficient allocation of capital, and the result is an overall decrease in welfare.¹³⁴ The Treasury's data are as follows:

*Corporate Tax Wedges for Selected Countries — 1991*¹³⁵

<u>State</u>	<u>Corporate Tax Wedge</u>
Japan	1.4
Canada	1.2
United Kingdom	0.9
United States	0.8
Germany	0.6
France	0.4

For example, the corporate tax wedge of Japan is higher than that of the United States, which may partially explain the high volume of Japanese investment in the United States; however, other questions of global allocative efficiency remain.

131. INTEGRATION, *supra* note 4, at 5. The size of the wedge depends on a variety of factors including the type of asset acquired, the corporate tax rate, and capital recovery allowances (depreciation). *Id.*

132. A. Lans Bovenberg et al., *Tax Incentives and International Capital Flows: The Case of the United States and Japan*, in TAXATION IN THE GLOBAL ECONOMY 283, 297 (Assaf Razin & Joel Slemrod eds., 1990).

133. *Id.* at 297-98.

134. *Id.* at 298. Investors do not necessarily invest capital in the state which yields the highest pre-tax return, resulting in inefficiencies. *See supra* note 127.

135. INTEGRATION, *supra* note 4, at 6. In the context of this Note, the numerical values are less critical than their comparative magnitudes.

2. Illustration

Assume that A has the opportunity to invest in a corporation in State X or in State Y. For purposes of this illustration, also assume that A is a resident of the state in which A chooses to invest.¹³⁶ Assume that State X imposes an effective corporate tax rate of thirty-five percent,¹³⁷ and the cost of production in State X¹³⁸ is such that A's investment would earn a fifteen percent rate of return. Assume that State Y imposes an effective corporate tax rate of sixty percent, but the cost of production is lower and A's investment would earn a twenty percent rate of return. Because the pre-tax rate of return is higher in State Y, A's allocation of resources would be efficient if A were to invest in State Y. As demonstrated below, however, this is not the case:

Effect of the Corporate Tax Wedge on Investment Decisions

	<u>State X</u>	<u>State Y</u>
Rate of return	15%	20%
Effective tax rate	35%	60%
Comparative corporate tax wedge	small	large
A's rate of return	9.75% ¹³⁹	8.00% ¹⁴⁰

These tax systems provide A with the "wrong" incentive. Instead of investing in the state in which an investment would provide greater pre-tax returns and result in an efficient allocation of resources, A will invest

136. Making A a resident of the state in which A chooses to invest eliminates the complicated calculations that would be required to ascertain the domestic treatment of income earned abroad.

137. Instead of considering whether State X's tax system is integrated or not, the concern here is the bottom line, *i.e.* the total percentage of tax imposed on the shareholder and corporation. *See supra* note 12. The assumption here is that a higher effective rate will yield a larger corporate tax wedge.

138. The cost of labor and cost of capital comprise the costs of production.

139. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment in State X is as follows: *A's actual rate of return* = (*investment's rate of return*)*(1 - *the effective tax rate*). Thus, A's actual rate of return is 9.75% [*A's actual rate of return* = $(0.15)*(1 - 0.35) = 0.0975$, or 9.75%].

140. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment in State Y is as follows: *A's actual rate of return* = (*investment's rate of return*)*(1 - *the effective tax rate*). Thus, A's actual rate of return is 8.00% [*A's actual rate of return* = $(0.20)*(1 - 0.60) = 0.0800$, or 8.00%].

inefficiently.

Note that if the corporate tax wedge were equal in both states, A would make the efficient investment decision.¹⁴¹ Suppose that the effective corporate tax rate in both states is thirty-five percent, and A is free to choose the state in which to invest.¹⁴² Assume that A's investment could earn a fifteen percent rate of return in State X, and a twenty percent rate of return in State Y.

Effect of the Corporate Tax Wedge on the Investment Decision

	<u>State X</u>	<u>State Y</u>
Investment's rate of return	15%	20%
Effective tax rate	35%	35%
Comparative corporate tax wedge	equal	equal
A's rate of return	9.75% ¹⁴³	13.00% ¹⁴⁴

These tax systems would not distort A's decision making, and A would invest in the state in which the investment would provide a higher return.

3. International Implications

The solution to global economic inefficiency appears to be complete tax harmonization between states, thereby providing equal tax incentives to invest in each state.¹⁴⁵ As a practical matter, however, complete tax harmonization is impossible, in part because the issues which shape a state's tax policy vary dramatically from state to state.¹⁴⁶ For example, a

141. Making the above calculations based on equal effective tax rates in State X and State Y would demonstrate this.

142. See *supra* note 134.

143. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment in State X is as follows: *A's actual rate of return = (investment's rate of return)*(1 - the effective tax rate)*. Thus, A's actual rate of return is 9.75% [*A's actual rate of return = (0.15)*(1 - 0.35) = 0.0975, or 9.75%*].

144. The formula for determining the actual rate of return that A would receive given the rate of return earned by A's corporate investment in State Y is as follows: *A's actual rate of return = (investment's rate of return)*(1 - the effective tax rate)*. Thus, A's actual rate of return is 13.00% [*A's actual rate of return = (0.20)*(1 - 0.35) = 0.1300, or 13.00%*].

145. See Bovenberg et al., *supra* note 132, at 314.

146. *Id.*

greater concern for environmental protection or a national policy favoring labor-intensive production may prompt a state to implement a tax policy that is more or less favorable to capital accumulation.¹⁴⁷

V. TAX POLICY CONCERNS IN AN INTERNATIONAL ECONOMY

A. *Perspective*

“Although the ‘international tail’ should not be allowed to wag the ‘domestic dog’ of integration, the tail cannot prudently be ignored.”¹⁴⁸ The formulation of tax policy is primarily a domestic issue, yet international concerns dominate the implementation of a state’s tax policy.¹⁴⁹ Differences in tax rates and tax systems influence the global pattern of production and trade and affect corporate choices regarding the states in which goods are manufactured, savings are derived, and investment takes place.¹⁵⁰ A brief survey of some of the tax rates and systems employed by selected states illustrates the variety of systems currently in use.

147. *See id.*

148. McLURE, *supra* note 34, at 15.

149. *See* McLURE, *supra* note 34, at 49. If domestic tax policy becomes too onerous, corporations may relocate or devise methods to avoid taxation, thereby negatively impacting the taxing government’s revenues. *See supra* note 46.

150. *See supra* subpart IV(C). Note that the state with the lowest corporate tax wedge, France, has one of the highest corporate tax rates.

Survey of Selected Tax Systems

<u>State</u>	<u>Tax Revenues as Percentage of Gross Domestic Product¹⁵¹</u>	<u>Federal or National Corporate Tax Rate</u>	<u>Type of Corporate Tax System¹⁵²</u>
Australia	28%	39% ¹⁵³	Integrated
Canada	32%	28% ¹⁵⁴	Integrated
France	37%	42% ¹⁵⁵	Integrated
Japan	21%	37.5% ¹⁵⁶	Integrated
Netherlands	44%	35% ¹⁵⁷	Integrated
United Kingdom	35%	35% ¹⁵⁸	Integrated
United States	29%	34% ¹⁵⁹	Classical

The states that have integrated tax systems do not necessarily employ identical forms of integration.¹⁶⁰

B. *The Integrated Global Economy*

The ramifications of a state's tax policy extend beyond the policy's direct impact on the behavior of corporations within that state's borders.¹⁶¹ The tax policy of one state can affect economic activity in others¹⁶² by altering the incentives for foreign investment in those

151. Kenneth C. Messere, *Overview*, in *WORLD TAX REFORM: A PROGRESS REPORT* 277, 285 (Joseph A. Pechman ed., 1987).

152. *Id.* at 282-83.

153. PRICE WATERHOUSE WORLD FIRM LIMITED, *CORPORATE TAXES: A WORLD-WIDE SUMMARY* 9 (1992).

154. *Id.* at 70. Note that an additional surtax is added to this rate. *Id.*

155. *Id.* at 157.

156. *Id.* at 271. For the sake of consistency and comparison with the other states in this table, this is the top rate on corporate income. The first 8 million yen earned is taxed at 28.0%. *Id.* Above 100 million yen, the entire amount is taxed at 37.5%. *Id.*

157. *Id.* at 364. Again, this is the top rate. The first 250,000 Guilder is taxed at 40%. *Id.*

158. *Id.* at 552. Again, this is the top rate. A 25% tax rate applies to companies earning below a certain level of tax-adjusted profits.

159. *Id.* at 559. In the United States, all corporate income over \$335,000 is taxed at a flat rate of 34%. *Id.* Lower rates of 15% and 25% apply to taxable income under \$75,000. I.R.C. § 11(b)(1) (1992).

160. See Messere, *supra* note 151, at 282-83.

161. Assaf Razin & Joel Slemrod, *Introduction to TAXATION IN THE GLOBAL ECONOMY* 1, 5 (Assaf Razin & Joel Slemrod eds., 1990).

162. *Id.* at 1.

states.¹⁶³ This can lead to the inefficient allocation of resources between states.¹⁶⁴ As barriers to trade and investment crumble, the effect of differences in tax systems on corporate activity will be exacerbated and may lead to an increasingly inefficient allocation of resources as well as self-defeating fiscal competition between states.¹⁶⁵

1. International Fiscal Competition

Some differences in tax systems are intentional. For example, a state could set lower corporate tax rates in order to attract foreign corporations.¹⁶⁶ Attractive as this idea may be to policymakers, it is not without costs. Gains attributable to this type of policy come at the expense of the state's trading partners.¹⁶⁷ Those trading partners are likely to react by making similar and reciprocal changes in their own tax systems.¹⁶⁸

The result of this type of fiscal competition is an inefficient allocation of global resources and lower tax revenues for all states involved.¹⁶⁹ Fiscal competition results in lower tax revenues and allocative inefficiencies because the gains to the first state are likely to be less than the costs to the rest of the world.¹⁷⁰ There is, therefore, a common interest in avoiding such competition,¹⁷¹ but this interest has not been strong enough to fully avoid the problem.¹⁷²

The challenge to United States policymakers in adopting tax legislation is to balance the desire to preserve tax revenues against the potential impairment of the international competitiveness of United States corporations.¹⁷³ Integrating the tax system in the manner the Treasury proposes would not lower the corporate tax rate to attract corporations to the United States.¹⁷⁴ Instead, integration would alter the tax rate to shareholders, thus removing the distortions inherent in the classical sys-

163. *Id.* at 3.

164. *Id.* at 1; *see also supra* Part IV.

165. Razin & Slemrod, *supra* note 161, at 1.

166. KAY & KING, *supra* note 26, at 200-201.

167. *See id.* at 201.

168. *Id.*

169. *See id.*

170. *Id.*

171. *Id.*

172. The EC has had some success in limiting the use of industrial subsidies and coordinating regional policies, but "the opportunity to apply similar principles to corporate tax systems has been more limited." *Id.*

173. Razin & Slemrod, *supra* note 161, at 2.

174. *See supra* section IV(A)(1).

tem¹⁷⁵ and reducing the competitive disadvantage currently facing United States corporations.¹⁷⁶

2. International Tax Enforcement

Just as states differ with respect to tax systems and the policy behind those systems, so do they differ in the vigor and success with which they enforce their tax systems.¹⁷⁷ Moreover, most governments lack the incentive and ability to enforce the tax laws of other states.¹⁷⁸ The result is that governments impose controls on the flow of trade and capital across their borders to protect domestic revenue without concern for the inhibiting effect such controls may have on trade.¹⁷⁹

Policymakers must balance the need to protect domestic revenue against the significant cost of impairing the international competitiveness of domestic business interests.¹⁸⁰ Adopting some form of integration does not present a major obstacle to this balancing process. As it evaluated the various means of accomplishing integration, the Treasury had revenue preservation as a paramount objective¹⁸¹ and its recommendations reflect that goal.

3. Jurisdiction

Which state is entitled to collect the tax due on a particular transaction or set of transactions is extremely important.¹⁸² Generally, a tax treaty settles the jurisdictional issue, allocating the revenues earned between the source state and the residence state.¹⁸³ Multinational corporations account for a growing proportion of economic activity and have the greatest opportunity to arrange their transactions to minimize their tax

175. See, e.g., *supra* notes 31-43 and accompanying text.

176. See *supra* subpart IV(B). A corporation operating under the classical system of taxation must earn a much higher pre-tax rate of return in order to attract investors away from investments in states with integrated tax systems. *Id.*

177. KAY & KING, *supra* note 26, at 198.

178. *Id.* at 207-08.

179. *Id.* at 198.

180. Razin & Slemrod, *supra* note 161, at 2.

181. See *supra* section III(A)(2).

182. KAY & KING, *supra* note 26, at 198.

183. The source state is the state in which income is generated. See, e.g., Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY*, 11, 12 (Assaf Razin & Joel Slemrod eds., 1990). The residence state is the state in which the taxpayer is a resident. See *id.*

liability.¹⁸⁴ Consequently, jurisdictional issues arise frequently in the context of corporate tax.¹⁸⁵

Implementation of an integrated tax system would not significantly affect the jurisdiction issue. Tax treaties are already in effect, and the Treasury does not recommend extending the benefits of integration to foreign investors.¹⁸⁶ Moreover, the Treasury does not believe that the foreign taxes which domestic corporations pay should receive the same treatment as those taxes which domestic corporations pay to the United States.¹⁸⁷ The Treasury concluded that if some alteration of the existing mechanisms was desired, treaty negotiations would be a more appropriate forum because such negotiations would encourage reciprocity from other states.¹⁸⁸ With reciprocity, the world would come closer to achieving complete tax harmonization and an integrated global economy.¹⁸⁹

C. Double Taxation

The overriding principle governing international taxation is the simple notion that an entity should not be required to pay tax twice on the same income.¹⁹⁰ The United States imposes taxes on its residents, individual and corporate, on a worldwide basis.¹⁹¹ Nonresident aliens, individuals, and corporations are subject to United States tax only to the extent that they earn income in the United States.¹⁹² When a corporation earns income in more than one state, it is potentially exposed to double taxation—that due to the state of incorporation¹⁹³ and that due to the state in

184. KAY & KING, *supra* note 26, at 205.

185. *See id.*

186. *See supra* section III(A)(2).

187. *See id.*

188. *See supra* notes 65-66 and accompanying text.

189. While this may not be the ideal to which nationalists would ascribe, it would improve global allocative efficiency. In this era of increased worldwide concern for the environment and preservation of scarce resources as well as increasingly interdependent economic markets, perhaps nationalist ideals are becoming as outdated as the classical system of taxation.

190. Ault & Bradford, *supra* note 183, at 27.

191. *Id.* at 12; I.R.C. § 61(a) (1992). Individuals are subject to United States tax if they are citizens of the United States, regardless of their actual place of residence. *Cook v. Tait*, 265 U.S. 47 (1924). Corporations are subject to United States tax if they were incorporated in the United States, without regard to their place of business, place of management, or place of shareholders' residence. *See, e.g.*, CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 45 (1991).

192. Ault & Bradford, *supra* note 183, at 12.

193. This assumes that the state in which a corporation is incorporated imposes a

which the income is earned.

To avoid double taxation on income, states commonly employ credit systems whereby the state of incorporation cedes the primary right to tax the corporation to the state in which the corporation earned its income.¹⁹⁴ The state of incorporation will usually retain a secondary right to tax the income earned in the foreign state to the extent that the foreign tax rate is lower than the tax rate in the state of incorporation.¹⁹⁵ Consider the following situation where a corporation incorporated in the United States earns income in a foreign state:

Net Effect When United States Tax Exceeds Foreign Tax

Foreign-source income earned	\$1,000,000
United States tax on worldwide income ¹⁹⁶	\$ 340,000
Less: Foreign tax credit ¹⁹⁷	<u>(300,000)</u>
Net tax owed to the U.S.	\$ 40,000

Note that the reverse is not true. If the foreign tax rate is higher than that in the state of incorporation, the corporation cannot use the excess foreign taxes paid to offset income earned in the state of incorporation. For example, if a United States corporation earns income in a foreign state that is subject to a higher tax rate in the foreign state, the following result is obtained:

worldwide tax on income, as does the United States. *See supra* note 191.

194. Ault & Bradford, *supra* note 183, at 12.

195. *Id.*

196. Assume a flat corporate tax rate of 34%, so that tax on \$1,000,000 would be equal to \$340,000 [$[\$1,000,000] \times (0.34) = \$340,000$].

197. The foreign tax credit is equal to the lesser of the foreign tax paid or the United States tax that would be owed on the amount of the foreign income. I.R.C. § 901 (1992). Assume that the foreign tax rate is 30%. The foreign tax paid would be \$300,000 [$[\$1,000,000] \times (0.30) = \$300,000$]. The United States tax that would be owed on the amount of foreign income would be \$340,000 [$[\$1,000,000] \times (0.34) = \$340,000$]. The lesser of these two amounts, \$300,000, is the amount of the foreign tax credit.

Net Effect When Foreign Tax Exceeds U.S. Tax

Foreign-source income	\$1,000,000
U.S. tax on worldwide income ¹⁹⁸	\$ 340,000
Less: Foreign tax credit ¹⁹⁹	<u>(340,000)</u>
Net tax owed to the United States	\$ 0

Given the inequities of imposing a double tax in the international context, it is surprising that there is not more support in the United States for an integrated tax system. An integrated tax system would replicate the results achieved in the international context.

VI. CONCLUSION

The use of debt to finance corporations, one of the primary ways to avoid the classical tax system's double taxation of corporate income, can have deleterious consequences, particularly in economic recessions. A corporation financed by debt is legally obligated to make interest payments to debtholders regardless of its financial condition.²⁰⁰ Confronted with inflexible interest payments, many corporations have difficulties in weathering economic downturns.

Failure to legislate relief from this double taxation has created the incentive to develop self-help means of integration as corporations struggle to provide integration's economic benefits in order to attract investors. To stay competitive, United States corporations are moving their operations to states that provide more favorable tax treatment. As corporations

198. Assume a flat corporate tax rate of 34%; thus tax on \$1,000,000 would be \$340,000 [$(\$1,000,000) \times (0.34) = \$340,000$].

199. The foreign tax credit is equal to the lesser of the foreign tax paid or the United States tax that would be due on the amount of the foreign income. I.R.C. § 901 (1992). Assume that the foreign tax rate is 50%; the foreign tax paid would be \$500,000 [$(\$1,000,000) \times (0.50) = \$500,000$]. The United States tax that would be due on the amount of foreign income would be \$340,000 [$(\$1,000,000) \times (0.34) = \$340,000$]. The lesser of these two amounts, \$340,000, is the amount of the foreign tax credit.

200. If a corporation tries to avoid this consequence by tying the payment of interest to the performance of the corporation, the Internal Revenue Service is likely to recharacterize the debt as equity and tax it to the corporation and shareholders accordingly. See, e.g., I.R.C. § 385 (1992); see also *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935) (holding that payment obligations to creditors are independent of corporate success).

move to other states the economic health of the United States is jeopardized. With jobs, money, and innovation leaving the United States, it is time for the United States Congress to take legislative action. Eliminating the double tax on corporate distributions would be a step in the right direction.

*Ann Louise Hardman**

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