Spring 2004

Income Tax Treaties and the Treatment of Dividends Received by Foreign Shareholders from Domestic Corporations under an Integrated System (Without the Double Level of Taxation)

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Cover Page Footnote
International Law; Commercial Law; Law
Income Tax Treaties and the Treatment of Dividends Received by Foreign Shareholders from Domestic Corporations Under an Integrated System (Without the Double Level of Taxation)

Marcos Valadao*

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I. Introduction

The American tax rate often exceeds thirty percent, making it important for foreigners investing in the United States to understand how their transactions will be taxed. One problem

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facing foreign investors is the American tax system’s double taxation of corporations, which results in double taxation of corporate dividends. The dividend exclusion proposal and the other alternatives would result in only one level of taxation.  


Another problem for foreign shareholders is international double taxation - taxation by the United States (jurisdiction of the income source) and by the domicile jurisdiction of the foreign taxpayer, and vice versa. There are several measures a country may adopt to avoid double taxation, however, including tax credits, exemption, exclusions or tax allowances, and tax treaties.

Only a few industrialized countries do not provide integration of corporate and individuals' income tax systems (e.g. Switzerland and Netherlands). The classical system of double taxation "makes it more difficult for U.S. companies to compete against foreign imports at home, or in foreign markets through exports from the United States, or through foreign direct investment."

But "[c]ritics of the proposal have questioned whether there will be a substantial effect on corporate investment because persons not subject to the individual income tax (e.g., foreign persons and tax-exempt institutions such as pension funds) hold substantial amounts of corporate equity."3

Two major problems related to international taxation arise from the proposal of integration of corporate tax. The first is whether the United States will somehow grant or deny the benefits of integration to foreign shareholders (inbound transactions). The second is whether the proposed model would consider corporate income taxes paid abroad the same as income taxes paid to the United States (outbound transactions).4 This article addresses only

Committee on Taxation 2003).

The Proposal was not approved. However, the U.S. Congress enacted the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, 117 Stat. 752, 108th Cong., 1st Sess. (2003) [hereinafter 2003 Tax Relief Act], taxing "qualified dividend income," at the same rates applied to "net capital gain" when received by domestic shareholders (individuals). 2003 Tax Relief Act, Sec. 302, I.R.C. § 1(h)(3) (2003). In brief, it means that the tax rate for qualified dividend income received by individuals (beginning January 1, 2003), is fifteen percent, and low-income shareholders, i.e., taxpayers at 10 or 15 percent marginal brackets, will pay five percent instead of the progressive tax rates as applied before the 2003 Tax Relief Act. See Stephen A. Lind et al., Fundamentals of Corporate Taxation: Cases and Materials - Student Update Memorandum 1-2, 11-12 (5th ed. 2003); see also infra notes 6 and 8 for detailed effects of the 2003 Act.


3 Joint Committee on Taxation 2003, supra note 1, at 29.

4 See McNulty, supra note 1, at 235. The income tax is based on worldwide
The purpose of this article is to compare three systems of corporate tax integration—dividend exclusion, imputation system, and deduction—as these apply to dividends received by foreign shareholders from domestic corporations (passive investment). This article will consider the effects of income tax treaties, commonly referred to as “treaties to avoid double taxation,” in making this analysis.

In Part II, this article will address the current tax structure, which allows for double taxation. Part III will explain how the three systems work to eliminate double taxation. Part IV will briefly compare the three alternatives as they apply to dividends received by foreign shareholders. The three alternatives will be compared in two scenarios— with and without tax treaties to avoid double taxation.\(^5\) The analyses will be based on the current tax treaty model, without examining the details of particular treaties. Lastly, in Part V, this article will set forth some conclusions and recommendations. This paper relies mostly on governmental proposals, official reports on the corporate tax integration, and on opinions of reliable commentators on the same issue. The official documents and the academic analysis of the proposal provide consistent clues to which directions the issue will take.

**II. Taxation Under the Current System**

Double taxation occurs in the United States in two ways: double taxation of foreign-earned income and double taxation of corporate dividends. Although tax treaties may provide some relief to taxpayers, the United States does not have such treaties with every country, limiting their overall effectiveness as a long-term solution to the double taxation problem.

\(^5\) This approach is realistic because the United States does not have such treaties with every country in the world, and the conclusions will be different depending on whether or not a treaty applies.
A. Taxation of Inbound Transactions

The United States, like many other countries, taxes its nationals (individual and companies incorporated in the United States) based on their worldwide income. This leads to double taxation, because where a taxpayer has income from multiple countries, the same income is taxed first by the country where it is produced (source country) and second by the country where the enterprise was founded or incorporated, or alternatively, the place of residence (domicile or citizenship criterion).\(^6\)

Inbound transactions, in the international sense, mean foreign persons conducting business and/or earning profits in the United States.\(^7\) The United States taxes foreign corporations and individuals on income that has a sufficient nexus to the United States.\(^8\) This taxable income may arise via active or direct investment or passive investment.

Active or direct investment may include acquiring or leasing of assets and conducting business in the United States.\(^9\) This category includes foreign companies with branches, i.e., permanent establishments in the United States. Services rendered in the United States generally may be considered inbound transactions and therefore taxed.\(^10\) Income that is “effectively connected with the conduct of trade or business” is taxed in the same manner and at the same rates as the income of individuals (citizens and resident aliens) and U.S. corporations – i.e., net income at progressive rates, but for individuals after the 2003 Tax

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Relief Act, the rate for dividends was decreased. Tax treaties may bring some relief for foreign companies doing business in the United States if it is conducted through a "permanent establishment" in the United States.

The second category of investment is passive investment, the issue under analysis in this article. Passive investment occurs when non-resident aliens and foreign corporations receive income (as dividends) from U.S. sources without the conduct of trade or business in the United States. Passive investment includes dividends, interest, rents, royalties, and some similar types of income derived from U.S. sources. The transactions may simply be buying securities or properties in the U.S. market without dealing with the operation of business. Because the foreign

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11 See supra note 1 and accompanying text; see also I.R.C. §§ 1, 1(h)(3), 11, 871(b), 872, 882 (2003). The income also may derive from activities performed without a permanent establishment of the foreign company, but with the conduct of a trade or business in the United States. The U.S. branch of a foreign corporation is subject to regular income tax on income effectively connected with U.S. trade or business and is also subject to a "branch profits tax" which is similar to the thirty percent withholding tax. "In effect, the branch profits tax treats the branch as if it were a U.S. corporation." I.R.C. § 884 (a); see Richard L. Doemberg, Overriding Tax Treaties: The U.S. Perspective, 9 EMORY INT’L L. REV. 71, 84-85 (1995). When these dividends (after regular tax and the branch profits tax) are sent to the parent corporation there is no taxation again – that is to say the "branch profits tax" substitutes the withholding tax. I.R.C. § 884(e)(3)(A (2003); see BITIKER & LOKKEN, supra note 6, at para. 67.1.1; THOMPSON JR., supra note 6, at 160-168.


13 Roehrdanz, supra note 9.

14 I.R.C. § 864 provides definitions for what is deemed to be direct or passive investment in inbound transactions. In general, what is not service performed in the United States, and is not income effectively connected to conduct of a trade or business in the United States, is passive investment, e.g., trading in stock and securities. I.R.C. § 864(b)(2)(A)(i) (2003). The General Explanation of the Tax Reform Act of 1986 dealing with Passive Foreign Investment Companies, also gives some guidance: "[P]assive income generally includes dividends, interest and its equivalents, passive rents and royalties, annuities, gains form the disposition of stocks and securities and certain other assets, certain gains from commodity trading, and certain foreign currency exchange
investor receives dividends, he may be subject to taxation. When a passive investment is in the form of mutual funds and income from it is in the form of dividends, it is subject to a gross-basis U.S. tax at a flat thirty percent rate. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an income tax treaty.

B. Taxation of Dividends

Dividends paid by U.S. corporations, either received by domestic or foreign shareholders, are also subject to double taxation. The first level of taxation – the corporation level – is the same for both, but the taxation of dividends at the shareholder level is different. Under current law, domestic shareholders are taxed on a net basis, and the tax rate may vary depending on the taxpayer. The general tax rate is fifteen percent for individuals, and there are progressive rates for corporations. Dividends received by foreign shareholders (individuals or corporations) from domestic corporations sourced in the United States are rates.” The General Explanation of the Tax Reform Act of 1986, 1024-26 (1986); see I.R.C. § 469(c)(2), (4) (2003); I.R.C. § 954(c)(1)(A), (2)(A) (2003); see also Comment, Nonshelterable Passive Activities and “Better” Investment, 11 Va. Tax Rev. 501, 501-02 (1991) (dealing with passive investment in general).


Id. at 222.

Id.

Id. at 223.

See sources cited supra note 1.

Before the 2003 Tax Relief Act, dividends paid to individuals were levied at progressive tax rates at the shareholder level. The 2003 Tax Relief Act did not change the rates to dividends paid to corporations. The 2003 Tax Relief Act also gave relief to dividends paid to individuals by foreign corporations. However, the dividends must be “qualified”, which happens when the foreign corporation is incorporated in a possession of the United States, or is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory. I.R.C. § 11(h)(11)(B)(2), (C) (2003); see also sources cited supra note 1.

taxed on a gross basis (no deductions are allowed) with a flat rate of thirty percent. Whether received by foreign or domestic shareholders, dividends derived from U.S. sources are subject to withholding tax. The Treasury Proposal does not modify this treatment.

Tax at the corporate level can be levied at the maximum rate of thirty-five percent. Assuming the new rates from the 2003 Tax Relief Act are applied, if this income is distributed as dividends to individual shareholders, the tax rate in the second layer may reach fifteen percent and the total effective tax on corporate income is calculated by combining the two layers of tax.

to dividends received from foreign corporations. For instance, dividends received by foreign shareholders from foreign corporations should not be taxed by the United States. But I.R.C. § 861(a)(2)(B) provides that the portion attributable to U.S. business income of the dividend may be treated as U.S. source income if twenty-five percent or more of a foreign corporation’s gross income is U.S. income for the three preceding years. I.R.C. § 861(a)(2)(B) (2003). It is clearly a disposition that carries difficulties in its enforceability. Dividends paid by foreign corporations will be not addressed in this paper.

See I.R.C. § 871(a) (2003) (for individuals); I.R.C. § 881 (2003) (for corporations in general). There are exceptions to this general rule. When the dividends paid are derived from foreign sources (eighty percent or more), there is no tax on that attributable foreign dividend (it is deemed as a foreign corporation paying dividends to foreign shareholders). I.R.C. § 871 (i) (2003). Dividends received by foreign shareholders from “80-20” corporations are not taxed to the extent that such dividends are derived from foreign sources. I.R.C. § 861(c). An “80-20” corporation is a corporation that at least eighty percent of the gross income from all sources of such corporation for the testing period (three-years period ending with the close of the taxable year) is active foreign business income. I.R.C. §§ 861(c), 871(i)(2)(B) (2003); see BITTKER & LOKKEN, supra note 6, para. 67.2.

See BITTKER & LOKKEN, supra note 6, at para. 67.2.3; THOMPSON JR., supra note 6, at 110.

See REVENUE PROPOSAL 2004, supra note 1, at 12. The 2003 TAX RELIEF ACT also did not change the treatment. See 2003 TAX RELIEF ACT, supra note 1.


See 2003 TAX RELIEF ACT, supra note 1; see also infra note 32 and accompanying text.

Dividends are the distributions by corporations to its shareholders, out of its earning and profits. I.R.C. § 316(a) (2003). Besides this general definition, the I.R.C. and Regulations provide other circumstances (e.g., a sale-repurchase transaction), which originates payments, to be treated as dividends. See BITTKER & LOKKEN, supra note 6, at para. 67.2.3, sub-item 1 “Dividends.”

ECONOMIC REPORT 2003, supra note 2, at 202.
Combining the two layers, the tax rate can be as high as 44.75 percent. Domestic corporations receiving dividends from domestic corporations generally are allowed a deduction of seventy percent or more of the amount of dividends received.

The 2003 Tax Relief Act does not directly affect the taxation of dividends paid to foreign shareholders. The major consequence of the 2003 Tax Relief Act was to increase the difference in treatment between domestic and foreign shareholders, mostly to resident shareholders in non-treaty countries. Nevertheless, the effects of the 2003 Tax Relief Act are transitory, and the trend toward tax integration is still alive.

C. Tax Treaties

Income tax treaties are essentially bilateral agreements reflecting mutual accommodations between the tax codes and treasuries of the negotiating countries.

29 Id. The example found in the ECONOMIC REPORT 2003 was based on a 38.6 percent tax rate at the shareholder level, which was changed by the 2003 Tax Relief Act. Under the "old" rates the effective rate was as high as 60.1 percent. It is clear that the amount of relief ("mitigation") that was given to individual shareholders for this case is around fifteen percent (60.1 - 44.75 = 15.35 percent). Furthermore, for lower income taxpayers (taxable at ten or fifteen percent marginal brackets), the tax rate for dividends is five percent (or zero percent in the taxable year 2008), in this case, the mitigation is bigger. I.R.C. § 1(H)(1)(B) (2003). It is worth noting that these provisions will last only until December 31, 2008, according to Sec. 303 of the 2003 Tax Relief Act, and that certain dividends are excluded from the Tax Relief dispositions. I.R.C. § 1(H)(11)(B)(ii) (2003).

30 There are anti-abuse rules to prevent corporations creating capital loss. See JOINT COMMITTEE ON TAXATION, supra note 1, at 18. Additionally, the dividends-received deduction on certain debt-financed portfolio stock is reduced. Id.

31 See 2003 TAX RELIEF ACT, supra note 1.

32 According to the Sec. 302 of the 2003 Tax Relief Act, it was enacted to be in force until December 31, 2008. See 2003 TAX RELIEF ACT, supra note 1.

33 ISENBERGH, supra note 6, para. 101.1; see also BITTKER & LOKKEN, supra note 6, at para. 65.1.6. Tax treaties to avoid double taxation are overwhelmingly bilateral (all treaties to avoid double taxation signed by the U.S. are bilateral). See Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 DUKE L.J. 1021, 1105-1109 (1997). But see generally Yariv Brauner, An International Tax Regime in Crystallization, 56 TAX L. REV. 259 (2003) (analyzing the new trend in international taxation towards multilateral tax treaties); John K. Sweet, Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles, 146
The problem of double taxation is as old as the history of tax jurisdictions. However, solving double taxation by tax treaty is a more recent phenomenon. In the nineteenth century, European countries were the first to enter into tax treaties to avoid double taxation, but there were few treaties. In the twentieth century, mostly after World War I, the number of tax treaties increased as the problem of double taxation became relevant for international transactions. The adoption of income tax by the United States in the beginning of the century increased its need for such treaties.

In 1920, the League of Nations requested a report on double taxation, which led to the first draft of a Model Convention in 1928. After World War II, as international trade increased, the need for such treaties became increasingly evident. In 1963, the Organization for Economic Cooperation and Development (OECD) issued its Model Convention. This OECD Model has been continuously updated. In 1980, the UNO issued the United Nations Model Double Taxation Convention between Developed and Developing Countries. One year later (1981), the United


See MANUEL PIRES, INTERNATIONAL JURIDICAL DOUBLE TAXATION OF INCOME 93 (1989).

From 1894 to 1913 eleven general tax treaties were signed. Id. at 95.

Id. at 95-100.

Hugh Ault affirmed:

The conceptual basis for modern tax treaties developed in the period between the first and second world wars. At that time, international economic relations were developing rapidly, but cross border transactions were impeded by overlapping tax claims, typically those of the country in which the internationally-invested capital originated and the country in which the capital was utilized.

States issued the United States Model Income Tax Convention, which it withdrew in 1992. Four years later, the United States approved the Model Convention of 1996.\textsuperscript{39}

The central focus of these treaties concerns the reduction of double taxation on international transactions executed between individuals and corporations of the treaty nations.\textsuperscript{40} The incidence of double taxation is often ameliorated through treaty provisions permitting tax reductions or exemptions for one country's residents on specific categories of income derived from the other country.\textsuperscript{41} These treaty provisions, when taken in the aggregate, have the effect of reapporportioning tax revenues between the contracting nations.\textsuperscript{42} In this regard, these bilateral treaties often serve an allocating function by shifting tax revenues from the treasury of the income source country to that of the resident country.\textsuperscript{43} Additional benefits of tax treaties include equalizing tax rates,\textsuperscript{44} furthering trade,\textsuperscript{45} and creating an international

\textsuperscript{39} See ROY ROHATGI, BASIC INTERNATIONAL TAXATION 43-44 (2002); see also MODEL CONVENTION, supra note 12.

\textsuperscript{40} ISENBERGH, supra note 6, para. 101.2. It should be noted, however, that the ultimate effectiveness of any future bilateral tax treaty depends upon mutual adherence to the agreement. There has been much concern among U.S. treaty partners regarding Congress's tendency to override treaty provisions through amendments in the Internal Revenue Code. See Detlev F. Vagts, The United States and Its Treaties: Observance and Breach, 95 AM. J. INT'L L. 313, 319-22 (2001). Justification for such action derives from the judicially recognized later-in-time rule, a doctrine which recognizes the superiority of more recent statutes over conflicting past treaty provisions. See id. at 313. Continued violations of double tax treaties by the unilateral actions of U.S. lawmakers will undoubtedly undermine the legitimacy of such agreements and preclude the avoidance of double taxation by international corporations. Id. However, the "scape clause," which allows the United States "to utilize U.S. domestic law to tax its citizens residing in other contracting states as though the treaty were not in effect" is not a treaty override, but a treaty provision. See Doernberg, supra note 11, at 72-73.

\textsuperscript{41} ISENBERGH, supra note 6.

\textsuperscript{42} Id.

\textsuperscript{43} Id. para. 101.3.

\textsuperscript{44} Id. para. 101.2.2. In addition to the revenue shifting effects bilateral treaties often create between the treasuries of partner nations, these agreements also affect the taxation of individuals and business associations investing internationally. Id. Because the income tax rates of the treaty nations usually differ, opportunities to invest in more favorable tax regimes often arise. Id. For example, if the income tax rates in the country of residence are lower than in the country of source, "exemption from tax in the country of source under a treaty improves the tax regime of residents of the other country." Id. The specific provisions contained in bilateral tax treaties are significantly influenced by
enforcement system.\footnote{46} The approaches of the OECD Model and the U.S. models are based on the system of corporate taxation (double level).\footnote{47} An important issue in tax treaties is the differences in the level of integration of corporate taxation in the two countries.\footnote{48}

The United States has entered into bilateral income tax treaties with more than fifty countries in hopes of promoting international trade and investment through the elimination of restrictive tax

the traditional pattern of economic trading between the two nations as developed by their relative bargaining powers. \textit{See id.} para. 101.3. For instance, technology and capital importing countries will most likely negotiate for treaty provisions in which taxes on royalties and licensing fees are imposed in the country of income source. \textit{Id.} On the other hand, those countries that exporters of technology and capital will bargain for terms authorizing taxation by the country of residence on the owner of the exported goods. \textit{Id.} Generally, countries will "prefer one pattern in their treaties with some countries and a different one in others, depending on the balance of flow of capital between them." \textit{Id.}

\footnote{45} \textit{Id.} para. 101.4. A further aim of bilateral tax treaties is the promotion of economic transactions between two countries that might not otherwise be executed due to overly burdensome national taxation. \textit{Id.} The combination of government imposed tax payments and the transactional costs associated with international trading often deter business entities from expanding beyond their national borders. \textit{Id.} Accordingly, treaty provisions concerning the allocation of taxation on business profits is of central importance to the contracting nations. \textit{Id.} In this regard, the concept of "permanent establishment" provides the "threshold of taxation" in bilateral income tax treaties. \textit{Id.} Specifically, a treaty nation will not tax the business profits of an enterprise located in the other nation unless that enterprise conducts business there via a "permanent establishment." \textit{Id.} Treaty negotiations should determine what exactly constitutes a "permanent establishment" in a particular agreement. \textit{Id.; see also} \textit{MODEL CONVENTION, supra} note 12.


\footnote{47} It is clear because, as Hugh Ault noted,"[i]t recognizes the separate right of the source state to tax dividend income in the hands of the investor after imposing a corporate level tax on the profits from which the dividend is paid . . . ." Ault, \textit{supra} note 38, at 569; \textit{see also} \textit{MODEL CONVENTION, supra} note 12, art. 10.

\footnote{48} See Ault, \textit{supra} note 38, at 499-590, 594. Hugh Ault's article deals with the effects of tax treaties, by assuming the U.S. to have adopted the dividend exclusion system and considering two resident countries with opposite views – Germany (integrated corporate tax) and Netherlands (classical system) – and also analyzing both direct and indirect investment. \textit{Id.} at 595-608.
barriers. The most recent agreements largely reflect the provisions found in the model income tax treaty issued by the U.S. Treasury Department in 1996. The U.S. model, a slight variation of the OECD model income tax treaty, serves as the foundation for the Treasury Department when “formulating its initial position in treaty negotiations.” Article 10 of the 1996 Model Convention suggests, in pertinent part, the following rules for taxing dividends:

Article 10. Dividends

1. Dividends paid by a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the payor is a resident and according to the laws of that State, but if the dividends are beneficially owned by a resident of the other Contracting State, except as otherwise provided, the tax so charged shall not exceed:

a) 5 percent of the gross amount of the dividends if the beneficial owner is a company that owns directly at least 10 percent of the voting stock of the company paying the dividends;

b) 15 percent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

It is clear that dividends received by foreign shareholders are taxed in the United States, thereby preserving double taxation, albeit to a more limited degree. Article 10 contains other provisions within its nine subparagraphs that offer explanations and some exceptions to the general rule. In most U.S. treaties, for example, the business profits of a treaty nation resident are not

49 See BITTKER & LOKKEN, supra note 6, para. 65.1.6.
50 See MODEL CONVENTION, supra note 12.
51 See BITTKER & LOKKEN, supra note 6, para. 65.1.6.
52 MODEL CONVENTION, supra note 12, art. 10 (emphasis added).
53 See id.
taxed unless that taxpayer possesses a permanent establishment in the United States.\textsuperscript{54} Further, assuming the taxpayer has a permanent establishment in the United States, only the profits resulting from that permanent establishment are subject to taxation.\textsuperscript{55}

It is also worthy to note that the existence of tax treaties is one of the conditions to tax dividends paid to individuals from foreign corporations at the low rates granted by the 2003 Tax Relief Act.\textsuperscript{56}

This adds to the disadvantage of countries that do not have an income tax treaty with the United States, particularly in terms of investment allocation.

III. The Three Proposals

The current so-called "classical" tax system taxes corporate profits at both the shareholder and corporate level, but corporate profits may be taxed more than twice when distribution is made through multiple unrelated corporations. This system brings inherent distortion that would be avoided if the taxation were integrated. The goal should be efficiency. Integration would reduce three inherent distorted incentives: (1) to invest in unincorporated businesses (such as limited liability partnerships) over corporate businesses; (2) to finance corporate investments with debt rather than new equity (because interest is deductible); and (3) to retain earnings or to structure distributions of corporate

\textsuperscript{54} See BITTKER & LOKKEN, supra note 6, para. 65.1.6. The Technical Explanation to the 1996 Model Convention affirms:

The Model is drawn from a number of sources. Instrumental in its development was the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the 1981 Model") and withdrawn as an official U.S. Model on July 17, 1992, the Model Double Taxation Convention on Income and Capital, and its Commentaries, published by the OECD, as updated in 1995 ("the OECD Model"), existing U.S. income tax treaties, recent U.S. negotiating experience, current U.S. tax laws and policies, and comments received from tax practitioners and other interested parties.


\textsuperscript{55} See BITTKER & LOKKEN, supra note 6, para. 65.1.6

\textsuperscript{56} See 2003 TAX RELIEF ACT, supra note 1.
profits in a manner that avoids double taxation. In order to promote corporate tax integration related to dividends treatment, the dividend exclusion, imputed system, and deduction proposals have been raised.

The discussion on double taxation of dividends is older than the 1992 proposals. It is closely linked to the discussion on debt and equity financing. The other aspect is that corporation and shareholders are different subjects, that is, different persons, and thus subject to tax as such. The judicial view of corporation and shareholder as two different entities supports the concept of double taxation. However, from an economic point of view, the wealth belongs to the shareholders who own the corporation, and they are still being taxed twice for the same wealth. Under this conception, the corporation as a separate entity is only a legal fiction. The discussion is not new. In 1989, the Reporter of the American Law Institute (ALI) had outlined a set of proposals of corporate tax reform to reduce the bias against equity finance; however, it was not an integration proposal.

57 1992 TREASURY REPORT, supra note 2, at vii-viii, 1-14; see also ECONOMIC REPORT 2003, supra note 1, at 202 (explaining that the double level taxation reduces corporate investments and that the high tax on capital may also “discourage risk taking and innovation through its effect on entrepreneurship”); REVENUE PROPOSAL 2004, supra note 1, at 11 (stating that double taxation increases for corporations to engage in transactions for the sole purpose of minimizing their tax liability).

58 Three basic alternatives were proposed by the Treasury Department: (1) the dividend exclusion prototype; (2) the shareholder allocation prototype; and (3) the Comprehensive Business Income Tax (CBIT) prototype. 1992 TREASURY REPORT, supra note 1, at viii. The later two proposals are not limited to dividends. Id. The shareholder allocation prototype was intended to be a system “in which all corporate income is allocated to shareholders and taxed in a manner similar to partnership income” – this option is not acceptable for simplification concerns and also because the inherent complexity of partnership taxation. Id. See generally, Lawrence Lokken, Taxation of Private Business Firms: Imagining a Future Without Subchapter K, 4 FLA. TAX. REV. 249, 285-86 (1999) (explaining that the complexity of partnership tax scheme failed to prevent manipulation in shifting loss and income). The other proposal named CBIT is a very comprehensive model for corporate income tax that will not be analyzed here. The Treasury Department in Part IV also described the imputation credit and the dividend deduction prototype, which will be focused in comparison with the dividend exclusion model. 1992 TREASURY REPORT, supra note 1, at 93-110.

59 See sources cited supra note 1.

60 1992 TREASURY REPORT, supra note 1, at 108; see also CHARLES E. McLUKE, BROOKINGS INSTITUTION, MUST CORPORATE INCOME BE TAXED TWICE? (1979).
The proposed systems eliminate the bias in favor of debt instead of equity financing. However, it happens only at the domestic level; at the international level, the bias still exists due to the fact that the thirty percent withholding tax would not be extinguished. It seems that the 2003 Tax Relief Act, which did not have too much repercussion for foreign shareholders, also did not eliminate that bias internally, regarding the "mitigation" of the taxation at the shareholder's level.

61 As a common feature to the three systems, the withholding tax would still apply to dividends paid by U.S. corporations to foreign shareholders. Professor Doemberg, rebutting the arguments in the 1992 TREASURY REPORT (at 77-80), which supports the same position assumed at the REVENUE PROPOSAL 2004 (supra note 1, at 20, see also JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 32), expressed a different point of view and made some arguments, e.g., that it (non-extension of integration to foreign shareholders) contrasts with the treatment of direct foreign investment made in the U.S. by a sole proprietor, partner or joint venturer (with only one level of taxation). He also stated that the argument that the extension of the integration to foreign shareholders would benefit only the foreign tax administrations and not the foreign investor is not completely valid, arguing that there are other areas where the U.S. has unilaterally extended tax reductions to nonresidents (e.g., portfolio interests exemption), and that experience suggests that the foreign investors would route investments into the U.S. through third countries to avoid or mitigate residence-state taxation. Professor Doemberg stated: "The increase in U.S. corporate capital, the decrease in the use of debt, more optimal corporate distribution policies, and an overall economic welfare gain all argue for unilateral integration benefits for foreign as well as U.S. shareholders." See Richard L. Doemberg, International Aspects of Individual and Corporate Tax Integration, 4 TAX NOTES Int'l 535, 538-539 (1992). However, it does not appear that there are any constitutional or statutory law problems in the United States that would bar Congress from denying the benefits of integration to foreign shareholders. See McNulty, supra note 1, at 247-48 (based on Professor Doemberg's conclusions)

62 See supra notes 1 and 33 and accompanying text. A good approach of the measurement of the effect that "mitigation" at the shareholder level, shifting the equilibrium point between equity and debt capitalization under the 2003 Tax Relief Act, was presented by Anthony P. Polito as follows: "To the extent that the old view of dividend distributions is accurate and dividends are taxed at the ordinary rate p[personal income tax rate], it necessarily drives up the effective shareholder-level tax on equity, and shifts the equilibrium of tax rates to favor debt capitalization. Even the taxation of dividends at capital gains rates, as temporarily imposed by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 302-303, 117 Stat. 752, 760-64, does not eliminate the bias unless, at the margin, c [corporate tax rate] is significantly lower than p. For a tax rate of thirty-five percent for interest income, and a fifteen percent tax rate for dividends, equity is favored only for corporate tax rates below approximately 23.5 percent. Even for a tax rate of forty percent for interest income, equity is favored only for corporate tax rates below about 29.4 percent. For most publicly traded corporations, the marginal corporate tax rate is thirty-four percent. I.R.C. 11(b)
A. Dividend Exclusion System

The first proposal to be examined is dividend exclusion. The dividend exclusion system would remove the double taxation of corporate dividends by allowing the corporation to continue to pay tax on its income at the regular rate schedule\(^\text{63}\) and to allow shareholders to exclude the dividends received\(^\text{64}\) from their tax basis.

Dividend exclusion is more complicated than it might seem. The system is designed to allow the exclusion only if the company has paid tax on its taxable income in order to avoid double taxation.\(^\text{65}\) This means that the amount of the dividends paid by a corporation will not match up with its credited amount — called the Excluded Dividend Amount (EDA) — because EDA takes into consideration the alternative minimum tax payment (AMT) and U.S. income taxes on foreign source income (which may be offset by foreign tax credits).\(^\text{66}\) Calculation of EDA is also based on the previous years’ income taxes. Therefore, income taxes shown in

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\(^{63}\) For this purpose, the income tax includes the taxes imposed on corporation by I.R.C. § 11 (corporate income tax), § 5 (alternative minimum tax), § 511 (unrelated business income tax), etc. See JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 19.

\(^{64}\) “For a distribution to be an excludable dividend, it must be a dividend under current law, i.e., out of earnings and profits.” REVENUE PROPOSAL 2004, supra note 1, at 15. But a corporation may alternatively permit its shareholders to increase the basis in their stock, if dividend distributions are less than the Excludable Dividend Amount (EDA). Id.

\(^{65}\) The Joint Committee on Taxation came up with the following description of the proposal (as set forth in H.R. 2 – introduced by Chairman Thomas, and S.2 – introduced by Senators Nickles and Miller on February 27, 2003):

Under the proposal, the excludable portion of any dividend received by a shareholder is not included in gross income. The excludable portion of any dividend is the portion of the dividend which bears the same ratio to the dividend as the amount of the corporation’s EDA for a calendar year bears to all dividends paid by the corporation during the calendar year. The EDA, as discussed below, generally measures the corporation’s fully taxed income reduced by taxes paid. In addition, shareholders are allowed to increase the basis in their income stock to the extent the EDA exceeds the dividends paid by the corporation during the calendar year. These rules apply to both individual and corporate shareholders.

JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 18.

\(^{66}\) See REVENUE PROPOSAL 2004, supra note 1, at 13-14.
tax returns filed in Year 1 will be used to compute the EDA for Year 2. The EDA will be determined for each year based on the formula: $\text{EDA} = \frac{(\text{U.S. income taxes before foreign tax credit})}{(0.35)} - (\text{U.S. income taxes}).$ For corporate shareholders, an excludable dividend received by a U.S. corporation will not be taxable and will increase the recipient corporation's EDA, remaining excludable even when redistributed by the recipient corporation to its shareholders.

Despite being a controversial issue, dividend exclusion is not a new concept. Many countries already have a dividend exclusion system in place. For example, Germany and Luxembourg provide fifty percent dividend exclusions to individuals (thus, if $1,000 in dividends is received, only $500 is taxed) and Greece provides a one hundred percent exclusion (fully exempting dividends from individual taxation).

The dividend exclusion proposal seems to be gaining great support throughout the United States, especially in the Bush Administration. In January 2003, President Bush proposed the creation of dividend exclusions because of his belief that eliminating the double taxation of dividends would provide a strong boost to the economy by injecting cash into the economy and cutting capital costs to businesses. However, Congress did not approve the proposal, but rather the 2003 Tax Relief Act.

B. Imputation System

The second proposal to be examined is imputation. Under the imputation system, a company pays tax on its taxable income. After dividend distribution, the shareholder rebuilds the basis by adding the tax paid by the corporation to the dividend received. A shareholder's tax liability is computed by applying the shareholder's marginal rate on the grossed-up amount of the dividend and then applying the amount paid by the corporation as

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67 Id.
68 Id.
69 See id. at 20.
71 See 2003 TAX RELIEF ACT, supra note 1.
a tax credit.\textsuperscript{72} The credit is nonrefundable, meaning that it will only reduce the taxpayer's tax liability to zero.\textsuperscript{73}

For example, under the previous tax rates for dividends,\textsuperscript{74} Corporation A has taxable income of $100. Assuming a thirty-five percent corporate tax rate, Corporation A would pay a tax of $35 with $65 remaining for distribution. In our present system, Shareholder B, the sole shareholder, would then receive the $65 as a corporate dividend, subject to Shareholder B's tax rate (here, 38.6%), leaving after-tax income to the shareholder of $39.91. The result is a double taxation rate exceeding sixty percent, in the aggregate, of the original $100 earned by Corporation A.\textsuperscript{75}

Compare this to the imputation system. Corporation A has the same taxable income, pays the same tax rate, and pays the remainder ($65) as a dividend to its sole shareholder, Shareholder B. But now the dividend is grossed-up by the amount of tax paid by Corporation A of $35, providing a total grossed-up dividend of $100 to Shareholder B. The grossed-up dividend would then be subject to Shareholder B’s tax rate (again, 38.6%), creating a tax liability of $38.60. This tax liability is then offset by a credit in the amount paid by Corporation A as tax ($35), reducing Shareholder B's net tax liability on the dividend to $3.60. This leaves Shareholder B with $61.40 of the original $100 net income of Corporation A, a single aggregate tax rate of 38.6%.\textsuperscript{76}

\begin{itemize}
\item\textsuperscript{72} This is similar to the American Law Institute (ALI) shareholder imputation credit proposal that “ultimately eliminates the corporate-level tax by allowing payment of the corporate tax to provide a credit when shareholders receive distributions and are taxed on them.” McNulty, \textit{supra} note 1, at 202.
\item\textsuperscript{73} See 1992 \textit{TREASURY REPORT}, \textit{supra} note 1, at 95.
\item\textsuperscript{74} Referring to acts prior to the 2003 Tax Relief Act, see sources cited at \textit{supra} note 1 and accompanying text.
\item\textsuperscript{75} Present System:
\begin{center}
\begin{tabular}{ll}
Corporation level: & \\
Taxable income: & $100.00 \\
Minus tax @ 35%: & - $35.00 \\
& $65.00 Dividend paid \\
Individual level: & \\
Dividend received: & $65.00 \\
Minus tax @ 38.6%: & - $25.09 \\
& $39.91 Net benefit to individual
\end{tabular}
\end{center}
\item\textsuperscript{76} Imputation System:
\end{itemize}
After the 2003 Tax Relief Act, assuming the fifteen percent rate for qualified dividends, the same example would leave the shareholder with $55.75 without the imputation system. Also considering the 15 percent dividend income tax rate but with the imputation system in force, it would leave the shareholder with $65. It seems that this system is not workable when the second

<table>
<thead>
<tr>
<th>Corporation level:</th>
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<tr>
<td>Taxable income:</td>
<td>$100.00</td>
<td></td>
</tr>
<tr>
<td>Minus tax @ 35%:</td>
<td>- $35.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$65.00 Dividend paid</td>
<td></td>
</tr>
<tr>
<td>Individual level:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend received:</td>
<td>$65.00</td>
<td></td>
</tr>
<tr>
<td>Grossed-up by Corp.'s tax:</td>
<td>+$35.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$100.00 Grossed-up dividend</td>
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<tr>
<td>Grossed-up dividend:</td>
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<tr>
<td>Minus tax @ 38.6%:</td>
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<td>Plus credit for Corp.'s tax:</td>
<td>+$35.00</td>
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<td></td>
<td>$3.60 Tax payable by individual</td>
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<td>Dividend received:</td>
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<td></td>
</tr>
<tr>
<td>Minus tax payable:</td>
<td>- $3.60</td>
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<tr>
<td></td>
<td>$61.40 Net benefit to individual</td>
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77 See sources cited supra notes 1, 24 and 33.

78 Present System:

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</thead>
<tbody>
<tr>
<td>Taxable income:</td>
<td>$100.00</td>
<td></td>
</tr>
<tr>
<td>Minus tax @ 35%:</td>
<td>- $35.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$65.00 Dividend paid</td>
<td></td>
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<tr>
<td>Individual level:</td>
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<td></td>
</tr>
<tr>
<td>Dividend received:</td>
<td>$65.00</td>
<td></td>
</tr>
<tr>
<td>Minus tax @ 15%:</td>
<td>- $9.75</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$55.25 Net benefit to individual</td>
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79 Imputation System:

<table>
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<tbody>
<tr>
<td>Taxable income:</td>
<td>$100.00</td>
<td></td>
</tr>
<tr>
<td>Minus tax @ 35%:</td>
<td>- $35.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$65.00 Dividend paid</td>
<td></td>
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</tbody>
</table>
level of taxation (shareholder) is taxed under lower tax rates than the first level (corporation). In such a situation, the result would be the same as an exemption to received dividends. The imputation method may be implemented using a credit limitation system, "in which tax is collected only at the shareholder level on distributed preference income," similar to the dividend exclusion method.80

C. Deduction System

The third proposal is the deduction system, which is quite simple. Under this system, interest and dividends would both be deductible, thereby reducing or eliminating the corporation’s taxable income.81 In other words, the income that flows through the corporation to the shareholders would only be taxed at the shareholder level as ordinary income. If a corporation distributes all net income as dividends, then the corporation would not be taxed, and only the shareholders would be taxed at the shareholder level.82 As a result, there would be only one level of taxation.

Individual level:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received</td>
<td>$ 65.00</td>
</tr>
<tr>
<td>Grossed-up by Corp.'s tax:</td>
<td>+$ 35.00</td>
</tr>
<tr>
<td></td>
<td>$ 100.00 Grossed-up dividend</td>
</tr>
<tr>
<td>Grossed-up dividend</td>
<td>$ 100.00</td>
</tr>
<tr>
<td>Minus tax @ 15.00</td>
<td>- $ 15.00</td>
</tr>
<tr>
<td>Plus credit for Corp.'s tax:</td>
<td>+ $ 35.00</td>
</tr>
<tr>
<td></td>
<td>$ 20.00 Tax credit (not refundable)</td>
</tr>
<tr>
<td>Dividend received</td>
<td>$ 65.00</td>
</tr>
<tr>
<td>Minus tax payable</td>
<td>- $ 0.00</td>
</tr>
<tr>
<td></td>
<td>$ 65.00 Net benefit to individual</td>
</tr>
</tbody>
</table>

80 Instead of adopting a compensatory tax system "in which a tax, creditable by shareholders, is collected at the corporate level on distributed preference income," the decision considered the factors of "not... eliminat[ing] the corporate level tax on earnings distributed to tax-exempt and foreign shareholders and not... treat[ing] identically U.S. corporate level taxes paid and foreign taxes on corporations’ foreign source income." 1992 TREASURY REPORT, supra note 1, at 97.

81 See 1992 TREASURY REPORT, supra note 1, at 107.

82 In a limit case, where all the shareholders of a certain corporation are exempt, and all the net income is distributed as dividends, then there will no tax to collect. This
The rationale for the deduction system is that it results in "equivalent treatment for debt and equity and that it taxes distributions at the shareholder rate."\(^8\) It was not fully considered by the 1992 Treasury Report because it produces results contrary to the general recommendations of the Department of Treasury.\(^8\) The report states that integration should not be an occasion to eliminate the corporate level tax "imposed under current law on distributions to tax-exempt and foreign shareholders" because of its results, and also because a dividend deduction would be more expensive than either a dividend exclusion or imputation credit system.\(^8\)

IV. The Three Alternatives Compared

The exclusion, imputation, and deduction proposals share one outcome – eliminating double taxation – but they differ in complexity and application. Further, the effects of tax treaties upon the three proposals cause different outcomes to occur as well. To show the different outcomes, it is helpful to compare the proposals in the context of passive investment by foreign shareholders.

A. Comparison Without Tax Treaties

1. Dividend Exclusion System

Under the proposed dividend exclusion system, foreign shareholders will be subject to a thirty percent withholding tax\(^8\) on dividends received, whether or not the dividends are excludable.\(^8\) The Joint Committee on Taxation said that "[i]n the type of situation works against the deduction system.

\(^8\) However, the equivalence is not perfect because interest is deductible when it accrues and dividends are deductible when they are paid. See 1992 Treasury Report, supra note 1, at 107.

\(^8\) Id.

\(^8\) Id.

\(^8\) The withholding tax will also apply to distributions from CREBA, but will not apply to Retained Earnings Basis Adjustment (REBA). See Revenue Proposal 2004, supra note 1, at 20. "REBA allocable to stock held by a foreign shareholder will not increase the basis of the foreign shareholder’s stock. Id. Any distributions to an origin shareholder from CREBA will not decrease the foreign shareholder’s stock basis.” Id.

\(^8\) See id.; see also Joint Committee on Taxation 2003, supra note 1, at 32. It is
case of foreign shareholders, withholding taxes applies to all dividends and distributions received from Cumulative Retained Earnings Basis Adjustment (CREBA). Dividends are not treated as excludable and basis adjustments are not made with respect to stock held by foreign persons.98

U.S. corporations paying dividends will be taxed at the corporate level. Thus, under this system there will no change for foreign shareholders.89 A foreign corporation that has U.S. shareholders and receives dividends from one or more U.S. corporations, however, will have to maintain the proper accounts (for computations and distributions of EDA and CREBA) and make the computations and allocations if it wishes to pay excludable dividends to its shareholders or allocate basis adjustments to them.90 This requirement that the foreign shareholders continue to maintain the financial allocations shows that the enforcement of the dividend exclusion policy is a difficult issue.

2. Imputation System

Under the imputation credit system, foreign shareholders would remain subject to two levels of U.S. tax, simply because imputation credits would not be available to foreign shareholders. Thus, current withholding of taxes would be applied.91

also in accordance with the position expressed by some scholars, that “[i]ntegration should be extended to foreign shareholders only through treaty negotiations, not by statute” and that “[d]ividend exclusion would most likely not be extended to foreign shareholders, nor would it treat foreign taxes paid by United States corporations the same as taxes paid to the United States, except by treaty negotiations.” John Livingston, Corporate Tax Integration in the United States: A Review of the Treasury’s Integration Study, 58 Mo. L. Rev. 717, 721, 724 (1993).

88 See JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 22.

89 One may say that there is a change related to the U.S. branch of a foreign corporation that is subject to regular income tax on income effectively connect with U.S. trade or business and the “branch profits tax”. See BITTKER & LOKKEN, supra note 6, at para. 76.1; see also Ault, supra note 38, at 605-06 (comparing the effects of taxation the Netherlands, a country which also adopts the double corporate taxation; the effect is a final tax rate as high as 81.5 percent for the foreign shareholder, which is clearly a “prohibitive” rate).

90 See JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 33.

91 “Neither approach [dividend exclusion and imputation credit] would treat inbound investment more harshly than under current law, because deferral of the second level of tax would continue.” 1992 TREASURY REPORT, supra note 1, at 80.
In other words, the rules that domestic law can impose on domestic shareholders to calculate the imputed credit (which corresponds to tax paid at corporate level) cannot be applied to foreign shareholders. Foreign shareholders are subject to a thirty percent withholding tax and to their own tax jurisdictions. To extend the benefits of the integration under the imputation system to foreign shareholders while keeping the withholding tax intact would require the withholding tax rate to take into consideration the income tax rate of each shareholder's country. As a result, the withholding tax rates would have to be the difference between the income tax rates of the shareholder's country and the U.S. corporate tax rate. It is obvious that such a method is completely unfeasible.

3. Deduction System

In the case of a dividend deduction, the corporation would be allowed the dividend deduction, but the foreign shareholder would be subject to the thirty percent withholding tax. In this case, the final result of the system would be preserved, considering that the thirty percent flat rate is roughly equivalent to the net basis and graduate rates paid by national shareholders.\(^9\) On the other hand, in order to maintain the current tax burden on foreign shareholders, the withholding tax rate would have to represent the amount paid at the corporation level plus thirty percent. To maintain parity with dividend reduction for domestic corporations, the branch profits tax on domestic branches of foreign corporations presumably would be modified.\(^9\)

Thus, one can say that without considering tax treaties, and assuming that the effects of integration would be extended to foreign shareholders, the deduction method would not bring

\(^9\) However, this affirmation is not completely true if one considers the individual shareholders. Under the current levels of tax rates for dividends (2003 Tax Relief Act), if a deduction system were adopted without restrictions, foreign individual shareholders would still paying more tax than domestic ones, due to the withholding thirty percent tax, while internal tax rate is fifteen percent or lower. See sources cited supra notes 1, 24 and 33.

\(^9\) Id. at 107; see also sources cited supra note 14. Richard L. Doernberg sustained: "An extension of the benefits of integration to nonresidents logically entails the elimination of the branch profits tax, which was enacted to take the place of a second-tier withholding tax on dividends paid from a corporation to its shareholders." See Doernberg, supra note 61, at 540.
problems; instead, it would make the system simpler (as is easy to see in a hypothetical situation where there would be only foreign shareholders). Considering that it is not the goal of the integration of corporate tax proposal to give relief to foreign shareholders, if this method was adopted, it would be necessary to create a rule to deny deduction for dividends paid to foreigners and to maintain the thirty percent withholding tax. The problem is that the suggested rule easily would be avoided by using a third party national to intermediate the gains.

B. Effects of Tax Treaties

The adoption of an integrated corporate tax system may upset (or offset) the balance of interests that are contained in the tax treaties signed by the United States. Specifically, traditional treaty rules reflect an allocation of revenue based on the classical, two-tier system for corporations and shareholders: the source country generally has the exclusive right to tax business profits earned therein by a domestic corporation and the two countries divide the right to tax profits when distributed, with the greater share of this revenue going to the residence country. Integration, of course, alters the original pool of tax revenue by decreasing the total (assuming no offsetting rate increases) and by reallocating it between the shareholder and corporation.94

The Department of Treasury recommended that foreign shareholders not be granted benefits of integration received by U.S. shareholders, except through treaty negotiation, arguing that most of the trading partners of the United States that have adopted similar systems of integrated corporate tax have followed the same approach.95 Although the Department of Treasury’s rationale may be correct, it is important to remember that the exemption for interests paid to foreign investors was a consequence of “market pressure” – specifically, a mechanism to attract foreign investment – and it was done by means of a statute. This kind of “market pressure” is likely to affect dividends as well.

The branch profits tax96 could be considered a violation of tax

94 1992 TREASURY REPORT, supra note 1, at 80.
95 See id. at 16, 74; see also sources cited supra note 79.
96 See sources cited supra note 24.
treaties as a consequence of the adoption of the integrated tax system, which reduces to one level the taxation on corporations. The question arises because the tax is imposed on a foreign corporation’s branch (a permanent establishment), and not on the foreign establishment. Article 24, Paragraph 2 of the 1996 Model Convention states:

The taxation on a permanent establishment or fixed base that a resident or enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises or residents of that other State carrying on the same activities.  

Thus, the difference of treatment between the national corporation and the permanent establishment or fixed base (branch) that a resident or enterprise of another country has in the United States should be considered a violation of the treaty. But Article 10 of the 1996 Model Convention explicitly allows this treatment as to dividends, resulting in no violation. If an income tax treaty does not have a similar clause, there would be a conflict (a violation of the treaty), but the most recently enacted law — here the tax treaty — would prevail.

1. Dividend Exclusion System

The proposed dividend exclusion system should be integrated into tax treaties because it permits the source country the ability to retain its corporate tax revenue. Thus, the U.S. companies that pay dividends could be taxed only at the corporate level, the withholding tax could be eliminated or reduced in distributions to treaty residents, and the shareholder’s country could credit the source country’s taxes in order to calculate the shareholder’s tax liability.

2. Imputation System

Under this system, foreign shareholders would be subject to current withholding taxes, but the tax treaty would give some relief — five or fifteen percent, depending on the shareholder,
instead of thirty percent to other countries. The tax at the corporate level would also be retained, making this system suitable to the current tax treaties.

There are some questions about this position. Some have concluded that refusing to extend by statute the imputation credit to foreign shareholders would violate the treaties. However, the reason that the system does not violate the treaties, which is also valid regarding the dividend exclusion system, is that no treaty requires that foreign shareholders receive the same tax credits as domestic shareholders, because “allowing or denying the imputation credit to the shareholders is an issue of how to tax the shareholder, not the corporation.”

Reducing the withholding tax rate for foreign shareholders also is suitable to the current system because it would roughly represent an approximation of the actual tax burden. However, if the intent were to extend the integration to other countries by allowing the foreign shareholder to use the income tax paid by U.S. corporations as credit against the domestic tax, there are further considerations. In this specific case, this “total integration system” would be feasible only if the other country also has adopted an integrated system similar to the one adopted by the United States. Otherwise, depending on the foreign income tax rates, it would create unfair discrimination to the foreign country’s taxpayers.

3. Deduction Method System

In the case of dividend deductions, the corporation would be allowed a dividend deduction, but the foreign shareholder would be subject to a thirty percent withholding tax. Bearing in mind that tax treaties may reduce the tax rates to as low as five or fifteen

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102 See, e.g., sources cited supra note 69; see also Ault, supra note 38, at 597-99 (analyzing the U.S.-Germany case (Germany adopts the imputation system); German taxpayers are allowed to gross up the basis and credit the foreign paid tax (withholding) against the tax due in Germany). The described mechanism for relief is the classical allowance of the source country withholding tax as credit for the foreign shareholder. However, in the present case, to grant the fully integration of corporate tax, the credit would be the tax paid at the corporation level to the source country, and without withholding tax at distribution to foreign shareholder. Otherwise, it would be the just the same “classical system”, and the treaty would only be giving some tax relief by reducing the rate of the withholding taxation.
percent, and also considering the deductibility of dividends paid, this method would lead to a considerable reduction of the tax burden. For instance, a corporation that pays dividends corresponding to all net income would not be taxed, and if the foreign shareholder recipient of the dividends is a company that directly owns at least ten percent of the voting stock of the company paying the dividends, the foreign shareholder would pay only five percent on the dividends received, without internal taxation.103

Considering the tax treaties and other forms of tax relief, the deduction method may yield considerable tax breaks, almost equivalent to an exemption at both levels (corporate and foreign shareholder). Also, under this method, there will be only one level of taxation for dividends paid. If the aim of the proposal is to not provide any relief to foreign shareholders, then it would be necessary to adopt a rule to deny deduction for dividends paid to foreigners, but to keep the thirty percent withholding tax (which may be reduced by treaty provisions). It seems that such a rule (one with no allowance for dividend deductions), however, would violate the tax treaties obligations.104

V. Conclusion

According to the proposal, foreign shareholders may not get a tax break as a result of the integration of corporate tax. Indeed, the system that was proposed (dividend exclusion) is consentaneous with this idea. Thus, if the thirty percent withholding tax for foreign shareholders is preserved, there will be no direct impact on foreign shareholders—taxation will change only for domestic shareholders.

Of the three proposals analyzed in this article, only the dividend deduction model would bring the undesirable effect of a tax break to foreign shareholders. Therefore, this model should be avoided. The other two models, dividend exclusion and imputation system, do not create this problem because they preserve the taxation at the corporate level. Both the dividend exclusion and imputation systems create this desired effect and do not reduce the tax level of foreign shareholders, but the imputation

103 See supra Part II.C.
104 See 1992 TREASURY REPORT, supra note 1, at 80.
system is more complex. Thus, the preferred method of integration is the dividend exclusion.

However, no matter which system of integration is used, there will be an indirect impact on foreign shareholders. Once implementation has been achieved, U.S. companies may change their equity strategies and corporate structures to take advantage of the increase in equity investments. As a result, the stock market will be more profitable and attract more foreign investors. However, the bias favoring debt over equity, even at the international level, will continue to exist because dividends paid to foreign shareholders are still taxed at the second level (thirty percent flat tax). Thus, while the proposed system eliminates the bias internally, it does not have the same result at the international level. As a result, there is no capital import neutrality because investments within the United States will be more heavily taxed if owned by foreign shareholders than domestic shareholders.\(^\text{105}\)

Keeping the second level of taxation for foreign shareholders, however, is inefficient from an economic standpoint.\(^\text{106}\) It will cause foreign investment to be allocated in sheltered forms simply to avoid the withholding tax.\(^\text{107}\) Thus, if the aim of the proposal

\(^{105}\) The Joint Committee on Taxation determined that:

The proposal is not neutral with respect to the source of investment fund. That is, the proposal generally would not change the after-tax return to investment by foreign persons. Therefore, some observe that to the extent that foreign persons are an important source of marginal investment capital there would be no incentive to increase aggregate investment in the United States.

JOINT COMMITTEE ON TAXATION 2003, supra note 1, at 32; see also McNulty, supra note 1, at 243-47.

\(^{106}\) One well-respected commentator concluded that:

Unless the integration system in the United States did extend its benefits to foreign shareholders and foreign taxes, the result would be undesirable economic and legal effects. . . . Presumably the governments of trading partners of the United States would object to this differential treatment of foreign taxes and foreign shareholders. Doing away with these effects would tend to promote ‘the efficient international allocation of capital’ and hence ‘would maximize economic welfare.’

McNulty, supra note 1, at 237.

\(^{107}\) "Multinational corporations will undoubtedly attempt various devices to maximize the allocation of EDA to U.S. shareholder distributions and to minimize its allocation to foreign distribution." Lorenz L. Bravenec & Fred Feucht, The Bush
was to make the system more neutral in terms of "capital import neutrality," the better option would be to extinguish the thirty percent withholding tax to foreign shareholders, giving them the same treatment that is given to domestic shareholders – that is, only one level of taxation.\(^{108}\)

Taking into consideration the existing treaties, which were negotiated under the classic double level of taxation on dividends, it can be said that the dividend exclusion and the imputation system would be feasible and may be integrated into the current tax treaties. But, in the case of the dividend deduction system, it would have as a consequence a reduction of the tax burden. Because the remedies for avoiding this reduction may violate tax treaty dispositions, this system shall not be accepted.

Tax treaties should extend the integration model to their parties as a matter of tax policy. However, assuming tax treaties are a strong tool for making trade policy and taking into consideration issues like reciprocity and the entire economic effect of the treaty, it seems that the decision whether to tax foreign shareholders involves more than simple economic analysis but also trade and political issues.

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\(^{108}\) Ten years ago (1994), Professor McNulty said:

If and when the United States adopts some form of integration or dividend relief, it will be doing so in an international context in which it should extend its domestic integration benefits to foreign income taxes and to foreign shareholders. Preferably unilaterally (by statute), as it has done with the foreign tax credit, for reasons of international comity and leadership, economics neutrality, and to induce and encourage other countries to follow this modern, selfless approach.

McNulty, supra note 1, at 250.