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Corporate Tax Integration in the United States: A Review of the Treasury's Integration Study

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Comment

Corporate Tax Integration in the United States: A Review of the Treasury's Integration Study*

I. INTRODUCTION

Tax system integration is not a new concept, but it has recently received an increased amount of discussion in the tax community. As used in this article, tax integration describes the concept of unifying the corporate and individual tax systems in order to insure that corporate income is taxed only once. Congress and others in the tax community are again considering whether or not the United States should integrate these two tax systems.

Whether to integrate is only the beginning of the debate. The determination of which detailed mechanism to be used to achieve integration is a significant decision with far-reaching effects and implications to the economy, the business community, and the government.

On January 6, 1992, the Treasury released its study on subchapter C[1] reform entitled, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once*,[2] (hereinafter "Integration Study"). The Integration Study discusses the need for integration, four integration prototype mechanisms,[3] and the policy recommendations to be considered for any integration mechanism that may eventually be adopted. The Integration Study

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1. Subchapter C, entitled "Corporate Distributions and Adjustments," comprises sections 301-385 of the Internal Revenue Code (hereinafter "I.R.C.") (Title 26 of the United States Code). Subchapter C utilizes the entity concept and thus treats corporations as separate taxpaying entities.

2. Treasury Department Report, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once*, (4 DTR G-2 SpSupp, 1/7/92) (hereinafter "Integration Study"). This study was required by Congress in the Tax Reform Act of 1986, Pub. L. No. 99-514, § 634, 100 Stat. 2282 (1986) (*codified at* 26 U.S.C. § 170 (1988)).

3. Integration Study, *supra* note 2, at v. The four integration prototype mechanisms discussed in the Integration Study are not exhaustive. They were selected by the Treasury to promote discussion. *Id.*

is not intended to be a legislative proposal, only to encourage further educated discussion of tax system integration.[4]

Part II of this Comment summarizes the current tax system in the United States and discusses some of its flaws. Part III will summarize the integration prototypes and discuss their impact on distortions of the double tax regime in light of general policy recommendations contained in the Integration Study. Part IV will be devoted to discussing various tax commentators' views on the subject of integration, and the paper will conclude with comments and conclusions concerning tax system integration in the United States.

II. THE UNITED STATES TAX STRUCTURE AND THE NEED FOR REFORM

A. Current United States Tax System

The tax system utilized by the United States is generally referred to as a "classical [tax] system."[5] This classical system imposes tax on distributed corporate income at least twice. The first tier of tax is at the corporate level on corporate earnings.[6] The second tier is at the shareholder level; distributed corporate profit, in the form of dividends, is again taxed.[7] Distributions that are made between multiple unrelated corporations can possibly be taxed more than twice.[8]

The concept of double taxation is easily illustrated. Corporate income is currently taxed at a maximum rate of 35%.[9] Any dividend to noncorporate shareholders could be subjected to tax at the maximum individual rate of 39.6%,[10] for a combined effective tax of 60.74%.[11]

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4. *Id.*

5. Alvin C. Warren, Jr., *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 719 (1981).

6. *See* I.R.C. § 11 (1988).

7. *See* I.R.C. § 61(a)(7) (1988).

8. Integration Study, *supra* note 2, at vii. Corporate profits distributed as dividends to corporate shareholders could be subjected to three levels of tax; once when earned, a second time when received as dividends by the corporate shareholder, and again when distributed to the ultimate noncorporate shareholder. This multiple taxation is partially alleviated by the dividend received deduction available to corporate shareholders under § 243 of the Internal Revenue Code. Corporate shareholders can deduct 70%, 80%, or 100% of their dividends received depending on their ownership interest in the distributing corporation. *See also* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 173 (1991).

9. *See* 1993 Omnibus Budget Reform and Reconciliation Act.

10. *See* I.R.C. § 1(a)-(h) (as amended in 1993).

Comparatively, any other income generated by an individual, even in a similar business activity using the partnership or sole proprietorship form, is subject to only one tier of tax.

B. Tax System Distortions

The current double tax regime in the United States is undesirable because it distorts financial decisions of taxpayers in the marketplace. The system of double taxation causes decisions to be based, in whole or in part, on tax considerations, rather than on fundamental economic considerations.[12] According to the Integration Study, the primary corporate financial decisions that are distorted by tax considerations are: "(1) whether to invest in noncorporate rather than corporate form, (2) whether to finance investments with debt rather than equity, and (3) whether to retain rather than distribute earnings."[13]

Distortion of these decisions can lead to inefficiencies and instabilities in the economy of the United States. The Integration Study states, "The bias against corporate sector investments compared with investments in the noncorporate sector reduces the productivity of the nation's capital investments and reduces potential national income."[14] Individuals who are cognizant of the additional tax burden on corporate earnings may be motivated to invest or operate in noncorporate forms of business. Tax consequences should not be the overriding factor when one considers investment or form of business. The tax consequences should be neutral,[15] rather than determinative.

Debt financing (financing through borrowing from a lender or issuance of corporate bonds) is generally less costly to corporations than equity financing[16] (financing through equity interests (i.e., stock)). The primary reason for this variance is that interest paid on debt financing is deductible by

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11. This combined effective tax percentage is illustrated as follows: $100 of income at the corporate level is subject to 35% tax, or $35. This theoretically allows $65 to be distributed to shareholders as dividends. The $65 would be subject to the maximum shareholder rate of 39.6%, or another layer of tax equal to $25.74. Thus, the original $100 of income was first subjected to $35 of tax, then $25.74 for a combined tax of $60.74 on $100, or 60.74%.

12. Integration Study, *supra* note 2, at 3.

13. *Id.*

14. *Id.* at 4.

15. *Id.* at 12. Tax neutrality is one of the main goals of integration as stated in the Integration Study. *Id.* At present, tax consequences make the noncorporate forms of business (e.g., partnerships, subchapter S corporations, limited liability companies, and sole proprietorships) popular, in large part due to the avoidance of the double tax levied on corporate income.

16. *Id.* at 6.

the corporation,[17] while dividends paid on equity are not deductible. This disparity has led to a trend in the United States for corporations to repurchase substantial amounts of equity and utilize debt financing as an alternative.[18] This trend has led to a postwar high in corporate net interest expense in 1990, equaling nineteen percent of corporate cash flow.[19] These relatively heavy debt burdens may weaken some corporations' financial stability to such an extent that they are forced into federal bankruptcy courts.[20]

Corporations may also be motivated to retain earnings or structure distributions in a manner that avoids the double tax.[21] A retained earnings strategy dictates that "corporate profits are not distributed as dividends, but retained and reinvested in the business for growth, with shareholders ultimately realizing the resulting stock appreciation on disposition of their shares."[22] This strategy is most popular when the capital gains rate is favorable to shareholders and the corporate tax rate is lower than the individual tax rate.[23]

Corporate distributions may also be structured so that earnings are paid out as deductible interest, rather than nondeductible dividends. The best way to accomplish this goal is to replace equity (corporate stock) with debt (corporate bonds).[24] Corporations have increased their share repurchases from $1.2 billion (or 5.4% of dividends) in 1970 to $47.9 billion (or 34% of dividends) in 1990.[25] In "1990, over one-quarter of corporate interest payments were attributable to the substitution of debt for equity through share repurchases."[26]

Double taxation is also faulted with disrupting the general policies of tax equity and administrative simplicity for the tax system.[27] An environment of tax inequity among taxpayers results from the violation of the economic principle of horizontal equity. Horizontal equity is the concept that similarly

17. *See* I.R.C. § 163 (1988).

18. Integration Study, *supra* note 2, at 8.

19. *Id.* at 10.

20. *Id.* at 11.

21. *Id.* at vii.

22. CURTIS J. BERGER & PETER J. WIEDENBECK, CASES AND MATERIALS ON PARTNERSHIP TAXATION § 1.01 (1989). *See also* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.02, at 1-4 (5th ed. 1987).

23. BERGER & WIEDENBECK, *supra* note 22, § 1.01.

24. Integration Study, *supra* note 2, at 18.

25. *Id.* at vii.

26. *Id.*

27. Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons From the Past and a Proposal for the Future*, 10 VA. TAX REV. 237, 242 (1990).

situated individuals pay like amounts of tax. The principle of horizontal equity is violated by double taxation, because an individual's stock investment results in income potentially being exposed to an effectively higher rate of tax of 60.74%, as opposed to the maximum 39.6% individual rate of tax endured by other investments.[28] The policy of administrative simplicity is thwarted when tax is collected at the corporate level, distributions are traced to shareholders, and then tax is again collected at the shareholder level.[29]

C. Policy Recommendations

The following policy recommendations were suggested in the Integration Study and intended to apply to any integration plan ultimately adopted:[30]

> [1] Integration should not result in the extension of corporate tax preferences to shareholders.[31]
> [2] Integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors.[32]
> [3] Integration should be extended to foreign shareholders only through treaty negotiations, not by statute.[33]
> [4] Foreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. Government.[34]

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28. *Id.* For this example, the current tax rates have been substituted for the rates used by Professor Taylor.

29. *Id. See generally*, Taylor, *supra* note 27, at 246-56.

30. Integration Study, *supra* note 2, at viii.

31. *Id.* Corporate tax preferences are items that receive favorable tax treatment under the Code which generally deviate from standard accounting rules. Examples include: accelerated depreciation, deferred income recognition rules, or credits available only to corporations. *Id.* at 63. This guideline is based on policy and revenue concerns, and generally has been adopted by most countries with an integrated system; Belgium, Canada, Denmark, and Japan are exceptions. *Id.* at 64.

32. *Id.* at ix. This is designed to ensure that business profits paid to tax-exempt entities do not escape all taxation under integration. *Id.* Tax-exempt entities include two general types: (1) pension funds, 401(k) plans, and similar plans; (2) charities, hospitals, educational and religious institutions. *Id.* at 67.

33. *Id.* at ix. According to the Integration Study, "[t]his is required to assure that U.S. shareholders receive reciprocal concessions from foreign tax jurisdictions." *Id.*

34. *Id.* According to the Integration Study, "[a]bsent this limitation, integration could eliminate all U.S. taxes on foreign source profits in many cases." *Id.*

III. INTEGRATION PROPOSALS

The Treasury Integration Study details the mechanics of four integration prototypes and discusses their impact on the tax distortions in light of accomplishing integration within the policy recommendations. See Appendix A for a comparison of the four principle integration prototypes.

A. Dividend Exclusion Prototype

The first prototype discussed is a dividend exclusion prototype, which is the integration mechanism eventually favored by the Integration Study.[35] This prototype allows shareholders to exclude from their gross income all corporate dividends they receive.[36] Corporations would continue to pay the same tax under existing corporate tax laws.[37] Corporations would also be required to maintain an Excludable Dividends Account (EDA) in order to track the corporate income on which corporate taxes have been paid.[38] According to the Integration Study, "the dividend exclusion prototype would apply the corporate tax rate . . . to both distributed and retained income, but would eliminate the shareholder level tax on dividends paid from fully-taxed corporate income. All other distributions, e.g., interest and return of capital, would be taxed in the same manner as under current law."[39] At some point, dividends could become includable in shareholders' gross income; this would occur after the corporation's EDA, which represents fully-taxed corporate income, was depleted.[40] This inclusion is necessary to ensure that dividends free from all levels of tax are not paid from corporate preference income[41] or untaxed foreign source income.[42] The EDA is increased when a corporation pays taxes or receives excludable dividends from other corporations.[43]

35. *Id.* at 15, 17.

36. *Id.* at 17.

37. *Id.*

38. *Id.*

39. *Id.* Although not addressed in the Integration Study, one may assume that current and accumulated earnings and profits accounts would still be maintained along with the EDA, due to their differences in purpose. Earnings and profits accounts are maintained to measure to the extent that a distribution is made from a corporation's economic income. *See also* BITTKER & EUSTICE, *supra* note 22, ¶¶ 7.03-.04.

40. Integration Study, *supra* note 2, at 17.

41. *See supra* note 31.

42. Integration Study, *supra* note 2, at 19.

43. *Id.* at 20.

It is correspondingly reduced when a corporation receives a tax refund or pays dividends.[44]

The Integration Study states, "[t]he principal advantage of the dividend exclusion prototype is its simplicity and relative ease of implementation."[45] A small and relatively reasonable burden would be placed on corporations to track distributions and manage their EDAs. Implementation could be achieved almost instantly with very little change to existing law.[46] This mechanism may also be favored due to its functional similarity to the corporate dividends received deductions available under § 243 of the Code.[47]

The impact of this prototype on the three tax distortions[48] is as follows. Dividend exclusion, by reducing the total tax on corporate earnings to the top corporate rate, "would narrow (but not eliminate) the rate differential between distributed corporate and noncorporate equity income and between corporate equity income and interest."[49] If this proposal were implemented, corporations would not be as motivated to favor debt over equity, because equity financing would no longer be subject to the present effective tax rate of 60.74%.[50] Moreover, this prototype would likely result in making the subchapter C form of entity organization more attractive than it is at present[51] and place it on more equal footing, from a tax perspective, with

44. *Id.*

45. *Id.* at 17.

46. *Id.* Section 61(7) of the Code would be deleted to exclude corporate dividends from the definition of gross income. Other Code sections and regulations would need to be added to govern the corporation aspects and the EDA. *See generally id.* at 17-25.

47. *See supra* note 8. The corporate dividends received deductions of § 243 of the Code were intended to encourage corporate investment in other affiliated corporations. Under § 243 corporations are generally allowed a deduction equal to 70% of the amount received as dividends from a domestic corporation. The deduction percentage increases to 80% or 100% when the receiving corporation owns greater than 20% or 80%, respectively, of the distributing corporation. *See* I.R.C. § 243 (Supp. III 1991).

48. *See supra* text accompanying note 13.

49. Integration Study, *supra* note 2, at 18. The rate differential between distributed corporate and noncorporate equity income would not be completely eliminated since there still is a disparity between the maximum individual rate and the maximum corporate rate.

50. *See supra* note 11.

51. The corporate subchapter C form of entity organization is unpopular because it subjects income earned to double taxation, once at the corporate level and again at the shareholder level. In comparison, partnership and subchapter S forms of entity organization act as pass-through entities; therefore, income earned is only subject to tax once. I.R.C. §§ 301, 761, 1361-1363 (1988). *See also* BITTKER & EUSTICE, *supra*

partnership and subchapter S forms. Dividend exclusion may also reduce the incentive for corporations to retain, rather than distribute, earnings, "at least to the extent that fully-taxed income can be distributed to taxable shareholders."[52]

In reference to the Integration Study's policy recommendations, dividend exclusion does not extend corporate tax preferences to shareholders, because shareholders can only exclude from their income dividends made from income that was fully taxed at the corporate level.[53] The total tax collected from tax-exempt investors will not be reduced under this prototype, because it retains the current corporate level of taxation on equity capital supplied by tax-exempt shareholders.[54] Dividend 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.[55]

Overall, a dividend exclusion prototype can accomplish a reduction of tax distortions within the framework of the policy recommendations in the Integration Study. This effectiveness, coupled with the simplicity and ease of implementation, should make a dividend exclusion prototype very appealing to lawmakers as well as taxpayers.

B. Shareholder Allocation Prototype

The shareholder allocation prototype allows a corporation to allocate all of its income among all of its shareholders as it is earned.[56] The corporation is still treated as a separate entity for many reporting and auditing purposes.[57] Shareholders include the allocated corporate income amounts in their gross income and reduce their corresponding tax liability with credits derived from

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note 22, ¶¶ 1.05, 1.07.

52. Integration Study, *supra* note 2, at 27 (footnote omitted). Corporations would probably be pressured by shareholders to distribute earnings to the full extent of the EDAs, because all of the dividend income could be excluded from gross income in the shareholders' hands. *See supra* note 46 and accompanying text.

53. Integration Study, *supra* note 2, at 17.

54. *Id.* A tax exempt organization is an organization which is exempt from tax according to the Code. Qualified retirement plans are exempt from taxation. In addition, the Code contains a list of exempt organizations including corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes and other organizations. *See* I.R.C. § 501(a)-(c) (1988).

55. Integration Study, *supra* note 2, at 17-18.

56. *Id.* at 27.

57. *Id.*

allocated portions of corporate taxes paid.[58] The shareholders' bases in their stock are increased by the allocated income and reduced by the allocated credits.[59] Any corporate distributions are first treated as a return of capital up to the basis amount, and thereafter, as capital gain.[60] Thus, retained earnings and distributed earnings are given equal tax treatment.[61] This prototype treats a corporation as an income and tax conduit, but falls short of a pure pass-through mechanism because: (1) losses do not flow through to shareholders; (2) the corporate level tax is retained; (3) corporations only report aggregate income amounts, rather than reporting items separately; and (4) tax integration benefits are not extended to tax-exempt shareholders or to foreign shareholders, except by treaty.[62] The following example demonstrates this prototype:

> A corporation has three classes of common stock, the terms of which provide for the allocation of 30 percent of corporate income to Class A, 20 percent to Class B, and 50 percent to Class C. The corporation has taxable income of $100, pays $31 in corporate tax and pays a $10 dividend with respect to Class C stock. The shareholder integration prototype allocates the income and the credit to each class of stock based on the respective percentages (so, for example, Class C would be allocated income of $50 and credits of $15.50). Within each class of stock, each share receives a pro rata amount. Holders of Class A stock would collectively increase their basis [sic] by $20.70 (.30 x ($100-$31)), holders of Class B stock would increase their basis [sic] by $13.80 (.20 x ($100-$31)), and holders of Class C stock would collectively increase their basis [sic] by $24.50 (.50 x ($100-$31)-$10).[63]

The shareholder allocation prototype was not favored due to its administrative complexities and policy results.[64] According to the Integration Study:

> [a]dministratively, shareholder allocation integration would require corporations and shareholders to amend governing

58. *Id.*

59. *Id.* Under I.R.C. § 1012 (1988), basis of property is generally the cost of the property, except as otherwise provided in other situations.

60. Integration Study, *supra* note 2, at 27.

61. *Id.*

62. *Id.*

63. *Id.* at 28.

64. *Id.* at 27.

> instruments for outstanding corporate stock to provide for income allocations, would require corporations to maintain capital accounts similar to those used under the partnership rules, and could create significant reporting difficulties for shareholders who sell stock during a year and for corporations that own stock.[65]

The effects of the shareholder allocation prototype on policy recommendations were also a factor leading to its disfavor. In violation of a policy recommendation, corporate level tax preferences (e.g., tax exempt interest on state or local bonds) would generally be extended to shareholders.[66] In order to maintain parity between retained and distributed earnings, this prototype must exempt from United States tax foreign source income that has borne no United States tax.[67] But, in harmony with the policy recommendation, there would be no reduction of tax collected on corporate income allocated to tax-exempt investors as long as the credits for corporate tax were not refundable to this group.[68]

Shareholder allocation equalizes the tax rate at the maximum individual rate across all sources of income for shareholders' equity and interest.[69] The result is a reduction of all three tax distortions.[70]

C. Comprehensive Business Income Tax Prototype

The Comprehensive Business Income Tax (CBIT) is a prototype that measures and taxes "the income of all business entities, including corporations and unincorporated business . . . at the entity level at a 31 percent rate."[71] Under CBIT, corporations would be denied deductions for interest paid and

65. *Id.* The rules governing partnerships under subchapter K, §§ 701-761 of the I.R.C., adopt a pass-through taxing model, as opposed to an entity model. Under a pass-through model, income and deductions are allocated and pass through to the individual partners. Capital accounts are maintained to track each partner's share of partnership capital. The Treasury Regulations include specific requirements as to partnership allocation in order for them to be upheld for tax purposes. *See* Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1992).

66. Integration Study, *supra* note 2, at 27.

67. *Id.*

68. *Id.* at 36. The refundability of credits under the shareholder allocation prototype is an issue that lawmakers would have to consider. If the credits were refundable, tax-exempt investors would receive a windfall.

69. *Id.*

70. *Id.* at 29.

71. *Id.* at 40 (footnote omitted).

would also be denied deductions for dividends paid.[72] Shareholders and debtholders alike would exclude from their gross incomes dividend income and interest income received, resulting in the equal treatment of debt and equity.[73] This prototype subjects interest and dividend income to a single level of tax, equal to the top individual rate, at the corporate level.[74]

CBIT is very complex; however, it would bring about the equal treatment of debt and equity, would tax corporate and noncorporate entities alike, and would significantly reduce tax distortions.[75] CBIT would apply to all but the smallest businesses, regardless of corporate, partnership, or sole proprietorship form.[76] Thus, all of these business forms would be required to pay tax at the entity level. The final result "is that one—but only one—level of tax would be collected on capital income earned by businesses."[77] CBIT would be phased in over a period of about ten years, due to its comprehensive method of integration, and it is claimed to be self-financing.[78] The CBIT prototype is very complicated because it requires an entirely new tax regime for taxing corporate distributions.[79] The Integration Report contains a detailed discussion of this mechanism and its consequences.[80]

D. Imputation Credit Prototype

The Imputation Credit Prototype discussed in the Integration Report "closely resembles the system that New Zealand adopted in 1988."[81] Under this prototype, corporations would continue to pay tax at current rates.[82] Shareholders would include in their income the gross amount of any cash dividend and the associated imputation tax credit for tax paid at the corporate level.[83] The tax paid at the corporate level would be tracked because the corporation would be required to maintain an account of its cumulative federal

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72. *Id.* Interest paid is deductible under current law. I.R.C. § 163 (1988). There is no deduction under current law for dividends paid.

73. Integration Study, *supra* note 2, at 40.

74. *Id.*

75. *Id.* at 39. The details of CBIT are beyond the scope of this Comment.

76. *Id.* at 41-42.

77. *Id.* at 39.

78. *Id.* CBIT, as studied, would produce additional revenue over current levels. *See infra* note 96.

79. *Id.* at 39-60.

80. *Id.*

81. *Id.* at 95.

82. *Id.*

83. *Id.*

income taxes paid.[84] The credit could be used by the shareholder to reduce tax liability down to zero, but could never result in a refund.[85] This prototype cancels out the corporate level tax, as long as the shareholders' tax rate is at least the same as the corporate rate.[86]

In the Treasury Integration Study, this prototype was discussed under a section entitled *The Roads Not Taken.*[87] Although the Treasury originally favored this type of integration mechanism due to its recent popularity in other countries, it was shunned due to "its complexity in creating an entirely new regime for taxing corporate dividends."[88]

E. Economic Effects of Integration

The potential economic effects from tax integration were approximated in the Integration Study. Depending on the prototype selected, there could be an increase of between two to eight percent in the amount of investment in corporate capital stock.[89] This would mean approximately $125 to $500 billion more in corporate capital.[90] Corporations would also be encouraged to reduce debt-to-asset ratios by approximately one to seven percentage points.[91] Assuming a distribution prototype, dividend payout ratios would likely be increased to somewhere between two and six percentage points.[92]

The Integration Report states, "[b]y shifting resources into the corporate sector, reducing corporate borrowing, and encouraging dividends, the integration prototypes generate changes in economic welfare."[93] Overall, it is estimated that the integration prototypes could increase economic welfare somewhere between 0.07% to 0.73% of annual consumption, translating to a $2.5 to $25 billion gain in the United States economy.[94]

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84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.* at 93.
88. *Id.*
89. *Id.* at 111.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.* These figures were obtained by the Integration Report preparers using four alternative models of the economy and two assumptions about how integration would be financed. *Id.* This is the full extent of information provided as to the calculation of these figures.

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F. Prototype Costs

The following are the projected revenue effects of the prototypes.[95] These figures represent the annual price of integration in lost revenue, except in the case of CBIT, which generates additional revenue:

Dividend Exclusion	($13.1 billion)
Comprehensive Business Income Tax	$3.2 billion or $41 billion[96]
Shareholder Allocation	($36.8 billion)
Imputation Credit	($14.6 billion)

It may be helpful to understand these estimates by placing them in perspective. When compared to the forecasted 1992 fiscal deficit of $369.5 billion, the cost of dividend exclusion is 3.5% of this deficit and shareholder allocation amounts to 10% of this deficit.[97]

These estimates may be viewed as surprisingly modest,[98] but it should be emphasized these costs represent annual costs, which will undoubtedly have a cumulative impact over time. The implications of the potential revenue loss are discussed below.

IV. TAX COMMENTATORS' VIEWS ON TAX SYSTEM INTEGRATION

Jasper L. Cummings, Jr., of counsel to the firm of Womble, Carlyle, Sandridge & Rice in Raleigh, North Carolina, argues against tax system integration on the grounds that the United States tax system has taken many years of fine tuning to reach its present "labyrinthine form,"[99] and any large, sudden tax upheaval could create a "devil that we don't know."[100] This argument is also presented in such a way that, if tax integration is inevitably implemented, it should deviate as little as possible from the current tax system.[101] This argument is embraced by the Integration Study through its favoring of the simple dividend exclusion prototype.[102]

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95. *Id.* at 150-52.

96. The CBIT will produce $3.2 billion of revenue if there is no taxation of capital gains on CBIT assets. The $41 billion figure represents the revenue with current law treatment of capital gains.

97. Jasper L. Cummings, Jr., *'Taxing Business Income Once': Where's the Beef? A Review and Critique of the Treasury Study*, 54 TAX NOTES 1391, 1395 (1992).

98. *Id.*

99. *Id.*

100. *Id.* (footnote omitted).

101. *Id.*

102. *Id.*

Gene Steuerle, a leading tax commentator, believes that even though tax system integration was rejected twice in the recent past, once in the Carter Administration[103] and once in the Reagan Administration,[104] its time may be upon us.[105] He cites four main reasons for this belief: (1) the recent past and future increases in corporate debt; (2) "backdoor" integration through increased use of the partnership form;[106] (3) "the extraordinary complexity

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103. The Treasury prepared a proposal which "dealt with corporate preferences by means of a 'tracking of taxes' mechanism." Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 TAX LAW. 195, 195 n.4 (1990). Representative Ullman introduced a similar proposal in Congress. *See* 124 CONG. REC. 2132, 7978 (1978).

104. The Reagan Administration introduced a proposal "based on a partial dividend deduction and a 'tracking of income' mechanism, which was included in the 1985 tax reform bill but was not enacted." Avi-Yonah, *supra* note 103, at 195 n.4. *See* H.R. REP. NO. 3838, 99th Cong., 1st Sess. 261 (1985); H.R. REP. NO. 426, 99th Cong., 1st Sess. 231-49 (1985). *See also* 2 TAX REFORM FOR FAIRNESS, SIMPLICITY AND GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 134-35 (1984).

105. Gene Steuerle, *Is Integration of Corporate and Individual Taxes Still Possible?*, 44 TAX NOTES 229, 229 (1989).

106. "Backdoor" integration is also accomplished in some states through the use of new limited liability companies (LLCs). These companies have some of the attributes of the partnership form and some of the corporate form, principally, limited liability. If the LLC is structured carefully under the entity classification rules of the regulations, it will be taxed as a partnership. *See* Rev. Rul. 88-76, 1988-2 C. B. 360. As of 9/1/93, LLCs had been adopted by 30 states: ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1992); COLO. REV. STAT. §§ 7-80-101 to -913 (Supp. 1992); Connecticut House Bill 6974 as amended, 1993 Regular Session (signed by governor June 23, 1993); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (Supp. 1992); Florida House Bill 1703, 13th Legislature, First Regular Session 1993 (became law without signature April 24, 1993); Georgia House Bill No. 264, 142nd General Assembly, First Regular Session 1993 (signed by governor April 5, 1993); Idaho House Bill No. 381 as amended, 52nd Legislature, First Regular Session 1993 (signed by governor March 26, 1993); Indiana Senate Bill No. 485 as amended, 108th Legislative Session, 1993 Regular (signed by governor May 13, 1993); IOWA CODE ANN. §§ 490A.100 - .1601 (West Supp. 1993); KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1992); LA. REV. STAT. ANN. §§ 12:1301 - a1369 (West Supp. 1993); MD. CORPS. & ASS'NS CODE ANN. §§ 4A-101 to -1103 (1993); MINN. STAT. ANN. §§ 322B.01 -.955 (West Supp. 1993); Michigan House Bill No. 4023 as amended, 87th Legislature, 1993 Regular Session (signed by governor April 14, 1993); Missouri Senate Bill No. 66 as amended, 87th Legislative Assembly, First Regular Session (signed by governor July 2, 1993); 1993 MONTANA LAWS ch. 120 (Montana Senate Bill No. 146 as amended, 53rd Legislature 1993 (signed by governor March 18, 1993)); Nebraska Legislative Bill No. 121 as amended, 93rd Legislature, First Regular Session 1993 (signed by governor June 2, 1993); NEV. REV. STAT. §§ 86.010 - .571 (1991); New Hampshire House Bill

in administering partnership taxes;" and (4) "the prejudice in the current tax system against new, risky ventures that must be formed as corporations."[107]

"Backdoor" integration can occur when tax advisors stress partnership formation rather than the corporate form over a long period of time.[108] This situation compounds the administrative complexities for multiple, large partnerships, both for the partners and the Service.[109] The numerous income tracking and reporting requirements of partnerships weave a complicated web that creates an administrative nightmare. The prejudice Steuerle cites refers to the fact that venture capital firms are practically forced into the corporate form, despite the double tax burden, in order to avoid the unfettered liability of partnerships.[110]

Lost revenue from integration is an issue that is difficult to put a finger on at this time.[111] Most commentators do not seem very concerned with the potential annual revenue loss from tax integration. This insouciance may be

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No. 690 as amended, 153rd Legislative Session 1993-1994 (signed by governor June 23, 1993); New Jersey Senate Bill No. 890, 205th Legislature, Second Regular Session 1993 (signed by governor July 30, 1993); New Mexico House Bill No. 448 as amended, 41st Legislature, First Regular Session 1993 (signed by governor April 7, 1993); North Dakota Senate Bill No. 2222 as amended, 53rd Legislative Assembly, 1993 First Session (signed by governor April 12, 1993); OKLA. STAT. ANN. tit. 18, §§ 2000 - 2060 (West Supp. 1993); Oregon Senate Bill No. 285 as amended, 67th Legislative Assembly, 1993 Regular Session (signed by governor June 24, 1993); R.I. GEN. LAWS § 7-16-1 to 7-16-75 (1992); South Dakota Senate Bill No. 139 as amended, 67th Legislative Assembly, 1993 Regular Session (signed by governor March 22, 1993); TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 1.01 - 9.02 (West 1993); UTAH CODE ANN. §§ 48-26-102 to -157 (Supp. 1993); VA. CODE ANN. §§ 13.1-1000 to -1123 (Michie 1993); W. VA. CODE §§ 31-1A-1 to 31-1A-69 (Supp. 1993). Furthermore, LLCs are under consideration in at least ten other state legislatures. *See* Alabama House Bill No. 769, 165th Legislature, 1993 Regular Session; California Senate Bill Nos. 469, 930, 1993-94 Regular Session; Hawaii House Bill No. 863, 17th Legislative Session, First Regular Session 1993; Maine House Bill No. 1123, 116th Legislature, First Regular Session 1993; New York Assembly Bill No. 8676, 215th General Assembly, First Regular Session 1993; Ohio House Bill 74, 120th General Assembly, 1993-94 Regular Session; Pennsylvania House Bill Nos. 705, 1719, 1059, 176th General Assembly, 1993-94 Regular Session; South Carolina House Bill No. 4283, Senate Bill No. 824, Statewide Session 1993; Tennessee House Bill No. 952, Senate Bill No. 554, 98th General Assembly, First Regular Session 1993; Washington House Bill 1235, 53rd Legislature, 1993 Regular Session.

107. Steuerle, *supra* note 105, at 229.

108. *Id.*

109. *Id.*

110. *Id.* at 229-30.

111. Loss of tax revenue arguably should be a large consideration in light of the amount of legislation aimed at reducing the deficit and balancing the annual budget.

the result of a belief that, if and when integration takes place, safeguards will be used to minimize the loss of revenue.[112] As shown by the costs of integration above, three of the prototypes will result in between \$3.1 billion and \$36.8 billion of lost revenue annually. The Integration Study did not specifically address any revenue substitutes.

It is most probable that any tax integration prototype implemented would be coupled with an increase in the individual tax rate to make up for any revenue loss.[113] Jeffrey Kwall, an Associate Professor of Law at Loyola University of Chicago School of Law, believes that proponents of integration ought to evaluate any integration prototypes "from a perspective that considers the ramifications of an alternative revenue source."[114] Professor Kwall assumes that any revenue loss caused by integration must be made up and that integration ought to be analyzed on the basis of the mechanism used to make up this revenue. He proposes that integration would require a tax rate increase on high-income individuals.[115] The high-income individuals would then pressure Congress to create additional tax preferences in order to minimize their tax liabilities.[116] These preferences and the higher tax "jeopardize the gains in equity and efficiency" recently achieved in moving the United States to a "low rate, broad-based income tax."[117] Kwall concludes that double taxation can be "reconciled with equity and efficiency" when one considers the adverse implications that would result from covering the projected integration loss with revenue from other sources.[118]

Cummings' argument is that tax system integration actually would not lead to significant general economic welfare gains.[119] He scoffs at the models discussed in the Integration Study, which contend that by removing tax distortions, "economic welfare" of the United States economy can be increased by \$2.5 to \$25 billion per year.[120] These numbers, he contends, are not all that extraordinary in a \$4 trillion domestic economy, they are not intuitively obvious to non-economists, and they may be sharply affected by replacement taxes that are conspicuously missing from the Integration Study.[121]

112. Gene Steurle, *A Simplified Integrated Tax*, 44 TAX NOTES 335, 336 (1989). *See also infra* note 113.

113. Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 638 (1990).

114. *Id.* at 616.

115. *Id.* at 617.

116. *Id.*

117. *Id.*

118. *Id.*

119. Cummings, *supra* note 97, at 1393.

120. *Id.*

121. *Id.* at 1393-94.

The American Law Institute (ALI) has done some studies on integration. Professor Alvin Warren of Harvard Law School, the ALI's reporter on their corporate integration project, presented the ALI's selected mechanism for integration.[122] The ALI's mechanism is one that treats "the corporate tax as if it were a withholding tax paid by a corporation on behalf of its shareholders and thus allow[s] shareholders a refundable credit for the corporate tax that they could use against their tax due on dividends."[123] Professor Warren, in reference to a tentative draft of an ALI project,[124] has concluded that integration is preferable in theory and workable in practice.[125]

Professor James Eustice of New York University School of Law, while attending an American Association of Law Schools (AALS) panel discussion, stated that "there has been a great deal of integration under current law, some of it official and some of it of the self-help variety."[126] Eustice mentioned several illustrations of official integration. For example, income of partnerships and Subchapter S corporations is subject to only one level of tax. Eustice expects the rules for S corporations[127] to become more lax and to eventually cover all but publicly traded corporations.[128] He also noted a

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122. Calvin H. Johnson, *Integration Discussion Highlights AALS Meeting in San Antonio*, 54 TAX NOTES 114, 114 (1992).

123. *Id.* This was one of four approaches considered by the ALI. The other three approaches are: (1) "repeal both the corporate tax and the realization convention and tax shareholders on increases in the value of unsold shares that are due to corporate earnings; [(2)] tax such corporations as partnerships and S corporations and pass through earnings to the shareholders; [and (3)] exclude dividends from shareholder tax." *Id.*

124. ALI FEDERAL INCOME TAX PROJECT, TENTATIVE DRAFT NO. 2, SUBCHAPTER C- CORPORATE DISTRIBUTIONS (1979).

125. Warren, *supra* note 5, at 772. Professor Warren, serving as Reporter, authored a recently released study as part of the ALI's Federal Income Tax Project. *See* ALI FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) (hereinafter "Reporter's Study"). This study advocates integration via "a shareholder credit for corporate taxes previously paid with respect to corporate income distributed as dividends." *Id.* at xv. This mechanism is similar to the Imputation Credit Prototype dismissed in the Integration Study for its complexity and creation of a new tax regime. *See supra* text accompanying note 88. Warren states that, "the Treasury report [Integration Study] and this [ALI] study should be considered complementary, in that they develop different legislative responses to the problems of current law." Reporter's Study at 11.

126. Johnson, *supra* note 122, at 115.

127. "Small business corporations" that meet the requirements of I.R.C. § 1361 can elect S corporation status. S corporations are limited to one class of stock and a limit of 35 shareholders, among other requirements. I.R.C. § 1361 (1988).

128. Johnson, *supra* note 122, at 115.

very popular "new game in town" in reference to Wyoming limited liability companies, which are treated as partnerships for tax purposes.[129] Eustice summarized that "[l]imited-liability companies are super S corporations in which shareholders can participate in management without forfeiting their limited liability or their tax rights as partners."[130] Mutual funds, regulated investment companies, real estate investment trusts, and real estate mortgage conduits also enjoy official corporate integration in the form of receiving a deduction for dividend distributions made to their shareholders.[131] Allowing consolidated returns among corporations avoids the possible multi-levels of tax.[132]

Professor Eustice also pointed out that corporations often effectuate self-help integration by making distributions in the form of salaries, rent, tax deductible interest, or royalties, rather than as straight dividends.[133] In some instances, these payments may actually be disguised dividends.[134]

Overall, Professor Eustice believes that integration is a costly process and would require taxes in other areas to be self-financing.[135] He argues for "small, incremental changes,"[136] because "Congress is capable of butchering the technical aspects of a tax revision . . . and integration will be multisection legislation affecting all questions in the taxation of corporations."[137]

Professor Scott Taylor of the University of New Mexico School of Law urged Congress to look at historical examples of integration in the United States to determine if any of the past mechanisms can "provide valuable lessons for the future."[138] Taylor contended that "the United States has had a pure, classical, double corporate tax for only 28 of the 87-year history of the tax."[139] He therefore suggested that integration has always been an ill-defined goal of lawmakers, who allowed partial integration in many different

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129. *Id.* The limited liability corporations qualify as partnerships for tax purposes because they achieve a 2-2 tie under the factors of Treasury Regulation § 301.7701-2 (as amended in 1983). *See also supra* note 106.

130. *Id.*

131. *Id. See also* I.R.C. §§ 561, 852(b) (1988) (regulated investment companies), and §§ 562, 857(b) (1988) (real estate investment trusts).

132. Johnson, *supra* note 122, at 115. *See also* I.R.C. §§ 1502, 1504 (1988).

133. Johnson, *supra* note 122, at 115.

134. BITTKER & EUSTICE, *supra* note 22, ¶ 1.03, at 1-8. For a general discussion of disguised dividends treatment in practice, see CURTIS J. BERGER & PETER J. WIEDENBECK, PARTNERSHIP TAXATION 14 (Model 2) (1989).

135. Johnson, *supra* note 122, at 115-16.

136. *Id.* at 115.

137. *Id.* at 116.

138. Taylor, *supra* note 27, at 239.

139. Johnson, *supra* note 122, at 115.

forms and models, without much of a comprehensive, concerted effort.[140] After reviewing all of the integration mechanisms of the past, Taylor concluded that "[t]he largest obstacle hindering enactment of an integration plan is the looming federal deficit."[141] He did not doubt congressional incentive for passage of any integration plan that would increase revenue, but intuitively observed that most workable integration plans lose moderate to large amounts of revenue.[142]

One of the core arguments advanced in favor of tax system integration in the United States is that all of our major trade partners have some form of integration.[143] This argument implies that tax system integration is the modern format for a tax system among the world's major economic countries. In his one-paragraph transmittal letter to Congress, Kenneth Gideon, former Treasury Assistant Secretary for Tax Policy, used this argument as the sole justification for integration.[144] However, one commentator noted that the "everyone else is doing it" argument should not alone be sufficient to compel United States tax system integration.[145]

Although release of the Integration Study was a big step towards tax integration in the United States, some congressional aides on tax writing committees believe that legislative action is years down the road.[146]

V. COMMENT

The Treasury's Integration Study has served its stated purpose of stimulating discussion of tax system integration; however, a substantial amount of additional effort needs to be expended to determine the best approach to integration in the United States before a final decision can be made. The integration effort should be a concerted one, rather than the limited, sporadic efforts made by different tax groups at different times in the past.

140. See Taylor, *supra* note 27, at 260-97 (discussing the integration models of the past).

141. *Id.* at 310.

142. *Id.*

143. Integration Study, *supra* note 2, at 2. Japan, however, recently returned to the classical unintegrated system in 1989. *Id.* at 159.

144. Cummings, *supra* note 97, at 1391 n.4. The transmittal letter is a type of cover letter to Congress and it accompanied the Integration Study.

145. See Avi-Yonah, *supra* note 103, for an overview of major countries' integration systems.

146. *Tax Committees to Look at Corporate Integration, But Aides See No Action*, BNA (6 DTR G-2, 1/9/92). This sentiment is shared by former Treasury Assistant Secretary for Tax Policy Kenneth Gideon. *Integration of Corporate and Individual Tax Systems is Desirable, Treasury Says*, BNA (4 DTR G-2, 1-7-92).

Further discussion of the feasibility of integrating the tax system in the United States should focus on three main aspects of any integration mechanism:

(1) the complexity of the integration mechanism and the amount of deviation from current tax law, considering the concept of administrative ease;

(2) the success of the integration mechanism in achieving the goal of tax neutrality and the reduction of the financial decision distortion cased by the classical tax system; and

(3) the revenue loss (cost) of the integration mechanism and the possible replacement taxes to cover the revenue loss.

First, the complexity of any integration mechanism and the deviation from current tax law is a very important aspect. Tax law in this country is a creature that has evolved slowly over the years and has reached its present state as a result of many competing interests. It would be foolish to think that the entire tax system could be instantly overhauled with the stroke of a pen and not result in the defeat of multiple taxpayers' expectations. It would be rational for persons to fear the unknown economic possibilities of their actions in a radically new tax environment. This view militates against the more complicated prototypes. The Shareholder Allocation prototype is administratively complex. The Comprehensive Business Income Tax is also complex and would require a concerted implementation effort over a period of approximately ten years. The Imputation Credit is complicated because it creates an entirely new tax regime for taxing corporate dividends. The Dividend Exclusion Prototype is the most attractive integration mechanism due to its relative simplicity, its ease of implementation, its relatively small change from the current tax system, and its relatively low cost.

The administrative ease of maintaining, as opposed to implementing, a new tax system should also be considered in the discussion of complexity. There is a strong incentive to steer tax law into the smooth waters of administrative ease rather than allowing the tax system to become mired in uncertainty and noncompliance due to unnecessary complexity.

Second, the ability of any integration proposal must be evaluated on its success in achieving the stated goal of integration, neutrality,[147] and its ability to reduce the distortion of financial decisions caused by the classical tax system. The ability of the integration proposal to accomplish these goals will directly determine the degree of efficiency to be realized by the economy as a whole and by corporate and individual taxpayers as well. It is readily apparent that each of the prototypes discussed in the Integration Study does a fairly equal job of accomplishing tax neutrality,[148] but often using vastly

147. Integration Study, *supra* note 2, at 12.

148. *See supra* note 15.

different avenues. Therefore, this policy of tax neutrality should be given less weight if one is deciding only among these four prototypes.

Third, the cost of achieving integration, in order to reap its benefits, must be considered in light of any replacement taxes used to cover any revenue loss. Several commentators gave this consideration considerable weight. In light of the ever increasing deficit, lawmakers would be foolish to attempt to effectuate tax integration at a substantial cost to the national treasury. It should be noted that the prototype costs stated above are *recurring annual* costs, as opposed to one time costs. It seems fairly obvious that some type of revenue substitute will have to be implemented to cover the prototype cost. Unfortunately, many commentators have glossed over the discussion of any replacement taxes. Professor Kwall realized the significance of this aspect of integration when he placed the discussion of integration into the context of considering the ramifications of alternative revenue sources.[149] It would be a grave error to cancel out the efficiencies of integration with an ill-advised replacement tax. This aspect of integration needs to be given considerable weight when integration prototypes are discussed.

The Integration Study is correct in its conclusion that the Dividend Exclusion Prototype is the most attractive mechanism at this time. Congress could possibly experiment with this prototype, in order to determine if the tax distortions are actually reduced and the benefits are actually derived as predicted. One manner of experimentation could use a phase-in of the dividend exclusion for individual taxpayers, for example, a 20% exclusion in year one, a 40% exclusion in year two, and a final phase-in of the dividend exclusion at the end of year five.[150] This model would give legislators, corporations, and individuals an opportunity to adjust to the new economic climate brought about by integration. A phase-in would also provide the opportunity for timely corrective adjustments needed to keep integration on its planned course. The teeth of a sudden revenue bite caused by the prototype's cost would also be dulled and any replacement tax could be phased in at the same time to cover the cost.

At this juncture of the integration debate, a driving force is needed to actually bring about integration in the near future. The most likely candidate for this role is the business community. The proliferation of limited liability companies (LLCs) among the states[151] has made tax integration imperative

149. Kwall, *supra* note 113, at 616-17.

150. For example: a taxpayer receiving $100 of corporate dividends would be able to exclude $20 from income in year one, $40 in year two, $60 in year three, $80 in year four, and all $100 in year five. The amount of exclusion is figured assuming the corporations had sufficient amounts in their Excludable Dividends Accounts (EDA) to cover these dividends.

151. *See supra* note 106.

for coporations. With LLCs, investors' returns are subject to only one layer of tax, since LLCs are taxed as partnerships if properly structured.[152] New businesses will find LLCs very attractive in relation to the traditional subchapter C form of organization. Without integration, subchapter C organizations will virtually be left behind as the dinosaur whose earnings are subject to two layers of tax.

Corporations should make integration a short term goal. The most viable means of accomplishing this goal is through a concerted lobbying effort. The Integration Study has laid the preliminary groundwork, corporate America must now make known its wish to have integration implemented.

VI. CONCLUSION

Tax system integration in the United States will result in economic efficiencies and benefits derived from tax neutrality, the placing of equity and debt financing on a level playing field, and making the subchapter C form of business more attractive in relation to the partnership and subchapter S forms. However, the mechanism used to realize these benefits must be judiciously considered and carefully implemented.

The two main hurdles to integration at this time are complexity and cost. Excessive complexity results in inefficiency and uncertainty in the marketplace. Thus, simplicity is an indispensable element of a workable integration model. The cost of any integration prototype will undoubtedly need to be covered by some type of replacement tax. The interrelation between the replacement tax, the prototype, and the projected benefits and costs of integration warrants further study.

The Integration Study has started the ball rolling for tax system integration in the United States. Concerted effort between the Treasury and outside groups, such as the ALI, could bring the goal of integration, in whatever finalized form, to reality.

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152. *See supra* note 106.

APPENDIX A[153]

Comparison of the four principal integration prototypes

Issues	Prototype: Dividend Exclusion Prototype	Shareholder Allocation Prototype	CBIT Prototype	Imputation Credit Prototype
Rates				
a) Distributed Income	Corporate Rate	Shareholder rate[154]	CBIT rate	Shareholder rate[154]
b) Retained Income[155]	Corporate rate (additional shareholder level tax depends on the treatment of capital gains; see Chapter 8)	Shareholder rate	CBIT rate (additional investor level tax depends on the treatment of capital gains; see Chapter 8)	Corporate rate (additional shareholder level tax depends on the treatment of capital gains; see Chapter 8)
Treatment of non-corporate businesses	Unaffected	Unaffected	CBIT applies to non-corporate businesses as well as corporations, except for very small businesses.	Unaffected

153. Integration Study, *supra* note 2, at x.

154. Plus 3 percentage points of corporate level tax not creditable because the prototype retains the corporate rate but provides credits at the shareholder rate.

155. Assuming no DRIP. See Chapter 9.

Comparison of the four principal integration prototypes				
	Prototype			
Issues	Dividend Exclusion Prototype	Shareholder Allocation Prototype	CBIT Prototype	Imputation Credit Prototype
Corporate tax preferences	Does not extend preferences to shareholders. Preference income is subject to shareholder tax when distributed.	Extends preferences to share-holders.	Does not extend pref-erences to investors. Preference income is subject to compensatory tax or investor level tax when distributed.	Does not extend pref-erences too sharehold-ers. Preference income is subject to shareholder tax when distributed.
Tax-exempt investors	Corporate equity income continues to bear one level of tax.	Corporate equity in-come con-tinues to bear one level of tax.	A CBIT entity's equity in-come and income used to pay inter-est bear one level of tax.	Corporate equity in-come con-tinues to bear one level of tax.
Foreign source income	Foreign taxes are creditable at the corporate level, but shielded in-come is sub-ject to share-holder when distributed.	Foreign taxes are creditable at the corpo-rate level and at the shareholder level.	Foreign taxes are creditable at the entity level, but shielded income is subject to compensatory tax or an investor level tax when distributed.	Foreign taxes are creditable at the corpo-rate level, but shielded income is subject to shareholder when distributed.

Comparison of the four principal integration prototypes				
	Prototype			
Issues	Dividend Exclusion Prototype	Shareholder Allocation Prototype	CBIT Prototype	Imputation Credit Prototype
Foreign investors	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.	A CBIT entity's equity income and income used to pay interest bear tax only at the entity level, and no withholding taxes are imposed on distributions to equity holders or on payments of interest.	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.
Treatment of debt	Unaffected	Unaffected	Equalizes treatment of debt and equity	Unaffected (unless bondholder credit system adopted)