PART II: PROTOTYPES

INTRODUCTION

This Part presents three prototypes for implementing integration in the United States: (1) a dividend exclusion prototype, (2) a shareholder allocation prototype, and (3) the Comprehensive Business Income Tax (CBIT) prototype.[1]

Our trading partners that have integrated their corporate tax systems, including most European countries, as well as Canada and Australia, have all adopted distribution-related integration systems. Such integrated systems retain a separate corporate level tax on undistributed earnings but eliminate part or all of the corporate level tax on corporate earnings distributed to shareholders as dividends. Distribution-related integration can be accomplished by excluding dividends from shareholders' income (a dividend exclusion system), by allowing shareholders a credit for corporate level taxes (an imputation credit system), or by allowing corporations a deduction for dividends (a dividend deduction system).

After considering each of these three alternatives, we determined that a dividend exclusion system would implement in a relatively simple and straightforward manner our policy recommendations. The flexibility of an imputation credit system in responding to important policy issues, such as the treatment of tax preferences, foreign taxes, and tax-exempt and foreign shareholders under integration, does not, in our view, outweigh its complexity in implementation. A dividend deduction system would produce results in many cases contrary to our policy recommendations. Chapter 2 outlines a dividend exclusion prototype, and Chapters 11 and 12 discuss the imputation credit and dividend deduction alternatives. Because an imputation credit system is the mechanism of corporate tax integration most frequently used abroad, we discuss an imputation credit prototype in considerable detail in Chapter 11.[2]

The Report also examines two integration systems that are not distribution-related. Chapter 3 describes a shareholder allocation integration prototype, which would extend integration to retained earnings by taxing both distributed and retained corporate earnings at the shareholder's tax rate. Chapter 4 describes the CBIT prototype, which, in effect, would extend a dividend exclusion system to payments of interest in order to equalize the treatment of debt and equity and would tax corporate and noncorporate businesses in the same manner. This Report recommends the dividend exclusion prototype and CBIT for further study. While we do not recommend adopting the shareholder allocation prototype, we include it here to illustrate how a traditional full integration or passthrough model might be implemented and the problems it presents.

Each of these prototypes would move the U.S. tax system in the direction of more neutral taxation of corporate income and, in so doing, would reduce significantly tax-induced distortions in the allocation of capital. The prototypes generally are structured to implement our recommendations on four major issues:

- <u>The benefit of corporate level tax preferences should not be extended to shareholders</u>. Tax preferences, e.g., exempt state and local bond interest and accelerated depreciation, may reduce the corporate level tax, but current law does not extend corporate level tax preferences to shareholders. When corporate earnings sheltered by preferences are distributed to shareholders, they are currently taxed. Integration of the corporate income tax need not become an occasion for expanding the benefits of tax preferences. Therefore, we do not recommend extending corporate level tax preferences to shareholders under integration, and we have attempted to develop administrable rules to reach this result whenever we could do so in a manner compatible with the prototype. See Chapter 5.
- <u>Integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors</u>. Under current law, tax-exempt organizations holding corporate stock, in fact, are not exempt from the corporate level tax imposed on corporate equity investments. Because corporate income is

subject to tax at the corporate level regardless of the exempt status of a shareholder, a tax-exempt organization is exempt only from the shareholder level tax. Integration presents the fundamental question whether under an integrated tax this treatment should continue, or whether integration should reduce the total taxes paid on corporate income allocable to tax-exempt entities. This Report recommends, in general, retaining the current level of taxation of corporate equity income allocable to tax-exempt shareholders. See Chapter 6. The CBIT prototype would introduce a corporate level tax on income allocable to tax-exempt bondholders as well. See Chapter 4.

- Integration should be extended to foreign shareholders only through treaty negotiations, not by statute. The United States generally imposes two levels of tax on foreign equity investment in U.S. corporations (inbound investment). Thus, the United States taxes the business profits of foreign owned domestic companies similarly to the profits of U.S. owned companies and also imposes significant withholding taxes on dividends paid to foreign investors. The basic issue that an integration proposal must resolve for inbound investment is whether, by statute, the United States should continue to collect two levels of tax on foreign owned corporate profits or whether foreign investors should receive benefits of integration similar to those received by domestic investors. This Report generally recommends that foreign shareholders not be granted integration benefits by statute, but instead that this issue be addressed through treaty negotiations in order to achieve reciprocity. Most of the major trading partners of the United States that have adopted integrated corporate tax regimes have followed this approach. See Chapter 7 and Appendix B.

- Foreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. Government. The United States permits U.S. corporations to credit foreign taxes against U.S. taxes on foreign source income (outbound investment) but taxes shareholders on the distribution of such income without regard to the foreign taxes paid on that income. Treating foreign and U.S. corporate level taxes equally under an integrated system by statute would significantly reduce the current U.S. tax claim against foreign source corporate profits and often would completely exempt such profits from U.S. taxation at both the corporate and shareholder levels. Such unilateral action would result in a significant departure from the current allocation of tax revenues between the source and residence country. We therefore recommend that foreign taxes not be treated, by statute, the same as U.S. taxes. As a consequence, the prototypes generally would retain the foreign tax credit at the corporate level but would continue to tax foreign source income when it is distributed to shareholders. Extending the benefits of integration to foreign source income is more properly accomplished in the context of bilateral treaty negotiations. See Chapter 7.

Chapter 2: Dividend Exclusion Prototype

2.A INTRODUCTION AND OVERVIEW OF PROTOTYPE

The dividend exclusion prototype set forth in this chapter would, with few changes in current law, implement many of this Report's key policy recommendations.[1] The principal advantage of the dividend exclusion prototype is its simplicity and relative ease of implementation. We considered an imputation credit prototype that would achieve results similar to the dividend exclusion prototype but at the cost of additional complexity, including an entirely new regime for taxing corporate distributions. Although we do not recommend an imputation credit system, such a system is described in Chapter 11 because it provides useful background for understanding the dividend exclusion prototype. A summary of the prototype follows.

Mechanics. Under the dividend exclusion prototype, corporations would continue to calculate their income under current law rules and pay tax at a 34 percent rate.[2] Shareholders receiving corporate distributions treated as dividends under current law, however, generally would exclude the dividends from gross income. The prototype requires corporations to keep an Excludable Distributions Account (EDA) to measure the amount of dividends that can be excluded by shareholders—essentially an amount on which corporate taxes have been paid. Thus, the dividend exclusion prototype would apply the corporate tax rate of 34 percent to both distributed and retained income but would eliminate the shareholder level tax on dividends paid from fully-taxed corporate income.[3] All other distributions, e.g., interest and returns of capital, would be taxed in the same manner as under current law.

Tax-Exempt Shareholders. The dividend exclusion prototype would automatically retain the current level of taxation of corporate income earned on equity capital supplied by tax-exempt shareholders. Income from equity investments by tax-exempt organizations would be taxed at the corporate level under the current corporate tax rules but, when distributed, would be exempt from tax at the shareholder level.[4]

Corporate Shareholders. A corporate shareholder would exclude from income excludable dividends received and would add the amount of such dividends to its EDA. The prototype retains the current dividends received deduction for taxable dividends.

Tax Preferences. The prototype retains the corporate tax preferences available under current law and the corporate alternative minimum tax. To avoid extending corporate tax preferences to shareholders, the prototype permits shareholders to exclude only those dividends deemed made out of income that has been taxed fully at the corporate level. Thus, corporate dividends paid to shareholders out of preference income would continue to be taxable as under current law. Mechanically, this is accomplished once the corporation's supply of fully-taxed income (as reflected in the EDA) is exhausted, by making additional dividends taxable to shareholders.[5] See Section 2.B. As under current law, preference income distributed to tax-exempt shareholders would escape taxation at both the corporate and shareholder levels.

Foreign Source Income. The prototype retains the current foreign tax credit system, including the corporate level indirect foreign tax credit for taxes paid by foreign subsidiaries. The prototype, however, does not treat foreign taxes the same as U.S. taxes in determining the EDA, with the consequence that, as under current law, distributions of foreign earnings that have been shielded by the foreign tax credit at the corporate level are taxable to shareholders when distributed.[6]

Foreign Shareholders. The prototype retains the current 30 percent statutory withholding tax on dividends. In addition, it retains the branch profits tax on earnings considered repatriated from U.S. branches of foreign corporations. Thus, as under current law, inbound investment is subject to two levels of U.S. tax, with reductions in the rate of withholding tax negotiated through tax treaties.[7]

Capital Gains and Share Repurchases. Chapter 8 discusses the treatment of capital gains on sales of corporate stock and the treatment of share repurchases.

Structural Issues. The dividend exclusion prototype does not require any major changes to current rules concerning the tax treatment of corporate acquisitions. Adopting the prototype does, however, require consideration of rules for the carryover or separation of corporation EDA balances in liquidations and tax-free corporate reorganizations.

Impact on Tax Distortions. Table 2.1 illustrates the impact of the dividend exclusion prototype on the three distortions integration seeks to address: the current law biases in favor of corporate debt over equity finance, corporate retentions over distributions, and the noncorporate over the corporate form. The only difference between the current law treatment of nonpreference, U.S. source business income and its treatment under the dividend exclusion prototype is the taxation of corporate equity income distributed to individuals. Since exclusion of dividends by individuals would remove the individual level tax, the total tax rate on distributed earnings would be reduced to the corporate rate (t_c, generally 34 percent), except for the influence of investor level taxes on foreign investors. This reduction would narrow (but not eliminate) the rate differential between distributed corporate and noncorporate equity income and between corporate equity income and interest. These reductions in differentials would help reduce the debt-over-corporate-equity-finance and noncorporate-over-corporate form distortions. The tax rate on undistributed corporate equity income would now be higher for individuals than the rate on distributed corporate equity income, so the tax bias against corporate distributions would likely be reversed, in the absence of a DRIP. See Chapter 9. For tax-exempt and foreign investors, there would be no change in the tax treatment of nonpreference, U.S. source business income. (The tax bias against distributed earnings thus would remain for foreign investors.)[8]

2.B THE NEED FOR A LIMITATION ON EXCLUDABLE DIVIDENDS

In General

An exclusion from shareholder level tax for all dividends received not only would eliminate the

Table 2.1
Total U.S. Tax Rate on a Dollar of NonPreference, U.S. Source Income from a U.S. Business Under Current Law and the Dividend Exclusion Prototype

Type of Income	Current Law	Dividend Exclusion Prototype
I. Individual Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_i$	t_c
Undistributed	$t_c+(1-t_c)t_g$	$t_c+(1-t_c)t_g$
Noncorporate Equity	t_i	t_i
Interest	t_i	t_i
Rents and Royalties	t_i	t_i
II. Tax Exempt Entity is Income Recipient		
Corporate Equity:		
Distributed	t_c	t_c
Undistributed	t_c	t_c
Noncorporate Equity	t_c	t_c
Interest	0	0
Rents and Royalties	0	0
III. Foreign Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_{WD}$	$t_c+(1-t_c)t_{WD}$
Undistributed	t_c	t_c
Noncorporate Equity	t_{WN}	t_{WN}
Interest	t_{WI}	t_{WI}
Rents and Royalties	t_{WR}	t_{WR}

Department of the Treasury
Office of Tax Policy

t_c = U.S. corporate income tax rate.
t_i = U.S. individual income tax rate.
t_g = U.S. effective individual tax rate on capital gains.
t_{WD}, t_{WN}, t_{WI}, t_{WR} = U.S. withholding rates on payments to foreigners of dividends, noncorporate equity income, business interest, and rents and royalties, respectively. Generally varies by recipient, type of income, and eligibility for treaty benefits and may be zero.

double tax on distributed corporate income, but also would eliminate the current shareholder level tax that serves as the only U.S. tax on distributed income that has been sheltered from corporate level tax by preferences and on distributed foreign source income that has borne only foreign taxes. To prevent the dividend exclusion system from extending preferences to shareholders and to ensure that foreign source income that has not borne U.S. tax at the corporate level is subject to tax at the shareholder level when distributed, the dividend exclusion prototype limits the amount of dividends that can be excluded at the corporate level to an amount that has been subject to U.S. tax at the corporate level. Thus, as under current law, corporate preference income would generally remain free of tax until distributed and, when distributed, would be taxed at shareholder rates. Foreign source income sheltered by foreign tax credits at the corporate level also would continue to be taxed when distributed to shareholders. See Chapters 5 and 7.

The prototype treats dividends as made first from a corporation's fully-taxed income, rather than from preference or foreign source income. Stacking dividends first against fully-taxed income should permit many corporations to continue their current dividend policy while paying excludable dividends. Even corporations with substantial preference or foreign source income can continue to pay dividends without incurring any additional corporate level tax, although the dividends would be taxable at the shareholder level. We considered, but rejected, the alternative of imposing a nonrefundable "compensatory tax" at the corporate level on distributions of preference or foreign source income.[9] See Chapter 5. A nonrefundable compensatory tax not only reduces cash available to pay dividends but also increases the total tax burden on dividends paid to tax-exempt and foreign shareholders as well as to any shareholder taxed at less than a 34 percent rate; on the other hand, imposition of such a tax would permit uniform dividend exclusion. On balance, concern that a compensatory tax would distort the dividend decisions of corporations, particularly those with large numbers of tax-exempt or foreign shareholders, by requiring them to pay an extra tax to maintain their current dividend policy, led us to the alternative described here. Section 11.B discusses a compensatory tax in more detail.

The prototype retains the corporate alternative minimum tax (AMT), which functions, as under current law, to curb the excessive use of tax preferences at the corporate level. The prototype treats AMT as taxes paid for purposes of determining the corporation's supply of fully-taxed income, but effectively converts income taxed at the 20 percent corporate AMT rate to a smaller amount of income taxed at the regular 34 percent rate.[10]

Identifying Distributed Preference Income: the EDA

To determine whether dividends are paid out of fully-taxed income or preference income, the prototype requires corporations to maintain an Excludable Distributions Account (EDA). Amounts included in the EDA are considered "fully-taxed income." Dividends paid are stacked first against fully-taxed income.

As a mechanical matter, the EDA measures a corporation's supply of fully-taxed income based on the taxes actually paid by the corporation. The corporation simply tracks actual corporate taxes paid and then converts that amount into an equivalent amount of after-tax income taxed at a 34 percent rate, using the following formula:

$$\text{Annual additions to EDA} = \left[\frac{\text{U.S. tax paid for taxable year}}{.34} - \text{U.S. tax paid for taxable year}\right] + \text{excludable dividends received}$$

Thus, for each $34 of taxes paid (whether regular corporate tax or AMT), the corporation may pay $66 of excludable dividends, i.e., each $1 of corporate taxes paid supports $1.94 of excludable dividends or each dollar of excludable dividends must be supported by at least $0.52 of corporate taxes paid.[11] The effect of calculating additions to the EDA at 34 percent is to ensure that distributed income has been taxed at the full corporate rate, even though, if taxable to shareholders, the dividend would be taxed, at most, at the 31 percent maximum individual rate.

The EDA increases when a corporation pays taxes (including estimated taxes) or, as described under "Corporate Shareholders" below, receives an excludable dividend from another corporation. The EDA decreases when a corporation pays a dividend or receives a refund of taxes paid. Dividends paid when the EDA has been reduced to zero are treated as paid from preference income and are fully includable in shareholder's income.

> Example. A corporation with a zero initial EDA balance earns $75 of taxable income and $25 of exempt income. The corporation pays $25.50 of corporate tax and has $74.50 available for distribution to shareholders. The $25.50 of tax supports the addition of $49.50 to the corporation's EDA ($25.50/.34−$25.50). If the corporation actually distributes $74.50, only $49.50 of the dividend is excludable, because the EDA balance is $49.50. The remaining $25 represents a distribution of preference income that is fully subject to tax at the shareholder level.

The prototype requires corporations to report annually to shareholders and the IRS the excludable and taxable portions of dividends. In the preceding example, the corporation would report the first $49.50 distributed as an excludable dividend and the next $25 distributed as a taxable dividend. Shareholders would include taxable dividends in income as under current law. Corporations also would report to the IRS annually the adjustments to and balance in the EDA.

Adjustments to a corporation's tax liability for a prior year are reflected as adjustments to the corporation's EDA in the current year. Making audit adjustments to the EDA in the current year avoids the problem of recharacterizing dividends paid in prior years.[12] An increase in a prior year's tax liability increases the EDA in the year the adjustment is made and the additional tax is paid, and a decrease in a prior year's tax liability, e.g., through carryback of a net operating loss, gives rise to a refund and requires a corresponding reduction in the EDA in the year the refund is received. Refunds would be limited to the balance in the corporation's EDA.[13] Refunds in excess of the EDA balance would be carried forward to be applied against future corporate taxes. Similarly, an NOL carryback would not be permitted to reduce the EDA below zero; losses in excess of this amount would be carried forward.[14]

Corporate Shareholders

Current law limits the imposition of multiple levels of corporate taxation by permitting corporate shareholders to deduct some or all of their dividends received from domestic corporations, depending on the degree of affiliation with the distributing corporation.

Under the prototype, distributions from an EDA are excludable from the income of any shareholder, including a corporate shareholder. The recipient corporation adds the amount of excludable dividends it receives to its EDA. This prevents the imposition of a second level of tax when excludable dividends are redistributed to the shareholders of the recipient corporation.

The prototype retains current law for taxable dividends (dividends in excess of the distributing corporation's EDA) received by corporations. Thus, taxable dividends received from a U.S. corporation (and a portion of dividends from certain foreign corporations engaged in business in the United States) would entitle the recipient to a dividends received deduction (DRD). A recipient corporation allowed only a 70 or 80 percent DRD would pay tax on the remainder of the dividend. Any taxes paid on the dividend would be added to the EDA, determined in accordance with the general formula for computing additions to the EDA set forth above. To the extent the recipient corporation qualifies for the DRD, the prototype defers the investor level tax on preference income until it is ultimately distributed to individual shareholders.[15]

Anti-abuse Rules

We have considered whether special rules are necessary to limit a corporation's ability to target (or "stream") excludable dividends to taxable shareholders and otherwise taxable dividends to tax-exempt shareholders. Streaming undercuts the prototype's preservation of the current level of taxation of corporate equity income paid to tax-exempt and foreign shareholders by denying refunds of corporate taxes paid. On the other hand, tax-exempt and foreign investors may enter into a variety of ordinary business structures that enable them to receive income not taxed at the corporate level, e.g., by holding debt instead of equity.[16] These arrangements are permitted under current law, and they are not limited under the prototype. The ability to arrange a capital structure to minimize taxes emphasizes the point that eliminating the double tax on dividends will not, by itself, eliminate the tax system's current bias in favor of debt financing. A more comprehensive approach such as CBIT (described in Chapter 4) is required to address this systemic bias.

In the dividend exclusion prototype, concerns about streaming are balanced against the cost of complexity by restricting only a limited class of streaming transactions. In the prototype, current law rules that apply in analogous situations are extended.[17] First, the prototype adopts a 45 day holding period requirement for dividends to be excludable to prevent tax-exempt shareholders from routinely selling stock to taxable shareholders just before payment of an excludable dividend and then repurchasing the stock.[18] Second, depending on the treatment of capital gains, the prototype could extend application of the extraordinary dividend rules of IRC § 1059 to excludable dividends in order to prevent taxable shareholders from "stripping" excludable dividends.[19] The existing rules of IRC § 305 also may be useful in preventing other kinds of streaming.[20]

Rules like those of IRC §§ 382 through 384, which limit the use of net operating losses and other corporate attributes after a change in ownership, are not included in the prototype. An EDA balance represents fully-taxed corporate income, and, in general, integration should prevent that income from being taxed again at the shareholder level. The issue is difficult, however, because allowing unlimited use of EDA balances may permit an acquiror to use a target's EDA balance to defer or eliminate tax on the acquiror's preference income.[21] On balance, we decided that extending the rules would create considerable complexity and may not provide any substantial benefit in addition to the rules discussed above.[22] If significant evidence of abuse develops, ownership change limitation rules could be adopted at that time.[23]

Policymakers may wish to consider whether interest expense paid on debt incurred to purchase corporate stock should be disallowed under rules like those of IRC § 265(a). In a dividend exclusion system, corporate earnings generally bear only one level of tax. See the example in Section 4.G.[24] While the potential for rate arbitrage exists under current law, it may be less of a problem where only one of two levels of tax is eliminated. The issue is a difficult one, however, because disallowing an interest deduction for interest paid to a taxable lender will result in the imposition of two levels of tax. Moreover, in CBIT, we recommend extending the interest disallowance rules with respect to CBIT debt and equity. See Section 4.G. There may be less pressure to adopt the same rule in the dividend exclusion prototype, however, because it does not equate the treatment of debt and equity.[25]

2.C FOREIGN SOURCE INCOME

Under the prototype, U.S. individual shareholders would continue to include in income dividends received from foreign corporations and to claim a foreign tax credit for any foreign withholding taxes imposed on the dividend. Similarly, U.S. corporate shareholders owning less than 10 percent of a foreign corporation's voting stock (the threshold requirement for the U.S. corporation being eligible to claim an indirect foreign tax credit under IRC § 902) would include in income dividends from the foreign corporation and would claim a foreign tax credit for foreign withholding taxes. The corporate shareholder would not add any amount to its EDA to reflect foreign income taxes paid by the foreign corporation or foreign withholding taxes on dividends.

U.S. corporate shareholders owning at least 10 percent of a foreign corporation's voting stock would continue to include in income dividends from the foreign corporation and to claim both a direct credit for foreign withholding taxes and an indirect foreign tax credit with respect to such dividends under the rules of IRC § 902 of current law, subject to the foreign tax credit limitation in IRC § 904. Under these provisions, the corporate shareholder receives a credit, subject to certain limitations, for foreign income taxes paid by the foreign corporation with respect to earnings out of which the dividends are paid. A U.S. corporation would increase its EDA only by an amount that reflects the residual U.S. tax (if any) imposed on the dividend income. Thus, absent any residual U.S. tax (and any EDA balance attributable to U.S. tax on U.S. source income), distributions out of foreign source income taxed abroad, in effect, would be taxed at the shareholder level as under present law.

U.S. corporations with foreign branch operations, or which receive interest, rents, royalties, or other income from foreign sources, would continue to be subject to current U.S. tax on their foreign source income with a credit under IRC § 901 for foreign income taxes. As with earnings of foreign subsidiaries, the U.S. corporation would increase its EDA only to reflect the amount of any residual U.S. tax imposed on the foreign source income.

Although we do not recommend a statutory rule permitting additions to an EDA based on payment of foreign taxes, consideration might be given to granting authority to enter into tax treaties that treat foreign taxes like U.S. taxes, where reciprocity exists.[26] Treating foreign taxes like U.S. taxes would allow a U.S. corporation doing business in a treaty jurisdiction to pay excludable dividends to its U.S. shareholders even if its income was entirely shielded from U.S. tax by foreign tax credits.[27]

2.D LOW-BRACKET SHAREHOLDERS

Taxing corporate income at a uniform rate at the corporate level significantly reduces the complexity of the dividend exclusion (and CBIT) prototypes and reduces the burdens of transition to a new system because refund and credit provisions are not required to deal with "overcollections" of tax from individual taxpayers with marginal rates lower than the 34 percent corporate rate. While this simplification concern has been a major factor in our decision to recommend a schedular system, inspection of the available data also suggests that the adoption of a schedular system will not result in significantly higher taxation of corporate income than the use of individual rates for most taxable shareholders. The data indicate that approximately two-thirds of corporate dividends paid to taxable individual shareholders, i.e., shareholders who are U.S. citizens or residents, are paid to individuals with average marginal tax rates of more than 25 percent.

It might at first appear that corporate income distributed to individuals with average marginal tax rates of less than 25 percent should be taxed at a lower rate, because a lower marginal rate indicates a lower income and, inferentially, less ability to pay. On the other hand, low-bracket shareholders who receive dividends clearly own some property, i.e., stock, and it is not clear whether their low taxable incomes accurately reflect their ability to pay.[28] Accordingly, the dividend exclusion and CBIT prototypes do not contain provisions reducing the rate of tax collected on corporate income distributed to low-bracket shareholders.

If policymakers desired to tax distributed corporate income at shareholder rates, a dividend exclusion system could allow a tax credit that would refund all or part of the excess tax collected at the corporate level. To refund fully the difference between 34 percent and the shareholder rate, the amount of the tax credit would equal (1) the amount of the dividend received, grossed up at the 34 percent rate, multiplied by (2) the difference between 34 percent and the shareholder's marginal tax rate. Each shareholder would calculate his own credit based on a formula (or a set of tables) and his marginal tax rate.[29]

> Example. A corporation earns $100, pays tax of $34, and distributes $66 to a shareholder in the 15 percent marginal tax bracket. The shareholder would owe no tax on the dividend and would be allowed a tax credit of $19 (($66/.66)×(.34−.15)), which could be used to offset other income.

Such credits would be allowed only for excludable dividends.[30] Allowing a shareholder tax credit for taxable dividends (dividends considered made out of preference income) would confer a shareholder level benefit for corporate level tax that had not been paid.

2.E INDIVIDUAL ALTERNATIVE MINIMUM TAX

Historically, individuals have been subject to a minimum tax to ensure that at least a small amount of tax is paid on an individual's economic income and to respond to public perceptions that permitting high-income individuals to pay little or no income tax undermines the fairness of the tax system. The exclusion for dividends described here might result in some high-income individuals paying little or no tax at the individual level, thus raising issues of public perception. The EDA, however, operates to ensure that any dividends excludable from an individual's gross income have already been subject to one level of tax at the corporate level. The investor's income tax has been prepaid at the corporate level at the 34 percent corporate rate, which exceeds the top individual rate. Including excludable dividends in the individual AMT would serve only to reinstitute a double tax on dividends and would undermine to some extent the basic goals of this system of integration.

2.F STRUCTURAL ISSUES

This section discusses several areas of current law that should be modified to reflect adoption of the dividend exclusion prototype. This section does not provide a comprehensive analysis of the technical changes required but instead raises issues for further development.

Corporate Acquisitions

The dividend exclusion prototype retains the basic rules governing the treatment of taxable and tax-free corporate asset and stock acquisitions. The prototype permits taxable asset acquisitions to be made with only a single level of tax. Corporate tax paid on gain recognized on the sale of assets would be treated like any other corporate level tax payment and would support a corresponding addition to the EDA, thus generally allowing a tax-free distribution of proceeds to shareholders when the corporation liquidates. Upon liquidation, shareholders would, as under current law, generally recognize gain to the extent liquidation proceeds exceed share basis. A shareholder's gain would be excludable, however, to the extent of a proportionate share of the liquidating corporation's EDA.[31] Stock acquisitions may face a higher tax burden than asset acquisitions if capital gains on corporate stock that are attributable to retained earnings are taxed in full at shareholder rates. See Chapter 8.

The prototype retains current law rules that treat a qualifying corporate reorganization as tax-free at the corporate level (with the target's tax attributes, including its asset bases, carrying over to the acquiror) and at the shareholder level.[32] Additional rules would be needed to coordinate the reorganization provisions with the dividend exclusion prototype. For example, the EDA of a corporation acquired in a reorganization should generally carry over to its successor. In a divisive reorganization, the EDA should be divided proportionately between the corporations.[33]

Earnings and Profits

The prototype retains the current law rules that treat a distribution as a dividend only to the extent of current and accumulated earnings and profits.[34] Distributions that exceed earnings and profits are treated as a return of capital to the extent of a shareholder's basis and then as gain on the disposition of the stock.[35] Under the prototype, only a distribution that is made out of the corporation's EDA is eligible for exclusion at the shareholder level. If a distribution is made when a corporation has no EDA balance but has earnings and profits, it is a taxable dividend; if the corporation has no earnings and profits, the distribution is treated as a return of capital to the extent of the shareholder's basis and then as gain.

Some commentators have argued that the earnings and profits rules should be eliminated under current law, essentially arguing that the complexity of the earnings and profits rules outweigh any benefits that may result.[36] In general, at least two alternatives to the earnings and profits rules are possible. All nonliquidating distributions to shareholders could be treated as dividends, except where a distribution results in a reduction in capital (stated or surplus) for corporate law purposes. Alternatively, all nonliquidating distributions to shareholders could be treated as dividends, subject generally to current rules allowing basis recovery with respect to transactions where a shareholder's interest in the corporation is reduced or terminated.

Under the dividend exclusion prototype, as under current law, replacing the earnings and profits rules with either of the alternative rules would simplify the determination of whether a corporate distribution is a dividend for tax purposes.[37] However, although the simplification benefits of eliminating the earnings and profits rules are important, we conclude that adoption of the dividend exclusion prototype, by itself, neither compels the elimination of the rules nor demands their retention.[38] Thus, under the dividend exclusion prototype, earnings and profits would continue to provide a rough measure of whether, for purposes of determining the shareholder level tax, a distribution represents income from, or a return of, a shareholder's investment.[39]

Dividend Reinvestment Plans (DRIPs)

Distributed earnings are subject to only one level of tax under the dividend exclusion prototype, but retained earnings may be subject to a greater tax burden to the extent that they increase the value of stock and are taxed as capital gains. See Chapter 8. A dividend reinvestment plan, or DRIP, is one way for corporations to extend the benefits of integration to retained earnings. In a dividend exclusion system, a DRIP would allow a corporation to treat its shareholders as if they had received an excludable cash dividend and had reinvested it in the corporation. The shareholder's basis would be increased to reflect the amount of the deemed dividend, ensuring that the shareholder would not be taxed on appreciation due to retained fully-taxed earnings when the stock is sold.

> Example. A corporation earns $100, pays $34 in tax, and adds $66 to its EDA. The corporation declares a deemed dividend of $66 and reduces the EDA by $66, and the shareholders increase their share basis by $66.

Chapter 9 discusses DRIPs.

2.G PENSION FUNDS

Under current law, contributions to qualified pension plans are generally deductible by the employer and are not currently includable by the employee. The employee is generally taxed only when distributions of benefits are made. The deduction provided to the employer combined with the deferral of income to the employee until benefits are paid effectively exempts the investment earnings on the contribution from tax.[40] Thus, pension fund income from investments in stock bear only one level of tax—the corporate tax paid by the corporation.

The dividend exclusion prototype does not change this treatment. Under the prototype, most dividends are excludable by shareholders. Thus, if dividends were received directly by plan beneficiaries, they would be tax-free. The earnings of pension plans would be taxed when distributed, however, even if the distributions were attributable to excludable dividends received by the plan on its investments. Just as under current law, however, the combination of the employer's deduction for contributions and the deferral of the beneficiary tax until earnings are distributed ensures that earnings on pension fund investments in stock are taxed only once. Although retaining the current treatment of pension funds in a dividend exclusion system perpetuates some bias against investments in stock by pension plans, the disincentive is no greater than under current law.

Chapter 3: Shareholder Allocation Prototype

3.A INTRODUCTION

The dividend exclusion prototype and other distribution-related systems of integration provide relief from double taxation only for distributed income. As a consequence, they may create an incentive for corporations to distribute, rather than retain, earnings at least to the extent that fully-taxed income can be distributed to taxable shareholders.[1] In contrast, the shareholder allocation prototype would extend integration to retained earnings by allocating a corporation's income among its shareholders as the income is earned. Shareholders would include allocated amounts in income, with a credit for corporate taxes paid, and would increase the basis in their shares by the amount of income allocated, less the amount of the credit. Distributions would be treated as a return of capital to the extent of a shareholder's basis and, thereafter, as a capital gain.[2]

Thus, the shareholder allocation prototype treats retained and distributed earnings equally. We do not favor adopting the shareholder allocation prototype, however, because of the policy results and administrative complexities it produces. As examples of policy problems, if it is to retain parity between retained and distributed earnings, the shareholder allocation prototype must extend tax preferences to shareholders and exempt from U.S. tax foreign source income that has borne no U.S. tax. While the shareholder allocation prototype reduces (but does not eliminate) current law's bias in favor of debt financing, the same is true of the dividend exclusion prototype, which is a simpler regime.[3] Administratively, shareholder allocation integration would require corporations and shareholders to amend governing 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.

We nevertheless discuss the shareholder allocation prototype in some detail because it is the integration system advanced by advocates of traditional full integration proposals, which generally would treat a corporation as a conduit and allocate income to shareholders as earned. This chapter shows how a passthrough model of integration might be modified to conform as closely as possible with our policy recommendations and identifies some of the most difficult administrative issues.[4]

In contrast to a pure passthrough model of integration, the shareholder allocation prototype (1) does not pass through losses to shareholders, (2) retains the corporate level tax, which would assume a function similar to a withholding of shareholder level tax, (3) requires corporations to report to shareholders only an aggregate income amount, rather than separately report all items, and (4) does not extend integration benefits to tax-exempt shareholders or to foreign shareholders except by treaty.

3.B OVERVIEW OF THE SHAREHOLDER ALLOCATION PROTOTYPE

The shareholder allocation prototype continues to treat the corporation as a separate entity for many reporting and auditing purposes. All tax items, including different types of income, deductions, losses and credits, are aggregated at the corporate level rather than being passed through to shareholders. To enhance compliance and mitigate shareholder cash flow problems, the prototype requires the corporation to pay income taxes at regular corporate rates as under current law. The corporation allocates its taxable income, as reported for regular tax purposes, among its shareholders. The shareholders include the allocated amounts in income and credit corporate taxes paid and corporate tax credits claimed (including the foreign tax credit and other corporate tax credits) against their tax liability. Shareholders with marginal tax rates less than the corporate rate may use excess credits to offset tax liability on other income but may not obtain refund of the credit.

> Example. A corporation has $100 of taxable income and owes $31 of corporate level tax.[5] The corporation also is entitled to a tax credit (e.g., a low-income housing credit) of $5. Thus, the corporation pays $26 in tax. The corporation allocates $100 of taxable income among its shareholders, together with $31 of tax credits ($26 tax actually paid plus $5 tax credit).[6]

Shareholders would increase share basis by (1) the amount of taxable income allocated to them, after subtracting corporate taxes paid (including corporate tax credits),[7] and (2) tax-exempt income. See Section 3.E. Thus, in the examples noted above, the shareholders' collective basis increases by $69. Share basis would decrease by the amount of distributions. Distributions to shareholders are treated as a nontaxable return of capital to the extent of a shareholder's basis in his stock. Distributions in excess of basis would be treated as gain recognized on the sale of the stock, which would generally be capital gain.[8]

Corporate losses and excess corporate tax credits would not flow through to shareholders but could be carried forward at the corporate level. Losses or excess tax credits could not be carried back to claim a refund of corporate tax, because that tax would already have been made available to offset shareholder tax on allocated income.[9] Current law limitations on the use and transfer of corporate losses and other tax attributes would continue to apply at the entity level.

Mechanics. Corporations would allocate income and taxes paid to the holder of stock on a quarterly record date. A corporation with multiple classes of stock would allocate tax items in accordance with the terms of the stock certificate, which would designate the share of income to be allocated to each class of stock. See Section 3.F. A U.S. corporate shareholder would allocate to its own shareholders its share of the second corporation's taxable income and tax credits. Intercorporate holdings may create difficult reporting issues. See Section 3.H.

The mechanics of shareholder allocation integration can be illustrated with a simple example.

> Example. 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.[10] Holders of Class A stock would collectively increase their basis by $20.70 (.30×($100−$31)), holders of Class B stock would increase their basis by $13.80 (0.20×($100−$31)), and holders of Class C stock would collectively increase their basis by $24.50 (.5×($100−$31)−$10).

Tax-Exempt Shareholders. To preserve one level of tax on corporate income allocable to tax-exempt shareholders, credits for corporate tax would not be refundable to tax-exempt shareholders. See Section 3.I.

Tax Preferences. The shareholder allocation prototype would generally extend corporate level tax preferences to shareholders. See Section 3.E.

Foreign Source Income and Foreign Shareholders. A U.S. corporation would pay corporate tax on its worldwide income and, where permitted under current law, could claim a foreign tax credit for foreign taxes paid directly and by a foreign subsidiary. The corporation would then allocate its taxable income to shareholders and the foreign tax credit would be creditable by shareholders. Section 3.I discusses the difficulty of implementing appropriate shareholder level foreign tax credit limitation rules. Income of a foreign corporation would be includable in income of U.S. corporate shareholders only as under current law, i.e., generally when distributed. The shareholder allocation prototype does not permit foreign shareholders, except pursuant to tax treaties, to claim a refund of the corporate tax or to use the credit for corporate tax to offset the 30 percent (or lower) withholding tax levied on dividends (which would continue to apply). Such treaty benefits should be provided only in return for reciprocal benefits.

Capital Gains and Share Repurchases. Chapter 8 discusses the treatment of capital gains on sales of corporate stock and the treatment of share repurchases.

Structural Issues. Section 3.G discusses the problems of midyear sales of stock, and Section 3.H discusses the reporting difficulties that arise in the case of intercorporate stock ownership. We do not discuss further the treatment of corporate taxable and tax-free acquisitions under the shareholder allocation prototype.

Impact on Tax Distortions. Table 3.1 illustrates the impact of the shareholder allocation prototype on the three distortions integration seeks to address: the current law biases in favor of corporate debt over equity finance, corporate retentions over distributions, and the noncorporate over the corporate form. For nonpreference, U.S. source income received by individuals, the shareholder allocation prototype is fully successful. All forms of income are taxed at the individual rate (t_i, which can range from zero to 31 percent). Equalization of the tax rate across all sources of income for individuals means that shareholder allocation reduces all three current law distortions. For tax-exempt and foreign investors, however, the shareholder allocation prototype makes no change in the current taxation of nonpreference, U.S. source income.

3.C CORPORATE LEVEL PAYMENT OF TAX

In theory, corporate level payment of tax is not an essential feature of shareholder allocation integration.[11] Shareholders could have the sole responsibility for payment of taxes on corporate level earnings, including retained earnings. Under such a system, corporations would report income to shareholders, who would include their allocable share of corporate income with other income on their returns and pay tax on their total income. Partnerships and S corporations follow this approach under current law. However, because tax is more likely to be collected if paid at the corporate level, the shareholder allocation prototype retains the current system requiring payment at the corporate level and then allocates to shareholders the corporation's taxable income and taxes paid.

Table 3.1
Total U.S. Tax Rate on a Dollar of NonPreference, U.S. Source Income from a U.S. Business Under Current Law and the Shareholder Allocation Prototype

Type of Income	Current Law	Shareholder Allocation Integration
I. Individual Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_i$	t_i
Undistributed	$t_c+(1-t_c)t_g$	t_i
Noncorporate Equity	t_i	t_i
Interest	t_i	t_i
Rents and Royalties	t_i	t_i
II. Tax Exempt Entity is Income Recipient		
Corporate Equity:		
Distributed	t_c	t_c
Undistributed	t_c	t_c
Noncorporate Equity	t_c	t_c
Interest	0	0
Rents and Royalties	0	0
III. Foreign Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_{WD}$	$t_c+(1-t_c)t_{WD}$
Undistributed	t_c	t_c
Noncorporate Equity	t_{WN}	t_{WN}
Interest	t_{WI}	t_{WI}
Rents and Royalties	t_{WR}	t_{WR}

Department of the Treasury
Office of Tax Policy

t_c = U.S. corporate income tax rate.
t_i = U.S. individual income tax rate.
t_g = U.S. effective individual tax rate on capital gains.
t_{WD}, t_{WN}, t_{WI}, t_{WR} = U.S. withholding rates on payments to foreigners of dividends, noncorporate equity income, business interest, and rents and royalties, respectively. Generally varies by recipient, type of income, and eligibility for treaty benefits and may be zero.

In addition to increasing compliance, retaining corporate level payment of tax provides a mechanism for imposing tax on corporate income allocable to tax-exempt and foreign shareholders. Denying refundability of credits for corporate level tax to tax-exempt shareholders, in effect, preserves current law, which taxes corporate equity income allocable to tax-exempt shareholders at the corporate level. Nonrefundability of credits also preserves current law for foreign shareholders. See Section 3.I.

3.D PASSTHROUGH OF CORPORATE LOSSES TO SHAREHOLDERS

While it would be possible to pass through to shareholders aggregate net losses incurred at the corporate level, the prototype does not do so.[12] Passthrough of corporate losses would raise a host of fundamental policy, technical, and administrative issues. For example, one issue is whether, as for partnerships (but generally not S corporations), shareholders would be permitted to include entity level debt in their basis to determine the extent to which losses could be passed through. A second issue is whether the current at-risk and passive activity rules would apply at the shareholder level to limit the use of losses incurred by corporations. Failure to apply these rules could allow taxpayers to use corporations as tax shelters and to circumvent current restrictions applicable to partnerships and S corporations. Passthrough of corporate losses also would create significant administrative complexity. Even small shareholders would have to track losses allocated to them, including losses in excess of basis carried forward from previous years, and would have to apply the at-risk rules and the passive activity loss rules.

To avoid the complexity created by applying additional loss limitations at the shareholder level and the need for anti-abuse rules, the shareholder allocation prototype denies passthrough of corporate losses to shareholders. Instead, corporate losses may be carried forward and used to offset corporate income in later years. This allows a reasonable degree of accuracy in measuring corporate income over time while minimizing complexity and opportunities for abuse.

3.E TAX TREATMENT OF PREFERENCES

Integration generally does not require extending the benefits of corporate level tax preferences to shareholders. Extending preferences to shareholders under integration would increase the value of corporate preferences relative to current law and would raise the revenue cost of integration. See Chapter 5. Accordingly, the dividend exclusion and CBIT prototypes are structured not to extend preferences to shareholders. See Section 2.B and Section 4.D.

In contrast, the shareholder allocation prototype generally extends preferences to shareholders. While we considered modifying the shareholder allocation prototype in order not to extend preferences to shareholders, we found such modifications to be difficult and inconsistent with the passthrough nature of the prototype. Eliminating preferences by including preference income in shareholder income as earned would treat corporate preference income more harshly than under current law.[13] Current law generally taxes corporate preference income at the shareholder level only when the income is distributed or stock is sold. While shareholder allocation could be modified to tax preference income only when distributed, doing so would effectively convert shareholder allocation into distribution-related integration, for which less cumbersome structures can be used.[14]

For these reasons, the shareholder allocation prototype generally passes through preferences to shareholders, but that feature is a major reason we do not favor the adoption of shareholder allocation. If policymakers were to adopt the shareholder allocation prototype, serious consideration should be given to restricting the preference items available to corporations.

The extent to which the shareholder allocation prototype extends preferences to shareholders depends on the type of preference. An exclusion preference, e.g., tax-exempt interest on state and local bonds, allows a corporation to earn economic income that is not included in taxable income and, thus, is not allocated to shareholders. The prototype provides a shareholder basis increase for tax-exempt income, similar to the basis increase provided under current partnership rules, which ensures that such income is not taxed to a shareholder who sells his stock or receives a distribution.[15] If such a special basis increase were not provided, then preference income attributable to an exclusion preference would be taxable upon distribution or sale of stock.

A credit preference, e.g., the credit for increasing research activities, reduces corporate level taxes payable. The shareholder allocation prototype passes through a credit preference to shareholders (to the extent it is claimed by the corporation) by treating it as corporate taxes paid, which are creditable by shareholders. A basis reduction for the amounts of taxable income shielded from tax by credit preferences would make these amounts taxable either upon the sale of stock or receipt of distributions in excess of basis.

A deferral preference, e.g., accelerated depreciation, initially reduces corporate taxable income relative to corporate economic income. In later years, however, as the deferral preference turns around, the corporation's taxable income exceeds its economic income. Thus, because the shareholder allocation prototype allocates only taxable income to shareholders, a shareholder who holds stock throughout the deferral period generally benefits from a deferral preference to the same extent as the corporation. As under the partnership rules, however, a shareholder's basis increases only by the amount of taxable income (and tax-exempt income) allocated to him. Thus, a shareholder who sells stock or receives a distribution from the corporation may realize taxable gain because the shareholder's basis does not reflect the economic income that has been sheltered at the corporate level by a deferral preference.[16] On the other hand, a distribution that does not exceed basis before the deferral preference reverses will be treated as a return of basis. In such a case, the deferral preference will not be taxed to the shareholder until the stock is sold.

Certain features of shareholder allocation integration indirectly limit the flowthrough of preferences. Because the shareholder allocation prototype does not allow losses to flow through to shareholders, preferences are not passed through to the extent they create corporate losses. In addition, because corporate debt is not included in shareholder basis and inside basis in assets is not stepped up to reflect the price paid for corporate shares, there could be disparities between inside and outside basis that could limit the benefit to shareholders of corporate level preferences.

A final issue involving preferences is the treatment of the corporate alternative minimum tax (AMT). In general, the corporate AMT would be retained under integration to limit use of preferences at the corporate level. Accordingly, the dividend exclusion prototype and the CBIT prototype retain the corporate AMT. The shareholder allocation prototype does not retain the corporate AMT because we found no simple and administrable mechanism for doing so in the context of a passthrough system.

For example, the approach most consistent with the passthrough nature of the shareholder allocation prototype would continue to collect AMT at the corporate level, include corporate alternative minimum taxable income (AMTI) in shareholder AMTI, and credit corporate AMT against an individual's liability for regular tax and AMT.[17] This approach would treat the corporate AMT as equivalent to a mechanism for withholding shareholder level AMT.[18] However, the inclusion of corporate AMTI in shareholder AMTI would increase unacceptably the complexity of information reporting to shareholders and the calculation of shareholder tax. We considered but rejected as unworkable other solutions designed to confine the complexity of the AMT calculation to the corporate level.[19]

3.F ALLOCATING INCOME AMONG DIFFERENT CLASSES OF STOCK

Under the shareholder allocation prototype, once the corporation determines its taxable income and taxes paid, additional rules are needed to allocate that amount among different classes of shares. Both S corporations and partnerships must make such allocations under current law. However, neither of these models is appropriate for shareholder allocation integration. The S corporation rules, which are designed for corporations with a single class of stock and a limited number of shareholders, cannot readily be adapted to more complex capital structures.[20] The partnership allocation rules are sufficiently flexible, but generally are too complex, to apply to widely held corporations. Therefore, the shareholder allocation prototype adopts a modified version of the partnership approach.

Under current law, a partnership may allocate its income in any manner that has "substantial economic effect."[21] Subject to this limitation, a partnership has great flexibility to allocate income and loss or particular items of income or deduction to particular partners. In general, an allocation of partnership taxable income or loss can have substantial economic effect only if such income or loss is allocated to the partner or partners that will receive the benefit or bear the burden of the economic consequences corresponding to the taxable income or loss. The economic consequences of partnership allocations are reflected in capital accounts maintained by the partnership in accordance with detailed regulations.[22]

The shareholder allocation prototype approximates the basic approach of the partnership allocation method while reducing its complexity. It retains the principal economic advantage of the partnership system by permitting allocations of income to reflect varying economic rights among different classes of stock.

Under the shareholder allocation prototype, a corporation can allocate varying amounts of income to different classes of stock, in accordance with the terms of the corporation's governing instruments. Within each class of stock, a corporation allocates every share a pro rata portion of the income and tax credits allocable to that class. A corporation could not allocate income separately from credits for taxes paid. Thus, while the corporation and shareholders may agree on the amount of income allocated to each class of stock, all income allocated carries a proportionate share of credits for corporate taxes paid. Allowing corporations to allocate income and credits disproportionately would allow corporations to allocate credits to taxable shareholders and income without credits to tax-exempt shareholders.

The shareholder allocation prototype simplifies the partnership model by (1) imputing to shareholders only a single amount of taxable income, (2) requiring that tax credits be allocated in proportion to income, and (3) not allocating corporate losses to .shareholders. As a consequence, the prototype permits considerable flexibility in corporate capital arrangements but does not allow corporations to adopt the complex allocations possible under the partnership rules (which permit special allocations of items of income, deduction, and loss).

A substantial disadvantage is that this approach requires corporations to maintain capital accounts for each class of shares. Although, as discussed below, these capital accounts are simpler than the capital accounts required to be maintained for each partner in a partnership under the regulations under IRC § 704(b), they still add complexity to the shareholder allocation system. Capital accounts are needed, however, to help ensure that allocations of tax consequences follow allocations of economic income. As the following simplified example demonstrates, without tax rules requiring capital accounts, the corporation could allocate tax liability without regard to the economic substance of the capital structure.

Example. Two shareholders each contribute $1,000 to a new corporation. One shareholder has a 15 percent marginal rate and enough other tax liability to absorb excess credits, and the other has a 31 percent marginal rate. The corporation issues Class

A stock, which is allocated 100 percent of the corporation's taxable income, to the low-bracket shareholder. The corporation issues Class B stock to the high-bracket shareholder and provides that no taxable income will be allocated to the Class B stock. Cash distributions, however, are to be made pro rata between the Class A stock and the Class B stock. If these allocations are respected, all the corporation's taxable income and credits for corporate taxes paid will be allocated to the 15 percent shareholder. The Class A shareholder's share basis will increase accordingly, but the Class B shareholder's basis will remain $1,000. Thus, when the corporation is liquidated, the low-bracket shareholder will realize a loss and the high-bracket shareholder will realize a gain. In the meantime, however, the shareholders have arranged for substantial deferral of tax by having the corporation's income taxed currently at 15 percent (rather than having half taxed at 15 percent and half taxed at 31 percent, in accordance with the economic bargain between the parties).

This strategy would fail if the allocations were subject to the "substantial economic effect" requirement of IRC § 704(b). The rules under IRC § 704(b) would require the allocation of equal amounts of income to the two shareholders in order to establish capital accounts that would permit an equal division of liquidation proceeds.

Thus, some capital account mechanism is needed in the shareholder allocation prototype. The remainder of this discussion outlines generally the mechanics of maintaining capital accounts. Because we do not recommend adoption of shareholder allocation, however, we have not developed the additional technical analysis needed for a workable capital account regime.[23]

Capital accounts should be easier to maintain under shareholder allocation than under the partnership rules because the shareholder allocation prototype passes through only a single item (net taxable income) and a proportionate amount of credits for taxes paid. As a consequence, capital accounts increase by the amount of income allocated, net of credits for corporate taxes paid, and decrease by the amount of distributions. Further, because each share of stock within a class of stock receives a pro rata share of the income and taxes allocated, it is not necessary to keep detailed capital accounts for each shareholder. Instead, capital accounts can be maintained for each class of stock. Rules also would be needed to govern the allocation of losses to capital accounts. Although losses are not passed through to shareholders, losses reduce corporate assets available for distribution and should be reflected in capital accounts. Special allocations of losses among classes of stock are permitted, if appropriately reflected in capital accounts. While special allocations of losses create additional complexity, relative to a system in which losses are required to be allocated in proportion to income allocations, they seem necessary to preserve corporations' ability to issue preferred stock.[24] It may be difficult, however, to fashion practical rules that allow special allocations of losses to capital accounts that are liberal enough to preserve typical corporate capital structures but are restrictive enough to prevent abuse.

Existing corporations would have to seek shareholder approval to modify the terms of outstanding stock to provide for allocations of corporate income and the maintenance of capital accounts. This is likely to be a lengthy and difficult process that would substantially complicate the transition to a shareholder allocation system of integration. Accordingly, while we do not recommend shareholder allocation, if it were adopted, we would recommend a delayed implementation. See Chapter 10. Additional transitional rules may be needed to provide relief where a corporation cannot obtain the necessary shareholder approvals, for example, because of state law or contractual supermajority requirements.

3.G CHANGE OF STOCK OWNERSHIP DURING THE YEAR

Allocating both a corporation's retained and distributed income to shareholders requires a mechanism to reflect changes in stock ownership during the period to which such income relates and thereby apportion income tax consequences among the corporation's various owners. The current rules are straightforward: corporations pay dividends to the shareholder who owns the stock on the dividend record date and the Code taxes the person who receives the dividend.

The shareholder allocation prototype requires that corporate taxable income and corresponding credits for corporate taxes paid be allocated to shareholders of record as of the end of each quarter of the corporation's taxable year.[25] Corporations would not close their books and file tax returns and information returns quarterly, but rather would close their books at year end and allocate net income ratably to the record holder of the stock at the end of the four quarters.[26]

Closing corporate books at year end and allocating income pro rata among shareholders of record unavoidably creates problems in the treatment of shareholders that sell shares before corporate income and corporate taxes are known at the end of the year. As long as there is uncertainty concerning a given quarter's income, the buyer and seller of stock will not be able to price the stock accurately.

> <u>Example</u>. At the beginning of the year, a corporation has assets of $100. Shareholder A owns 100 percent of the single class of stock and has a basis in the stock of $100. The corporation's taxable year is the calendar year. On July 1, when the corporation has earned $25 of taxable income, A sells all her stock to Shareholder B for $117.25. If the corporation's books closed on June 30, it would pay $7.75 of corporate tax and would allocate $25 of income and $7.75 of tax credits to A. If A has a marginal tax rate of 31 percent, the taxable income allocated to her will be exactly offset by the allocated credits. A's basis in her stock would increase to $117.25, and A would report no gain on the sale. Because the shareholder allocation prototype does not determine taxable income until year end, A's final basis will be determined based on her pro rata share of the actual earnings and taxes paid for the year, which will turn on events subsequent to A's sale of stock and may differ from estimated earnings as of the date of sale. For example, if the corporation's taxable income for the full year is $80, A will be allocated $40 of income and $12.40 of tax credits and her basis will increase to $127.60. She will report a capital loss of $10.35.[27]

Thus, while a shareholder can tentatively calculate gain on a sale at the time the sale is made, that estimate may need to be revised based on more precise or differing information available only later and may even require the filing of an amended return.[28] The problem of amended returns may be particularly acute for shareholders that hold stock in corporations with taxable years other than the calendar year. The uncertainty of income allocations may result in some inefficiency in pricing sales of stock, although sellers of large blocks of stock may be able to limit uncertainty by effectively shifting the tax burden through contractual mechanisms.

This uncertainty could be reduced by requiring a quarterly closing of corporate books.[29] We rejected such a requirement, however, as imposing too great a reporting burden at the corporate level. Requiring quarterly filings of Form 1120 and quarterly information reports to shareholders would significantly increase the tax reporting burden on corporations. Although many large corporations must file quarterly financial statements (10-Qs) with the Securities and Exchange Commission (SEC), and most corporations must make quarterly estimated tax payments, refining that information to the degree of precision needed for tax return purposes can be a time-consuming process. Requiring a true quarterly closing of books would in effect abandon the taxable year concept and substitute a "taxable quarter" regime.[30]

Some intermediate solution may be possible. For example, capital gains and extraordinary dispositions could be allocated to the quarter in which they occurred. Large corporations might be required to provide estimates of each quarter's income, based on 10-Q filings (if any) and the kinds of calculations used for estimated taxes. Shareholders could be permitted to report the estimated income and tax amounts and make corrections when final reports were issued after year end. Such a system would, however, allow a significant degree of latitude to corporations unless there were rules governing the quarterly estimating and annual correction process. Such rules would likely be complex.

This problem would not exist in a pure pass-through integration system with no corporate level tax, no differences in the treatment of capital gains and losses and ordinary income and full flow through of corporate losses to shareholders.[31] For the policy reasons stated above, however, the shareholder allocation system retains the corporate level tax and does not require a quarterly closing of books. Accordingly, unless a satisfactory intermediate solution can be devised, the uncertainty of tax consequences for midyear sales of stock is unavoidable and is one of the significant obstacles to adoption of the shareholder allocation prototype.

3.H REPORTING AND AUDITING CONSIDERATIONS

As the preceding discussion makes clear, any passthrough integration system would increase the administrative burden on corporations and their shareholders. Although the shareholder allocation prototype includes simplified reporting provisions, it does require corporations to provide information reports (not now required) to shareholders showing each shareholder's portion of corporate taxable income and credits for corporate taxes paid (including other tax credits claimed by the corporation). The information returns also would have to provide information on appropriate basis adjustments. Because basis will increase for tax-exempt income, the basis adjustment will not necessarily be the same as the allocated income less the allocated tax credits. Shareholders, in turn, must take into account both corporate income and credits for corporate taxes paid in calculating their own tax liability and will need to keep detailed records to determine share basis when stock is sold.

Another administrative problem is the timing of income reporting. For example, U.S. corporations cannot report taxable income and corporate level taxes to shareholders until they receive reports of the taxable income and credits of other U.S. corporations in which they own stock. We have been unable to devise a precise solution for these timing issues. The taxable years of members of a consolidated group or other closely held and closely affiliated corporations can be conformed so that income is calculated at the same time. For corporate portfolio shareholders, however, timing difficulties may be severe. Before shareholder allocation could be implemented, it would be necessary to design a reporting system capable of accommodating corporate cross-ownership.[32]

The shareholder allocation system also requires substantial changes in the way corporations and shareholders are audited. In theory, under a shareholder allocation system, any increase or decrease in tax as a result of an adjustment to a tax return, resulting from an IRS audit or an amended return, should be reflected in the tax liability of the shareholders. The current system for partnerships carries an adjustment back to the partners' taxable year in which the understatement arose. Thus, if in 1990, it were determined that a partnership's income for 1988 had been understated by $1,000, the increase of $1,000 would be allocated to those who were partners in 1988. Extending this regime to corporations under integration would require the IRS to track and adjust the returns of shareholders holding stock in prior years. Furthermore, under such a system an adjustment in one year may require related adjustments in other years.

To avoid these problems, the shareholder allocation integration prototype would treat any audit or other adjustment to corporate income as a taxable event in the year of the adjustment. Under the prototype, it is unnecessary to adjust returns of prior year shareholders because adjustments to corporate income would be treated as an increase or decrease in the corporation's current year taxes and income. The adjustments would be passed through to current year shareholders.[33] The IRS would collect deficiencies directly from the corporation, and the corporation would pass through the credits for corporate taxes paid along with the additional income. Shareholders' bases would be adjusted to reflect the additional income.

3.I TREATMENT OF TAX-EXEMPT AND FOREIGN SHAREHOLDERS

Tax-Exempt Shareholders

The shareholder allocation prototype maintains the current taxation of corporate equity income allocated to tax-exempt shareholders by making shareholder credits for corporate level taxes nonrefundable to tax-exempt shareholders. Thus, tax on corporate income allocable to a tax-exempt shareholder would be taxed at the corporate level at the corporate rate. Tax-exempt shareholders would not be subject to UBIT on corporate income allocated to them and would not be allowed to use credits for corporate taxes paid to offset UBIT liability on other income.

Foreign Shareholders

We believe that foreign shareholders making investments in the United States should not receive, by statute, the benefits of integration received by U.S. shareholders. Thus, the shareholder allocation prototype denies refunds of corporate level taxes to foreign shareholders and continues to impose U.S. withholding tax on dividends. As under current law, corporate tax would be paid at the corporate level and withholding tax would be imposed at the investor level. The branch profits tax would continue to apply to U.S. branches of foreign corporations. Although in principle, the shareholder level withholding tax might be imposed on income allocated annually, the prototype continues to impose withholding tax only when distributions are made. Annual imposition of both the corporate and the investor level taxes would increase the tax burden on foreign investments in U.S. corporations as well as the disparity in the treatment of debt and equity owned by foreign investors. Denying integration benefits to foreign shareholders under the shareholder allocation prototype does not violate U.S. tax treaty obligations. Refundability of all or a part of the credit could be considered in treaty negotiations in exchange for reciprocal benefits. See Chapter 7.

3.J FOREIGN SOURCE INCOME

We do not believe that an integrated tax system should, by statute, treat foreign taxes like taxes paid to the U.S. Government. Extending the benefits of integration to foreign taxed income, if appropriate, is more properly achieved through bilateral tax treaty negotiations. See Chapter 7. Accordingly, the dividend exclusion and CBIT prototypes are designed to collect at least one full level of U.S. tax on foreign source income earned by U.S. corporations.

In contrast, the shareholder allocation prototype treats foreign taxes paid like U.S. taxes paid. As a consequence, depending on foreign tax rates, the United States may collect only a residual U.S. tax or no tax at all on corporate foreign source income. We considered modifying the shareholder allocation prototype to account separately for foreign taxes and deny foreign tax credits to shareholders, but such modifications are complex and fundamentally inconsistent with the pass-through nature of the prototype.[34] Denying a foreign tax credit would be harsher than current law, which generally allows a foreign tax credit at the corporate level and defers the shareholder level tax on foreign source income until it is distributed. Modifying the shareholder allocation prototype to tax foreign source income to shareholders only when distributed would effectively convert shareholder allocation into distribution-related integration.

Accordingly, the shareholder allocation prototype allows a foreign tax credit, computed under current law rules, to offset corporate level tax. The foreign tax credit, like other corporate tax credits, is passed through to shareholders. One issue this approach raises is how, if at all, the foreign tax credit limitation rules should be applied at the shareholder level. Although the foreign tax credit limitation is computed initially at the corporate level, additional restrictions would be necessary to prevent individuals with marginal tax rates of less than 31 percent from using foreign tax credits to offset liability for U.S. tax on other income.[35]

As under current law, the shareholder allocation prototype allows an individual U.S. shareholder holding stock directly in a foreign corporation to claim a foreign tax credit for withholding taxes paid on dividends. The prototype does not extend the indirect foreign tax credit of IRC § 902 to individual shareholders of a foreign corporation. The indirect credit was originally intended to prevent multiple taxation of corporate income earned through a foreign subsidiary. Because the shareholder allocation regime extends integration to foreign taxes, however, permitting individuals owning more than 10 percent of the stock of a foreign corporation to claim an indirect credit may merit consideration. Extending the indirect credit to U.S. individual shareholders would remove the disparity that would otherwise exist between foreign corporate stock held directly and foreign corporate stock held through a U.S. corporation. Such a change, however, would be a significant departure from current law and would exacerbate the problem of fashioning an appropriate limitation rule at the shareholder level.

Another issue for outbound investment in structuring the shareholder allocation integration prototype is whether to retain or eliminate the deferral allowed for profits earned through foreign subsidiaries. As Chapter 7 explains, the deferral rule provides that profits of a U.S. investor earned through a foreign corporation are generally not subject to U.S. tax until the profits are repatriated. Although theoretical consistency in implementing a shareholder allocation integration system would require eliminating the deferral rule, taxing foreign income currently is not essential to shareholder allocation. As a practical matter, it would be difficult to end deferral for U.S. portfolio shareholders, because sufficient information would not be available from the foreign corporation to determine the domestic shareholder's tax liability on undistributed income. Even for large shareholders, requiring annual reporting of income and foreign taxes paid by foreign subsidiaries would compound the reporting problems discussed in Section 3.H. A corporation with foreign subsidiaries could not accurately report to its shareholders its own income for the year until its subsidiaries had paid their own taxes in foreign jurisdictions. Accordingly, the shareholder allocation prototype permits U.S. shareholders in foreign corporations to continue to take income into account only when dividends are received. The same rule applies to U.S. corporate shareholders, subject to the current Subpart F and other current inclusion rules.

Chapter 4: Comprehensive Business Income Tax Prototype

4.A INTRODUCTION

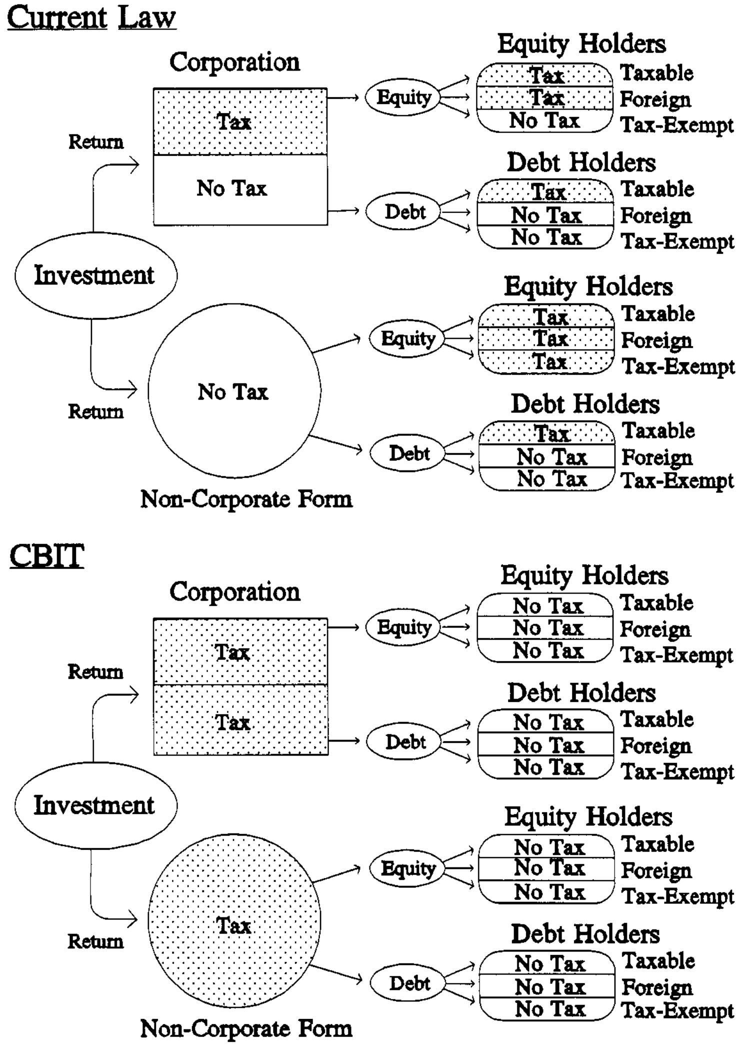
The Comprehensive Business Income Tax (CBIT) is the most comprehensive of the integration prototypes developed in this Report.[1] It is not expected that implementation of CBIT would begin in the short term, and full implementation would likely be phased in over a period of about 10 years.[2] The CBIT prototype represents a very long-term, comprehensive option for equalizing the tax treatment of debt and equity.

CBIT would equate the treatment of debt and equity, would tax corporate and noncorporate businesses alike, and would significantly reduce the tax distortions between retained and distributed earnings. CBIT would accomplish these results by not allowing deductions for dividends or interest paid by the corporation, while excluding from income any dividends or interest received by shareholders and debtholders. To ensure consistent treatment of corporate and noncorporate entities, CBIT would apply to all but the smallest businesses, whether conducted in corporate form or as partnerships or sole proprietorships. The result is that one—but only one—level of tax would be collected on capital income earned by businesses. An illustration of taxation under the current classical corporate tax and CBIT is depicted in Figure 4.1.

Under current law, income distributed on corporate equity generally bears two levels of tax, while interest paid to suppliers of debt capital bears at most one level of tax. CBIT not only eliminates the double taxation of corporate equity income, but also provides equal treatment for debt income. By denying a deduction for interest, the CBIT prototype subjects interest income, like dividend income, to a single level of U.S. tax equal to the top individual rate of 31 percent rate, regardless of the lender's actual marginal tax rate and regardless of the lender's status as a tax-exempt or foreign entity.[3]

Without any overall revenue loss, the CBIT prototype permits a reduction in the rate of tax on corporations from 34 percent to the top individual rate of 31 percent.[4] A lower rate of tax on capital supplied by tax-exempt, foreign or low-income

Figure 4.1
Comparison of CBIT and Current Law[1]



[1]The figures do not take into account tax preferences or taxes imposed by other countries.

investors could be incorporated into a CBIT regime, but we have chosen not to include these complicating provisions in the prototype described in this chapter.[5] Taxing income from business capital at a 31 percent rate enhances economic efficiency and advances the policy goals set forth in Chapter 1.[6] CBIT taxes corporate and noncorporate businesses (other than very small businesses) under identical rules, thus eliminating the current tax bias against the corporate form. CBIT also makes significant progress toward the removal of incentives to retain earnings, although a compensatory tax on distributions of preference income, if included in CBIT, would provide some incentive to retain such income.

Like the other prototypes, the CBIT prototype is structured to conform as closely as possible to the policy decisions summarized in the introduction to this part with respect to the treatment of preferences and tax-exempt and foreign investors. Since CBIT would be a greater change from current law than either distribution-related integration or shareholder allocation integration—both of which would apply only to corporate equity—a very gradual phase-in of CBIT over a long period will be necessary in order to reduce the economic dislocations and the gains and losses that might result during the transition. See Chapter 10.[7]

4.B OVERVIEW OF CBIT PROTOTYPE

General Mechanics. Under CBIT, distributions of business income as dividends or interest are not generally taxed when received by investors (see the discussion of tax preferences below). The income of all business entities, including corporations and unincorporated businesses, is measured and taxed at the entity level at a 31 percent rate.[8] The CBIT tax base is generally the corporate income tax base under current law, except that no deduction is allowed for interest expense, and dividends and interest received from CBIT entities are excluded. Losses incurred at the entity level do not pass through to the equity holders. Unused losses can be carried over at the entity level, however, generally in the same manner as under the current law rules applicable to corporations.[9]

Small Business Exception. Because it is difficult to separate returns to capital from returns to labor in the case of very small businesses, taxing all capital income from those businesses at the 31 percent CBIT rate might overtax some labor income that otherwise would be taxable to an individual in a lower bracket. The CBIT prototype includes an exception for very small businesses. See Section 4.C.

Tax Preferences. Tax preferences available to corporations generally would be available to CBIT entities. To implement this Report's general recommendation that preferences not be extended to shareholders, a flat rate nonrefundable tax of 31 percent (a compensatory tax) could be imposed at the entity level on dividends and interest deemed paid from preference income. Alternatively, investors could be required to include in income any interest or dividends considered to be paid out of preference income. The choice between these two methods is discussed in Section 4.D. In either case, businesses would determine which distributions are made out of preference income by maintaining an Excludable Distributions Account (EDA), which is similar to the EDA described in Chapter 2 under the dividend exclusion prototype. The EDA would reflect taxes paid and the prototype would stack interest and dividend payments first against fully-taxed income.[10] See Section 4.D.

CBIT Entities as Investors. CBIT entities are governed by the rules applicable to nonCBIT investors. Income from investments (other than dividends and interest from CBIT entities) is taxed to the CBIT entity as under current law. Dividends and interest from CBIT entities are not taxed in the hands of the recipient CBIT entity and would result in an appropriate addition to the recipient entity's EDA (thereby enabling the recipient CBIT entity to distribute such receipts without paying additional tax). Additional rules would be needed for taxable dividends and interest paid by CBIT entities if a compensatory tax were not adopted. See Section 4.D.

Foreign Source Income. CBIT entities would be entitled to a foreign tax credit computed as under current law, with modifications to reflect the nondeductibility of interest under CBIT. Foreign source income shielded from U.S. tax by foreign tax credits would be treated in a manner similar to preference income when distributed and either would be subject to a compensatory tax or would be taxable at the investor level at that time. As with distributions from preference income, stacking distributions first against fully-taxed income will limit somewhat application of these rules.

Low-Bracket Investors. While the CBIT prototype does not include explicit relief for low-bracket equity holders and debtholders, it is possible to reduce the effective rate of tax on CBIT investments from 31 percent to the investor rate with an investor credit for entity level taxes paid. See Section 4.F.

Tax-Exempt and Foreign Investors. Interest and dividends paid to tax-exempt and foreign investors by a CBIT entity are net of the 31 percent entity level tax; however, in general neither tax-exempt nor foreign investors are subject to additional U.S. tax on interest or dividends received from CBIT entities. If a compensatory tax is adopted, all dividends and interest would be excludable. As Section 4.D discusses, however, the alternative to a compensatory tax is to tax preference and foreign source income at the investor level.

We recognize that, in imposing one level of source-based taxation on interest paid to foreign investors, CBIT would represent a departure from current policy on inbound debt investment. Any such departure would have to be the result of extensive international discussions with tax authorities and market participants.[11]

Capital Gains and Share Repurchases. Chapter 8 discusses the treatment of capital gains on CBIT equity and debt and the treatment of share repurchases.

NonCBIT Interest and Other Capital Income. CBIT does not require any change in the current taxation of interest paid on debt issued by a borrower other than an entity subject to CBIT. Thus, for example, home mortgage interest would continue to be deductible by an individual borrower and includable in the income of the recipient. State and local bond interest would remain excludable from gross income to the same extent as under current law. Interest on Treasury debt would, as under current law, be includable in income by the recipient.[12] See "Interest Not Subject to CBIT" in Section 4.G.

Impact on tax distortions. Table 4.1 illustrates the impact of the CBIT prototype on the three distortions integration seeks address: the current law biases in favor of corporate debt over equity finance, corporate retentions over distributions, and the noncorporate over the corporate form. In general, CBIT is very successful in achieving the goals of integration because it removes most differentials in the tax rates on alternative income sources for domestic and foreign investors and tax-exempt entities. The near-uniform tax rate on all nonpreference, U.S. source business income is the maximum individual income tax rate (t_i^m, 31 percent under current law). For individual investors, the only exceptions to this uniform rate are for undistributed corporate equity income (if capital gains on corporate stock continue to be taxed) and for rent and royalties, which would continue to be taxed at regular individual rates. For tax-exempt entities and foreign investors, the only exception to the uniform rate on nonpreference, U.S. source business income is the rate on rents and royalties, for which current law rates would be retained.

4.C ENTITIES NOT SUBJECT TO CBIT

In theory, CBIT would apply to all businesses, without regard to size or legal form of organization. Thus, all sole proprietorships, partnerships, S corporations and other business entities would be subject to an entity level tax. After the phase-in of CBIT, current law distortions between the corporate and noncorporate business sectors would thus be eliminated, and taxpayers' choice of business entity would depend entirely upon nontax considerations. To preserve these

Table 4.1
Total U.S. Tax Rate on a Dollar of NonPreference, U.S. Source Income from a U.S. Business Under Current Law and the CBIT Prototype

Type of Income	Current Law	CBIT
I. Individual Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_i$	t_i^m
Undistributed	$t_c+(1-t_c)t_g$	$t_i^m+(1-t_i^m)t_g$
Noncorporate Equity	t_i	t_i^m
Interest	t_i	t_i^m
Rents and Royalties	t_i	t_i
II. Tax Exempt Entity is Income Recipient		
Corporate Equity:		
Distributed	t_c	t_i^m
Undistributed	t_c	t_i^m
Noncorporate Equity	t_c	t_i^m
Interest	0	t_i^m
Rents and Royalties	0	0
III. Foreign Investor is Income Recipient		
Corporate Equity:		
Distributed	$t_c+(1-t_c)t_{WD}$	t_i^m
Undistributed	t_c	t_i^m
Noncorporate Equity	t_{WN}	t_i^m
Interest	t_{WI}	t_i^m
Rents and Royalties	t_{WR}	t_{WR}

Department of the Treasury
Office of Tax Policy

t_c = U.S. corporate income tax rate.
t_i = U.S. individual income tax rate.
t_i^m = Maximum U.S. individual income tax rate.
t_g = U.S. effective individual tax rate on capital gains; is zero in one version of the prototype.
t_{WD}, t_{WN}, t_{WI}, t_{WR} = U.S. withholding rates on payments to foreigners of dividends, noncorporate equity income, business interest, and rents and royalties, respectively. Generally varies by recipient, type of income, and eligibility for treaty benefits and may be zero.

neutrality benefits, we believe that any small business exception to CBIT should be limited to very small entities.

The CBIT prototype includes an exception for small businesses with gross receipts of less than $100,000. Such businesses would continue to deduct their interest expense, and the interest they pay would be taxable to the recipients. Any wages or profits distributed by an exempt small business would be taxable to the recipients at the recipients' marginal tax rates. CBIT interest and dividends received by a small business would be excludable. We concluded that such an exception was desirable because of complexities that might otherwise arise in the transition from current law to CBIT and difficulties in separating capital income from labor income for very small businesses (proprietorships, in particular). Although CBIT generally taxes the income shares of creditors and equityholders at a uniform 31 percent rate, it does not alter the current progressive individual rate structure (with graduated rates from 15 to 31 percent) for taxing wages or other labor income and nonCBIT capital income. While all CBIT taxpayers would be allowed to deduct reasonable compensation paid for services to the same extent as under current law, these rules may be inadequate for small businesses. In many small businesses, income received by an owner-manager, in fact, may be a mixture of returns on both physical and human capital. Ignoring the distinction and subjecting all the owner-manager's income to the uniform CBIT rate, might overtax the labor component of the owner-manager's income. In addition, not allowing losses to flow through currently might create significant hardship where the owner-manager draws a salary. With a small business exception, however defined, all returns on capital in such nonCBIT small businesses would be taxed at the investors' separate rates instead of at the uniform CBIT rate.[13]

We concluded that an exclusion based on annual gross receipts would be the simplest to structure and estimate at the current conceptual phase of the prototype's development. For purposes of determining an entity's eligibility for the exception, dividends and interest received from CBIT entities would be included (although they would not be taxable to the receiving entity). Such a definition of the exclusion has several advantages. A gross receipts criterion is objective and easier to apply from a compliance and enforcement standpoint than the alternatives discussed below. It can be determined readily from documents currently generated for tax compliance purposes.[14] So long as the lower bound of gross receipts determining CBIT status is low, we believe that aggregation rules for nonCBIT entities should be unnecessary.[15]

Other criteria are possible. Ideally, the criteria should be related to the potential "blurring" of owners' capital and labor incomes. For example, businesses with substantial equity held by individuals who also supply substantial labor to the enterprise might qualify. Other definitions currently used in the Code or elsewhere include criteria such as whether the business is closely held (as measured by the number of shareholders), the value of the business (as measured by the value of stock, net worth, or the value or adjusted basis of assets), the annual amount (or average annual amount) of net income, and the number of employees. The correlation between blurring of labor and capital income of owner-managers and some of these characteristics may depend on the nature of the business, industry characteristics, and other factors. We believe the more practical course, however, is simply to exempt certain "small businesses" based on size.[16]

4.D TAX PREFERENCES

Introduction

We have made a general recommendation in this Report that integration should not become an occasion for extending corporate level tax preferences to shareholders. Future policymakers seem likely, however, to retain many of the preferences currently available to corporations under the Code. Absent special rules, CBIT's general exclusion of dividends and interest from income would automatically extend those preferences to shareholders.[17]

There are two general mechanisms which could be used to ensure that one level of tax is imposed on preference income when it is distributed. First, CBIT entities could be required to report to shareholders and debtholders the amount, if any, of each dividend or interest payment that is made out of preference income. The investor would then include that amount in income and pay tax at the investor's tax rate. This is the mechanism we recommend in the dividend exclusion prototype.[18] The alternative approach is to impose a 31 percent compensatory tax at the entity level on all distributions from preference income. Such a compensatory tax would not be refundable to tax-exempt or foreign investors.

Although both systems have advantages, the dividend exclusion prototype (and the imputation credit prototype described in Chapter 11) reject a compensatory tax in favor of shareholder level taxation of distributed preference income and foreign source income shielded from U.S. tax by foreign tax credits. As Section 11.B discusses, in those prototypes, which are limited to corporate equity, this Report would tax preference income and foreign source income at the shareholder level in order to preserve current tax and dividend policy for corporations with substantial amounts of such income.

Under CBIT, however, a compensatory tax has considerable conceptual and practical appeal. Adopting a compensatory tax would permit investors to exclude all dividends and interest received from any CBIT entity. Thus, CBIT would consistently collect tax on capital income, whether interest or dividends, at the entity level at a 31 percent rate.

A compensatory tax would be simpler at the investor level. Because all distributions with respect to CBIT investments would be excludable by investors, no information reporting to shareholders or debtholders would be required. On the other hand, if preference income distributed as interest or dividends were subject to investor level tax, CBIT entities would have to provide information reports to the IRS and to investors, indicating the extent to which a distribution is excludable. A compensatory tax under CBIT also would permit the complete repeal of the withholding tax on dividends and interest paid to foreign investors. See Section 4.E.

The principal disadvantage of a compensatory tax under CBIT is that our economic analysis suggests that it would create significant inefficiencies in corporate payout decisions. Our data indicate that even if distributions were stacked first against fully-taxed income, a compensatory tax would impose a significant entity level tax burden on distributions. Our models of corporate behavior predict that, to avoid this additional tax, CBIT entities would increase their reliance on retained earnings as a source of finance and would rely less on both new equity and debt. Under the assumptions of our models, this effect is strong enough to distort corporate payout decisions as much as under current law. See Section 13.D. Accordingly, the remainder of this chapter describes the differences in treatment necessary under the CBIT prototype if no compensatory tax is imposed and distributed preference income and foreign source income are taxed at the investor level.[19]

Excludable Distributions Account

The prototype identifies distributions out of preference income and foreign source income shielded from tax by foreign tax credits by requiring CBIT entities to maintain an Excludable Distributions Account (EDA). (The EDA is similar to the EDA described in Chapter 2, except that interest payments as well as dividend payments are charged against the account.) For each \$1.00 of U.S. tax paid, approximately \$2.23 would be credited to the EDA. The annual addition to the EDA is referred to as fully-taxed income and is calculated using the following formula:

$$\text{Annual additions to EDA} = \left[\frac{\text{U.S. tax paid for taxable year}}{.31} - \text{U.S. tax paid for taxable year}\right] + \text{equity distributions and interest received from CBIT entities}$$

The EDA is reduced by the amount of all dividend and interest payments, in the order in which payments are made. The EDA is also reduced by approximately \$2.23 per \$1.00 of tax refunded. Positive EDA balances may be carried forward without limitation.

The prototype stacks payments first against fully-taxed income. Distributions of interest or dividends reduce the EDA. When the EDA is reduced to zero, distributions would be subject to compensatory tax or, alternatively, would be taxable to the investor.[20] As in the dividend exclusion prototype, refunds of entity level tax would not reduce the EDA below zero. Refunds in excess of the taxes reflected by the EDA balance would be applied to reduce future entity level tax payments. Similarly, net operating losses in excess of the EDA would be carried forward.

To illustrate, assume that a corporation subject to CBIT earns \$100 in taxable income and \$100 of preference income, and pays \$31 in regular CBIT taxes but neither pays nor receives dividends or interest. Its EDA is thus \$69 [\$31/.31 − \$31]. If it then pays \$75 in interest and dividends, it will pay a compensatory tax of \$1.86 [.31 × (\$75 − \$69)] or, alternatively, the \$6 of distributions that is attributable to preference income will be taxable to investors.[21]

If a compensatory tax is adopted, all distributions on equity and debt of CBIT entities will be excludable. A CBIT entity receiving a distribution would add the amount received to its own EDA. If, alternatively, distributions of preference income were taxable to investors, the prototype could either (1) tax CBIT entities currently on such distributions[22] or (2) provide a deduction, similar to the current dividends received deduction, for such receipts to defer tax until the income is redistributed to a nonCBIT entity.[23]

Alternative Minimum Tax Consequences of CBIT

The CBIT system retains an entity level alternative minimum tax (AMT) similar to the corporate AMT under current law. As under current law, the entity level minimum tax would ensure that some entity level tax is imposed currently on a profitable business. In a CBIT AMT, however, neither interest expense nor dividends would be deductible and dividends and interest from CBIT entities would be excluded. Because the CBIT tax base provides no deduction for interest paid, it is likely that relatively few nonfinancial businesses would have regular tax liabilities low enough to trigger a CBIT AMT imposed at the current 20 percent rate. As in the dividend exclusion prototype, AMT would be treated as taxes paid in the same manner as the regular CBIT tax; however, the divisor in the EDA formula would still be the regular CBIT tax rate, 31 percent. Thus, a CBIT entity could not distribute all of its alternative minimum taxable income (AMTI) without triggering a compensatory tax or an investor level tax.

Adopting CBIT might permit significant simplifying modifications to the current individual AMT. If CBIT applied to all but small business entities, the individual AMT base would apply principally to two items: (1) excess itemized deductions and (2) State and local tax-exempt bond income treated as a preference under current law.[24] It would be inappropriate, however, to include excludable CBIT interest or equity income in an investor's AMTI because any such tax imposed would be a second level of tax on income that had already been subjected to tax at the highest individual rate.[25]

4.E INTERNATIONAL CONSIDERATIONS

Taxation of Income from Outbound Investment

This Report recommends that the tax burden imposed by any integration prototype on income from U.S. investment in foreign businesses (outbound investment) be roughly equivalent to the tax burden imposed on such income under current law. The shift from two-tier taxation of corporate foreign source income to a single-tier tax should not result in the collection of a significantly greater or lesser amount of tax revenue from such income than under current law. See Chapter 7.

Under current law, foreign source income earned through a domestic corporation is potentially subject to U.S. tax at both the corporate and the shareholder levels. At the corporate level, foreign source income is subject to a 34 percent tax, which may be reduced substantially or eliminated by foreign tax credits. If the U.S. corporate tax liability on foreign source income is less than the foreign tax imposed on the income, excess foreign tax credits may arise. Upon distribution, the income generally is subject to full taxation at the shareholder's marginal tax rate, without a foreign tax credit. This approach is consistent with U.S. income tax treaty commitments. No U.S. treaties require that investors in a U.S. corporation receive tax relief from foreign taxes paid by the corporation.

Foreign Source Income of CBIT Entities and Other Business Entities

Under the CBIT prototype, results comparable to those under current law are achieved by allowing the foreign tax credit (with a modified limitation, as described below) to offset the regular CBIT tax in full, but adding no amount to the EDA to reflect foreign source income sheltered from U.S. tax by foreign tax credits.[26]

The EDA mechanism does not distinguish between foreign source income shielded from the regular CBIT tax by the foreign tax credit and U.S. source preference income. Both benefit from the stacking rule that treats distributions as arising first from income subject to the regular CBIT tax. Accordingly, as with preference income, so long as foreign source income shielded from CBIT by the foreign tax credit is not distributed, it will bear no further tax burden. The CBIT compensatory tax or an investor level tax will be triggered only when such income is distributed—the same circumstance that would result in imposition of a shareholder level tax under current law.

If a compensatory tax is not adopted, this stacking rule ensures that the total Federal tax burden on outbound investment by corporations should not vary significantly from that imposed under current law, apart from the effect of the expanded tax base for foreign branch income resulting from the nondeductibility of interest. Imposition of a compensatory tax could increase the tax revenue collected from outbound investment. In either case, the tax burden on outbound investment by corporations may actually be less for foreign source income subject to foreign tax at a rate less than the CBIT rate, which will be subject to only a single level of residual U.S. tax.

CBIT will, however, require modification of the current rules for computing the foreign tax credit. Under current law, the foreign tax credit limitation is equal to the product of (1) the taxpayer's pre-credit U.S. tax liability on worldwide taxable income and (2) the ratio of the taxpayer's foreign source taxable income to its worldwide taxable income. This usually reduces to the product of the U.S. tax rate and the foreign source income. The foreign source income of a U.S. taxpayer is currently computed under U.S. tax principles for this purpose.[27] In the case of a foreign subsidiary, the amount of foreign taxes that are deemed paid by a 10 percent U.S. corporate shareholder in respect of a particular dividend distribution is equal to the total foreign taxes paid by the subsidiary, multiplied by the ratio of the dividend to the total earnings of the subsidiary. (This amount is subject to the limitation just described.)

If foreign source income were computed under CBIT principles, i.e., with no deduction for interest, problems would arise. In the case of foreign branch operations of CBIT entities, the amount of foreign source income in the limitation formula could increase dramatically. Such an increase would seriously mismatch the computation of taxable income and tax liability by a foreign jurisdiction that allowed a deduction for interest. Assuming that foreign tax rates were high enough to provide an adequate supply of credits, no U.S. tax would be collected currently on foreign source income used to pay interest. Instead, U.S. tax would be collected only when such income was deemed to have been distributed by the entity and a compensatory tax (or an investor level tax) was imposed. In the case of a foreign subsidiary, the amount of earnings in the denominator of the indirect credit fraction could increase dramatically, seriously diluting the amount of foreign taxes attributed to a particular distribution of earnings.

Accordingly, the CBIT prototype assumes that, in computing the foreign tax credit limitation, foreign source income of a branch will be reduced by interest expense claimed with respect to the foreign operations.[28] Similarly, in computing the indirect foreign tax credit, earnings of the foreign subsidiary will be reduced by interest expense claimed by the subsidiary.[29] Under this approach, CBIT entities will continue to enjoy approximately the same level of direct and indirect foreign tax credits as under current law. Some reduction will occur, however, by reason of lowering the regular CBIT tax rate to 31 percent from the current 34 percent.

Several additional effects of CBIT on the taxation of foreign source income should be noted. As explained above, CBIT would subject all business organizations to an entity level tax. This has at least two possible implications for the foreign tax credit. First, it suggests that an indirect credit for foreign taxes deemed paid by a foreign subsidiary should be available to noncorporate domestic shareholders, such as partnerships, that are CBIT entities. Under CBIT, the purpose of the indirect credit would defer the additional level of CBIT tax until the time of distribution (when a compensatory tax or an investor level tax would be imposed) to avoid the burden of an immediate tax on foreign source profits. If the indirect credit were not extended to partnerships and other noncorporate CBIT entities, there would continue to be a strong bias in favor of the corporate vehicle for multinational enterprises.

Second, the equal treatment of all business entities under CBIT means that foreign tax credits will not fully relieve CBIT tax in circumstances where U.S. tax is fully relieved under current law. If a domestic partnership or S corporation receives a dividend, interest, or royalty payment from a foreign corporation (or other foreign payor) under current law, and the payment has been subject to a foreign withholding tax, the recipient is eligible for a foreign tax credit, and no further U.S. tax is imposed to the extent that the partners or shareholders are individuals. Under CBIT, however, the credit would only relieve the regular CBIT tax. A compensatory tax or an investor level tax would be imposed when the foreign profits are redistributed to the partner or shareholder.

Finally, CBIT requires some consideration of the treatment of foreign business entities. Under current law, deferral of U.S. tax on foreign profits is available when the profits are earned through a foreign corporation. When such profits are earned through a foreign partnership, the U.S. tax is not deferred, and the results are essentially the same as for a foreign branch office of a U.S. taxpayer. Under the CBIT prototype, foreign entities would generally be treated as nonCBIT entities. Thus, interest paid by a foreign entity would continue to be taxable to a U.S. lender, and would continue to be deductible by the foreign entity.[30] In addition, deferral would continue to be permitted for profits earned through a foreign corporation.

Foreign branches of CBIT entities. In the case of a foreign branch of a U.S. CBIT entity, the expanded CBIT income base of the branch would be included in the U.S. CBIT entity's income currently. Foreign source income earned by a CBIT entity through a foreign branch would be subject to residual regular CBIT tax prior to distribution. As discussed above, there will always be a residual regular CBIT tax on the portion of the foreign source income base that is excluded from the computation of the foreign tax credit. Where the foreign jurisdiction's tax is computed with an interest deduction, such income will bear, in effect, the same tax that it would have borne if earned from domestic sources. With respect to the remaining portion of the foreign source income base, a residual regular CBIT tax will be imposed if the foreign income tax liability is less than the regular CBIT liability, with the effect that such income also will bear the same pre-distribution aggregate tax (foreign tax plus CBIT tax) that it would have borne if it were earned from domestic sources.[31] If the foreign income tax liability on the remaining portion of the foreign source income base is higher than the regular CBIT liability, such income will bear a pre-distribution tax rate that is higher than the CBIT rate applicable to domestic source income. This disparity, which also exists under current law, is entirely attributable to higher foreign tax rates.

Foreign portfolio equity investment (less than 10 percent of total equity) by a CBIT entity. Foreign source portfolio dividends received by a CBIT entity would be subject to source country income taxation at the level of the foreign corporation and to a second level source country withholding tax upon distribution. Regular CBIT would apply to the foreign source dividend when received by a CBIT entity, subject to offset by a foreign tax credit for the source country withholding tax. In most cases, some regular CBIT would be collected, because regular CBIT liability would generally exceed the foreign withholding tax by virtue of treaty rate reductions and by virtue of the expansion of the CBIT income base to include income paid out as interest. While such income is subject to an additional level of taxation (the foreign corporate level tax) relative to income earned through investment in a U.S. subsidiary, the disparity should be approximately the same as under current law. If distributed by the CBIT entity, such income, to the extent shielded from regular CBIT by the foreign tax credit, would be subject to the CBIT compensatory tax or an investor level tax. If the CBIT entity is a corporation, this result generally will be comparable to the result under current law. To the extent residual regular CBIT is paid, the result will be better than under current law for shareholders now taxable on dividend income. A CBIT entity that is a partnership with individual shareholders or an S corporation may be treated less favorably than under current law in certain circumstances.

Foreign direct equity investment (10 percent or more of total equity). Foreign source income earned by a CBIT entity through a direct equity investment would be subject to full source country corporate level tax and to a second level source country withholding tax upon distribution of a dividend from the foreign subsidiary. The CBIT entity (whether a corporation or partnership) would receive a credit both for the source country withholding tax and for the source country corporate level tax under IRC § 902. Thus, regular CBIT would be imposed only to the extent that the regular CBIT liability exceeded the total amount of foreign taxes paid or deemed paid. Given the opportunity to defer the CBIT compensatory tax or investor level tax by retention of foreign subsidiary profits at the CBIT entity level, the disparity between direct equity investment in a foreign subsidiary and investment in a domestic subsidiary under CBIT should not vary significantly from current law. If distributed by the CBIT entity, such income would be subject to the CBIT compensatory tax or an investor level tax to the extent it was shielded from regular CBIT by foreign tax credits. However, as with portfolio investment, the result will generally be similar to the result under current law in cases where such dividends would be taxed fully. To the extent subject to residual regular CBIT, such income will be taxed less heavily than under current law. A CBIT entity that is a partnership or an S corporation may be treated less favorably than under current law (depending on whether the IRC § 902 credit is extended to such shareholders).

<u>Foreign debt investment</u>. Foreign source income earned by a CBIT entity through a debt investment in a foreign entity or subsidiary would escape source country income taxation to the extent that interest is deductible for foreign income tax purposes. While such income potentially would be subject to a foreign withholding tax upon distribution as interest, the CBIT entity would receive a foreign tax credit for the withholding tax (subject to the foreign tax credit limitation). Thus, regular CBIT would be imposed only to the extent that regular CBIT liability exceeds the foreign withholding tax. Interest income received from a domestic subsidiary also would be subject to CBIT, in this case imposed on the subsidiary. Thus, outbound debt investment should not be subject to greater entity level tax than domestic debt investment until such income is distributed. The CBIT compensatory tax or an investor level tax then would apply to the extent the income had been shielded from U.S. tax by foreign tax credits. The impact of the CBIT compensatory tax or an investor level tax, if and to the extent imposed, will be similar to the consequences described for the imposition of such tax on foreign portfolio equity investment.

Foreign Source Income
Earned Directly by Individuals

Under CBIT, foreign corporations and other foreign entities would be treated as nonCBIT entities. Accordingly, as under current law, interest and dividend income received directly by a U.S. resident individual from a foreign corporation would be subject to tax at the individual's marginal tax rate. CBIT does not require the modification of the foreign tax credit allowed to individuals under current law.

Taxation of Income from Inbound Investment

As noted in Section 4.A, we view CBIT as a very long-range option for equalizing the treatment of debt and equity. We anticipate that adoption of CBIT would be preceded by a lengthy period of consideration and, when implemented, CBIT would be phased-in over a period of about 10 years. See Chapter 10.

Both the dividend exclusion prototype and the shareholder allocation prototype retain the current U.S. withholding tax on dividends paid to foreign shareholders and the branch profits tax on U.S. branches of foreign corporations. Retaining the second level of tax on equity income in those prototypes simply replicates current law and permits reduction of the second level of tax through tax treaty negotiations.

We make a different recommendation in CBIT, however. Retaining current law in the context of CBIT would require collecting two levels of tax on dividends and zero or one level of tax on interest. (Chapter 7 discusses the current law taxation of foreign investors.) Such treatment would violate the equality between debt and equity that is one of the principal goals of CBIT. To maintain parity between debt and equity, the

CBIT prototype removes the remaining withholding taxes on both interest and dividends paid by CBIT entities.[32] The result is to subject both debt and equity income to CBIT taxation once at the entity level.

Elimination of the remaining withholding taxes on both dividends and nonportfolio interest under CBIT would clearly affect U.S. income tax treaty negotiations. While existing U.S. treaties provide for reciprocal reductions of source country tax rates on interest and dividends, CBIT might reduce U.S. treaty partners' incentive to grant a reciprocal exemption in future negotiations.[33] In order to obtain a reciprocal exemption, it might be necessary for the United States to make concessions either with respect to entity level tax collected on dividends and interest or CBIT compensatory taxes (if any) imposed on dividends and interest. For example, a tax credit for CBIT taxes paid could be made available only on a bilateral basis. Any such treaty concessions should be made in a manner to protect CBIT's basic goal of equating the taxation of debt and equity.

If a compensatory tax were not adopted, distributed preference income and shielded foreign source income will be taxable to investors.

We recognize that adoption of CBIT would represent a departure from current policy on inbound debt investment and that any such departure would require extensive international discussions with tax authorities and market participants.

Conduct of a U.S. Trade or Business

As under current law, income earned by a foreign investor through the conduct of a U.S. trade or business would be taxed in the same manner as income earned by U.S. residents. CBIT rules would apply to foreign business activities in the United States. Thus, interest expense attributable to a U.S. trade or business would be nondeductible, and the current law provisions governing the allocation of interest expense to effectively connected income would be unnecessary.[34]

Small Business Exception

The small business exception would apply to inbound investment. See Section 4.C. Distributions from small, nonCBIT corporations to foreigners would remain subject to current statutory withholding at 30 percent, unless that rate is reduced by treaty provision.[35] In the case of a U.S. branch of a foreign corporation, the size criteria would be applied on the basis of the gross effectively connected receipts of the branch.

4.F IMPACT OF CBIT ON INVESTMENT BEHAVIOR OF LOW-BRACKET, TAX-EXEMPT, AND FOREIGN INVESTORS

Overview

Because substantial nontax factors influence investment behavior, we cannot predict with certainty CBIT's impact on the manner in which investors allocate their portfolios. Indeed, if tax considerations were paramount, there would be a strong bias under current law against any investment by low-bracket taxpayers and domestic tax-exempts in domestic corporate equities (as opposed to debt). Current experience indicates, however, that both of these groups invest in corporate equity. While special statutory withholding provisions, the statutory exemption for capital gains realized by foreign investors on property investments other than in real property, and treaty mitigation provisions make it hard to generalize in the case of foreign investors, the tax provisions of current law, if given paramount effect, would direct their investment toward domestic debt rather than corporate equity in most instances. Other nontax factors are important, however, and foreign investment in domestic equity occurs despite higher tax rates than for domestic debt.

The United States' stable economic and political climate attracts investment. The size of our consumer market attracts foreign sellers and investors. Opportunities for diversification not available through alternative investments can override tax disadvantages. These nontax factors will temper portfolio shifts by these classes of taxpayers. Considering these countervailing forces, we believe that the best approach is to adopt a gradual phase-in of CBIT, rather than specific measures for low-bracket, tax-exempt and foreign investors although we discuss such measures below. To preserve CBIT's neutrality between debt and equity, the discussion contemplates identical treatment of debt and equity. The reductions of tax due to these mechanisms, of course, will have revenue consequences.

Interest Rate Impact of CBIT

The interest rate on CBIT debt will be less than the interest rate on nonCBIT debt, potentially by an amount up to the 31 percent entity level tax, because interest received on CBIT debt represents an after-tax return.[36] For example, if market interest rates on nonCBIT debt were 10 percent, a debt instrument issued by a CBIT entity might bear interest at a rate as low as 6.9 percent. If this were the case, the after-tax return on the two instruments would be the same for a taxable investor with a 31 percent marginal rate. While predicting the actual rate relationship between CBIT and nonCBIT debt is impossible, experience with the ratio of interest on tax-exempt state and local bonds to that on taxable corporate bonds suggests that the CBIT interest rate may not reflect a 31 percent tax rate, because there may be insufficient demand for CBIT debt by investors with a marginal rate of 31 percent. Thus, for example, if a nonCBIT bond bore interest at a 10 percent pre-tax rate, a CBIT bond might bear interest at 8 percent if it were necessary to attract lower-bracket investors to CBIT debt. In such a case, the 8 percent (after-tax) CBIT return would be more attractive to an investor in the 31 percent bracket than the 10 percent (pre-tax) nonCBIT return.

Because interest rates on CBIT debt should be lower than the rates on nonCBIT debt, low-bracket, tax-exempt, or foreign investors (collectively, tax-favored investors) can be expected to increase their holdings of nonCBIT debt and decrease their holdings of CBIT debt. (Overall, these portfolio shifts may be offset by increased demand for CBIT debt and equity by taxable investors.) Depending on their tax rates, tax-favored investors, for example, might prefer a 10 percent nonCBIT bond to an 8 percent CBIT bond. For any investor with a marginal rate of less than 20 percent, a 10 percent nonCBIT return is worth more than an 8 percent CBIT (after-tax) return. While a rate differential of less than 15 percent between CBIT and nonCBIT bond rates should not affect the portfolio choices of low-bracket individual taxpayers, any rate differential could affect investment choices by tax-exempt and foreign investors since, as under current law, all nonCBIT interest paid to tax-exempt investors (and portfolio interest paid to foreign investors) is tax-free at the investor level. Domestic tax-exempt entities might be expected to decrease holdings of CBIT debt and increase holdings of governmental or other nonCBIT debt and CBIT equity.[37]

The treatment of preference income under CBIT further complicates the analysis of the expected rate differential between CBIT and nonCBIT investments. If a compensatory tax were imposed, all CBIT investments would pay an after-tax return, and one would generally expect the risk adjusted return on CBIT investments to be the same. On the other hand, if payments of dividends and interest out of preference and foreign source income are taxable to investors, issuers with substantial preference and foreign source income may pay a higher return than issuers with substantial fully-taxed income.

If CBIT were adopted, special attention would have to be given to its impact on international capital flows.

Low-Bracket Investors

As discussed in Chapter 1, we have structured the CBIT prototype to impose a uniform 31 percent tax on earnings on capital invested in CBIT entities. However, the impact of CBIT on taxable equity holders and bondholders with marginal rates of less than 31 percent could be lessened by providing those investors with a tax credit. This credit could be designed to give those investors a tax benefit equal to all or a portion of the difference between their marginal rate and the 31 percent CBIT rate. While the credit would not be refundable, it could offset tax on other income. The effect would be similar to full refundability for any investor with enough other tax liability to absorb the credit.[38] If a compensatory tax were not imposed, the credit would be available only for excludable payments.

The credit is essentially the same as the shareholder credit for low-bracket investors described in Section 2.D in the context of the dividend exclusion prototype. Because CBIT extends to both dividends and interest, the credit would be available to both equity holders and bondholders.

Example. Assume that a CBIT entity earns $100 of income and pays $31 in tax. It then distributes $69 as interest to a bondholder with a marginal tax rate of 15 percent. Applying the formula set forth in Section 2.D (adjusted to reflect the 31 percent CBIT rate), a bondholder credit of $16 (i.e., $\$69/.69 \times (.31 - .15)$) would produce a tax benefit equal to the difference between the bondholder rate and the CBIT rate.

Tax-Exempt Investors

Under the other prototypes described in this Report, denying refundability of corporate level taxes preserves the current law treatment of corporate equity owned by tax-exempt and foreign investors. Under CBIT, however, some offset for corporate level taxes would tend to move CBIT closer to current law by mitigating the additional tax burden the prototype places on interest earned by tax-exempt investors. As with low-bracket shareholders, the credit could be set at a rate that would refund either all or a portion of the tax imposed at the 31 percent CBIT rate. If a compensatory tax is not imposed, the credit would be available only for excludable payments.

Because tax-exempt investors have little or no tax liability, they would be unable to benefit from the nonrefundable investor credit described in the preceding section. One possibility would make the investor credit described above refundable. An alternative approach would combine an investor level credit with a tax on investment income of tax-exempt entities. Under this approach, tax-exempt and foreign investors would be liable for tax on all investment income (interest, dividends, capital gains, rents, royalties, and other investment income). The rate of this tax could be set to produce overall revenues (taking into account the investor credit) equivalent to those currently borne by equity supplied by the tax-exempt sector. A tax-exempt entity could then use the investor level credit to offset the tax due on other investment income. See Section 6.D.[39]

Imposing a tax on investment income and allowing a credit would treat CBIT and nonCBIT debt instruments alike (although it probably would not fully compensate for the interest rate differential between CBIT and nonCBIT debt). It generally would encourage tax-exempt entities to hold a mixture of CBIT and nonCBIT debt and equity, because the nonrefundable investor credit associated with CBIT debt and equity could be used to offset the tax due on other kinds of investment income. This approach would minimize differences between CBIT and nonCBIT investments, just as it could minimize differences between debt and equity under distribution-related integration.[40]

Foreign Investors

The absence of special relief for foreign debt investors in the CBIT prototype reflects our judgment that elimination of the withholding tax on CBIT dividends and interest and elimination of the branch tax may balance the CBIT change as to debt, recognizing that, under CBIT, foreign investors may prefer nonCBIT debt to CBIT debt and CBIT equity to equity under current law.

Nevertheless, either of the mechanisms described for tax-exempt investors—a refundable credit or the investment tax and credit mechanism described in the preceding section—could be used to provide relief for foreign investors. A gradual phase-in of CBIT also would allow assessment of the need for such mechanisms based on experience.

Impact of Relief Measures for Low-Bracket, Tax-Exempt and Foreign Investors on the CBIT Prototype

Our recommended CBIT prototype contains none of the relief mechanisms discussed in the preceding sections. Adoption of any of these mechanisms would result in a revenue loss which would have to be recovered elsewhere in the prototype or in other offsetting revenues not now required by the prototype. For example, a compensatory tax could be imposed. (The estimates for the CBIT prototype in Section 13.H do not include a compensatory tax.) In addition, the decisions to eliminate the branch tax and withholding taxes for foreign investors could be re-examined (although such a modification would be contrary to the goal of imposing a single level of U.S. tax).

4.G STRUCTURAL ISSUES

Current Law Interest Deduction Limitations Under CBIT

Under current law, interest paid or incurred by businesses generally is deductible. In special circumstances, however, the Code limits business interest deductions. These limitations serve several purposes, such as treating debt instruments with equity characteristics as equity, preventing mismatches in the timing of income and expense, and preventing tax arbitrage by borrowing to purchase tax-favored investments.

CBIT's elimination of the deduction for business interest by all but the smallest businesses could allow a major simplification in the Code by eliminating (or substantially reducing) the need for several provisions designed to prevent excessive and mismatched interest deductions. Thin capitalization will no longer be a tax concern. We believe the following Code sections could be repealed or substantially reduced in scope:

- IRC § 385 (granting Treasury the authority to define the distinction between debt and equity) and IRC § 279 (denying deductions for equity-like debt) would be repealed,
- IRC § 163(e)(5) and (i) (deferring interest deductions on high-yield discount obligations) and IRC § 163(j) (deferring excessive interest deductions on certain related-party debt—the anti-earnings stripping provision) would be repealed,
- IRC § 267(a)(2) (relating to matching of interest income and deductions between related parties) would no longer apply to interest paid by CBIT entities,
- IRC § 469 (the passive loss rules) and IRC § 465 (the at risk rules) would have no application to interest paid by a CBIT entity,
- IRC § 263A(f) (relating to capitalization of interest with respect to self-constructed assets and inventory) could be repealed, and IRC § 266 (the election to capitalize interest generally) could be repealed with respect to CBIT entities,[41]
- IRC § 1277 (restricting interest deductions allocable to accrued market discount) and IRC § 1282 (restricting interest deductions allocable to accrued discount) might no longer apply to interest paid by CBIT entities,
- IRC § 263(g) (requiring capitalization of interest and other costs of carrying a straddle) might no longer apply to interest paid by a CBIT entity,
- IRC § 265(a)(2) (disallowing deductions for interest incurred to purchase obligations bearing tax-exempt interest) might no longer apply to interest paid by a CBIT entity,
- IRC § 265(b) (relating to disallowance of interest deductions of financial institutions allocable to tax-exempt obligations) and IRC § 291(e)(1)(B)(ii) (an earlier version of IRC § 265(b) applicable for tax-exempt obligations acquired by financial institutions between 1982 and 1986) could be repealed,[42] and
- IRC § 264(a)(2), (3), and (4) (denying interest deductions on certain debts relating to life insurance policies) might not apply to interest paid by CBIT entities.

CBIT will expand the scope of provisions, such as IRC § 265(a)(2) (which currently disallows deductions for interest on indebtedness incurred or continued to purchase or carry obligations bearing tax-exempt interest) and IRC § 265(a)(1) (which currently disallows expense allocable to tax-exempt income other than interest), to apply to taxpayers who receive CBIT interest and dividends. While the expanded interest disallowance rules would not apply to CBIT entities, it would apply to individuals and small business entities to disallow interest on debt incurred or continued to purchase or carry equity or debt of CBIT entities.[43] Absent such expansion, much of the CBIT tax base would erode in tax arbitrage transactions illustrated by the following hypothetical example:

> Example. Assume that, for each year of its operation, CBIT entity X earns $1 million, pays $310,000 in regular CBIT tax and pays the remaining $690,000 as a dividend to individual A, its sole shareholder. The $690,000 is not taxable to A.
>
> Assume that A borrowed $6,900,000 from tax-exempt entity C at 10 percent interest per year to purchase the X stock. If A is allowed a deduction of $690,000 for interest paid, he can shelter up to $690,000 in income from other sources while using his excludable CBIT dividends to pay the interest to C. C will pay no tax on the $690,000 in interest it receives each year. If the $690,000 deduction allowed to A shelters income otherwise taxable at 31 percent, $213,900 of the tax paid by X will in effect be refunded to A. While the interest paid and dividend received in this example are equal, they need not be. If C is willing to loan A $10 million against his X stock on the same terms, A's interest deduction, if used against other income, would fully offset the CBIT tax X paid with respect to the distribution to A.[44]

Under current law, this is simply one of many opportunities for rate arbitrage through the issuance of debt by taxable issuers to tax-exempt and foreign lenders. CBIT, however, generally eliminates businesses' ability to pay interest to tax-exempt and foreign lenders without the payment of one level of tax. Thus, to prevent the erosion of the CBIT base, it is also necessary to prevent investor level rate arbitrage through borrowing.

Application of modified IRC § 265 would be equally appropriate if a compensatory tax is not adopted and interest and dividends paid by CBIT entities out of preference income are taxable to investors. In either case, the potential for arbitrage is the same. See "Anti-abuse Rules" in Section 2.B.

Finally, some of the interest deduction limitations CBIT might eliminate may serve policies that would continue to be important but would require new mechanisms under CBIT. One example is current law's requirement that debt obligations be issued in registered form. Currently IRC § 163(f) denies a deduction for interest on unregistered obligations for which registration is required. This sanction would have no deterrent effect for CBIT entities because CBIT eliminates interest deductions. Because interest received from CBIT entities will not be taxed to the investor, the need for registration of debt instruments of CBIT entities for tax enforcement purposes will be greatly reduced. However, registration may be desirable for nontax law enforcement purposes, and replacement sanctions may be needed.[45]

Identifying Disguised Interest

CBIT entities and their investors will be indifferent to the characterization of payments to investors as either interest or dividends, because neither will be deductible by the CBIT entity and neither will be taxable to the investor. However, tax tensions will remain and may be exacerbated by CBIT with respect to rent and royalty payments and allocations between principal and interest on the purchase of capital assets.

If the market rate of interest on CBIT debt does not fully reflect the nondeductibility of interest payments, it will generally be advantageous to a CBIT entity to restructure such payments, where possible, into deductible rental and royalty payments. Such a restructuring will generally be disadvantageous to taxable recipients since it will convert interest that is not taxed into taxable rents or royalties. No such tension will exist, however, if the recipient is a tax-exempt entity or a CBIT entity that is in a net operating loss position. Similarly, CBIT entities can be expected to maximize principal and minimize interest payments on capital purchases, since asset basis will give rise to deductible cost recovery while interest payments are nondeductible. Again, taxable sellers may have opposing interests depending on how gains on asset sales are taxed.[46] As with rents and royalties, these tensions will not exist where the seller is tax-exempt or is a CBIT entity with a net operating loss.

CBIT therefore will put increased pressure on standards, such as those the Internal Revenue Service has developed, distinguishing finance leases (which are treated for tax purposes as loans and hence generate nondeductible interest for a CBIT entity) from true leases (which are respected as such for tax purposes and hence give rise to deductible rentals for CBIT entities).[47] We believe that it would be prudent in a CBIT regime to include standards for distinguishing interest from rents and royalties in the Code, modeling them on existing standards, such as those the Service has developed for leases, or on IRC § 467, which imputes interest to prevent uneconomic accruals of rent.[48]

Purchase price allocations are inherently factual and governed by the standards of the market. While CBIT may change the tax stakes in such allocations, the problem presented is no different from that confronting the Internal Revenue Service in making fair market value determinations under current law. We do not contemplate that statutory change will be needed in this connection to implement CBIT.

The current original issue discount (OID) and imputed interest rules may be needed in order to distinguish interest from principal. For example, in the case of sales of property in exchange for debt, these rules are needed to determine the buyer's basis and the seller's amount realized.[49] Similarly, in the case of debt issued for cash, these rules are needed to distinguish payments of interest (which reduce the EDA and, when the EDA is exhausted, are subject to compensatory tax or investor level tax) from payments of principal.[50]

Interest Not Subject to CBIT

CBIT does not dictate any change in the current taxation of interest paid on debt issued by a nonCBIT borrower. Thus, for example, home mortgage interest and personal investment interest incurred to carry nonCBIT assets would continue to be deductible by an individual borrower to the same extent as under current law and includable in the income of the recipient. Nonmortgage, personal interest would continue to be nondeductible by the borrower and includable by the lender. State and local bond interest would generally remain excludable from gross income to the same extent as under current law. Interest on Treasury debt would, as under current law, be includable in income by the recipient.[51]

One administrative issue raised by nonCBIT debt is tracking income and deductions related to such debt. For example, maintaining the current law treatment for home mortgage interest, interest on Federal debt, and debt issued by foreign and tax-exempt entities under CBIT will require special reporting rules to identify such interest as includable in income and to permit it to retain its special character when it is collected and distributed by a REMIC, REIT, or other passthrough entity.

Under CBIT, interest earned on bonds issued by State and local governments would retain its current exemption from tax,[52] but interest income on debt issued by CBIT entities generally would be exempt. Under CBIT, the rate of interest on exempt state and local obligations may approximate the interest rate on corporate debt of similar risk and maturity. Thus, State and local governments might view CBIT as eliminating the borrowing advantage they currently enjoy relative to corporate issuers. State and local debt would, however, retain its advantage over Treasury and other nonCBIT debt such as home mortgages.

Pension Funds

As Section 2.G discusses, the immediate deduction for employer contributions to pension plans, combined with the deferral of income to the employee until benefits are paid, effectively exempts the investment earnings on the contribution from tax. As a consequence, under current law pension fund investment earnings from investments in corporate stock bear only one level of tax—the corporate tax paid by the corporation. Investment earnings on pension fund investments in corporate debt, however, bear no tax at all under current law, because corporate income used to pay interest is not taxed at the corporate level.[53] Under CBIT, however, investment earnings from both CBIT debt and equity will be taxed at the payor level, with the consequence that pension plans will earn an after-tax return on such investments. The introduction of CBIT thus eliminates the deferral of tax on inside buildup.

The position of pension plan trusts under current law could be replicated in CBIT only by refunding the CBIT entity level tax on interest paid to pension trusts. This step would eliminate the need to revise pension tax rules, but would undermine CBIT's fundamental goals of treating debt and equity alike and collecting a uniform tax on business capital income regardless of the identity of the investor.

To equate the treatment of CBIT debt and equity investments by pension funds, we recommend requiring pension trusts to maintain separate accounts for CBIT income and other amounts, e.g., contributions and nonCBIT income,[54] to treat all distributions made each year as made proportionately from the income of each account, and to notify pension payees of the amount from each account included in their pension payments. Payees would be entitled to exclude from income pension distributions from the CBIT income account, thereby reducing the tax burden on corporate equity investments relative to current law.

Because pension trusts will enjoy no inside build-up advantage over other investors with respect to the CBIT assets they hold, CBIT might induce such trusts to alter their portfolio mix toward nonCBIT assets. The degree to which this occurs depends on the relationship of CBIT to nonCBIT yields and the portfolio and diversification advantages of particular investments.

If a compensatory tax were not adopted, pension funds would add only excludable CBIT income to the CBIT income account. In general, taxing distributed preference income at the investor level, rather than imposing a compensatory tax, would lessen the extent to which adoption of CBIT removes the tax-free inside build-up on CBIT investments.

Subchapter C Recognition and Reorganization Rules

As in the dividend exclusion prototype, the CBIT prototype retains the basic rules of Subchapter C governing the treatment of taxable and tax-free corporate asset and stock acquisitions. CBIT entity gain on asset sales would be taxable to the CBIT entity and payment of tax on the gains would give rise to additions to the EDA, thereby permitting distribution of the after tax proceeds of such asset sales to investors without further tax. As in the dividend exclusion prototype, the Subchapter C reorganization rules would be retained, and no special limitations analogous to IRC §§ 382 and 383 would apply to the EDA. See Section 2.F. As in the dividend exclusion prototype, EDAs would be combined in acquisitive reorganizations and allocated in divisive transactions. Liquidations would generally be treated as in the dividend exclusion prototype. A liquidating entity's EDA would generally be allocated among equity holders in proportion to the amount of other assets distributed to them, and any gain would be excludable to the extent of the allocable EDA.[55]

In CBIT, however, partnerships are treated as CBIT entities. Imposing Subchapter C structural rules on partnerships would change current law significantly by eliminating the partnership rules found in IRC §§ 731-732 which permit tax-free distribution of partnership property to partners.[56] While the CBIT prototype contemplates that the existing Subchapter C recognition rules for distributions ultimately should be applied to all CBIT entities, policymakers concerned about the implications of such a rule on changes in the organization form of smaller CBIT enterprises could create carryover basis exceptions to the

Subchapter C recognition rules for smaller CBIT entities.[57]

Capital Gains, Dividend Reinvestment Plans, and Share Repurchases

If a compensatory tax were adopted, a full exemption of investor level gains and losses on equity and debt could be viewed as consistent with CBIT's exemption of investor level tax on dividends and interest. However, the fundamental problem of capital gains taxation in CBIT is similar to that encountered in other integration prototypes and either resolution (to tax or to exempt capital gains) will be controversial. See Chapter 8. If capital gains are taxed under CBIT, corporations might implement a dividend reinvestment plan (see Chapter 9) to reduce the incidence of double taxation on retained earnings. The appropriate treatment of share repurchases under CBIT also depends on treatment of capital gains. See Section 8.E.

4.H CONDUITS

Treatment of Conduits under CBIT

Current law exempts certain organizations from entity level tax. These entities function as tax conduits; they either are granted complete passthrough status or are taxed only on their undistributed income. Partnerships generally are granted passthrough status if they meet certain classification tests that distinguish them from corporations.[58] Certain publicly traded partnerships are always treated as corporations.[59] Regulated investment companies (RICs) are taxable corporations but are allowed a deduction for dividends paid out of both ordinary income and capital gains.[60] A typical RIC is a mutual fund that makes diversified investments for its shareholders. Real estate investment trusts (REITs) are taxed similarly to RICs but are restricted to investing predominately in real estate.[61] Real estate mortgage investment conduits (REMICs) are entities that hold fixed pools of mortgages and have both regular interests, providing for fixed, unconditional payments and taxed as debt, and a single class of residual interests, taxed essentially like equity interests in a partnership.[62] Holders of REMIC residual interests are taxed on their pro rata share of the REMIC's net income.

A cooperative, generally, is an organization that transacts business with and for its patrons (owners). Some cooperatives enjoy a limited exemption from tax. Subchapter T cooperatives are treated as corporations under current law but are allowed a special deduction for patronage dividends and per unit returns allocated to patrons based on business activity. While this results in effective conduit treatment of patronage distributions and allocations, other earnings of a cooperative are subjected to corporate taxation.[63] Typical cooperatives include farmers' cooperatives that purchase farmers' crops, sell them, and remit the proceeds to the farmers or purchase feed and seed for resale to farmers. Other cooperatives include grocery, hardware, drug, book, and clothing stores that operate on a cooperative basis.

Conduits that are not taxable entities under current law could continue as such under CBIT or could be treated as CBIT entities. To the extent that a conduit holds only CBIT equity or debt, its status as a conduit is irrelevant. A RIC, for example, that holds only CBIT bonds would pay no entity level tax even if it were treated as a CBIT entity, because all of its interest income and capital gains would be exempt from tax. Any dividends paid to shareholders also would be exempt from tax. Conduit status would be equally irrelevant, whether CBIT included a compensatory tax or instead imposed tax at the investor level on distributions out of preference income. See Section 4.D.

Thus, the treatment of nonCBIT income earned by conduits is the principal issue in deciding whether conduits should retain their passthrough status. One of the principal purposes for conduit status under current law is to provide relief from the double tax applicable to corporations. Because CBIT subjects corporate income only to a single level of tax, CBIT might replace the need for conduits. In addition, retaining conduit status for some entities would provide a means for avoiding the CBIT regime. Conduit status permits income to be taxed at shareholders' rates (which, for tax-exempt shareholders, may be zero), rather than at the CBIT rate. Thus, there would be an incentive to have nonCBIT assets held through a conduit rather than through a CBIT entity.

Partnerships

The CBIT prototype treats partnerships as CBIT entities in order to avoid perpetuating the bias against doing business in the corporate form. Exempting partnerships from CBIT would create incentives for investors to choose the partnership form whenever the tax benefits of passthrough treatment outweighed the business costs of operating in partnership rather than corporate form.

> Example. A group of investors (including some tax-exempt organizations) is considering undertaking a business venture. The investors decide to conduct business through a partnership rather than a CBIT entity so business income will be taxed at the investors' rates rather than at the CBIT rate.

By removing taxes from the determinants of organizational form, CBIT enhances neutrality.

In general, under CBIT, partnerships that do not qualify for the small business exception described in Section 4.C would be taxed like other CBIT entities. Thus, a partnership would be subject to entity level tax each year on its earnings (computed under the normal corporate tax rules but without a deduction for interest), but would not allocate earnings to equity holders. Like other CBIT entities, a partnership would maintain an EDA and would track actual distributions (rather than allocations of income) to partners and interest payments on debt. Distributions and payments in excess of the EDA would be subject to compensatory tax (or investor level tax).[64]

Subjecting partnerships to CBIT may treat certain types of partnership income less favorably than under current law. For example, partnership income would be subject to tax at the CBIT rate, rather than at the partners' individual rates. Partnership losses, preference income, and foreign tax credits would no longer pass through to partners. Distributed preference income and sheltered foreign source income would be subject to compensatory tax (or investor level tax). If these results are undesirable, policymakers may wish to expand the class of partnerships that are exempt from CBIT beyond the small business exception discussed in Section 4.C. However, the advantages of doing so should be weighed against the costs of retaining tax incentives favoring noncorporate forms of organization.

RICs, REITs, and REMICs

The analysis for these special purpose passthrough entities may be somewhat different, however. There is an argument that they should retain conduit status because they serve an important function as pooled investment vehicles for small investors. To the extent that individuals and tax-exempt organizations could purchase and hold nonCBIT investments, e.g., home mortgages, Treasury securities, and tax-exempt bonds, directly, they should be permitted to do so indirectly through a RIC or REIT.

> Example. A CBIT corporation would like to issue new shares in order to purchase a new building. Corporate earnings used to pay dividends on those shares would, however, bear tax at the CBIT rate. The corporation decides instead to lease its new building from a REIT, which issues shares to fund the purchase. As a consequence, the corporation can deduct the payments of rent, and dividends paid by the REIT are taxed at shareholder rates.

While the preceding example might be viewed as avoidance of CBIT, the incentives to engage in this form of transaction under current law are as strong as they would be under CBIT. In addition, given a decision to simplify CBIT by making it a 31 percent tax on all capital income, it might be considered worthwhile to maintain investment opportunities for low-bracket investors that will bear tax at the investor's tax rate rather than the CBIT rate.[65] Maintaining conduit status for RICs, REITs, and REMICs will require the expansion of IRC § 265(a)(3) to deny such conduits the ability to deduct expenditures related to the purchase or carrying of CBIT assets. With this modification, however, it should be possible to retain current rules for such entities. This approach will make enforcement of the leasing standards discussed under "Identifying Disguised Interest" in Section 4.G particularly important in maintaining the CBIT base.

Given the decision to treat partnerships generally as CBIT entities, it may be appropriate to make changes in the REIT qualification rules to allow entities with fewer than 100 shareholders and state law partnerships to qualify as REITs for tax purposes. This would avoid conferring an advantage on large, corporate REITs in real estate investing. Similar relaxation of the RIC qualification rules might be considered.

Cooperatives

We believe the limited conduit status granted to Subchapter T cooperatives would continue to be the appropriate model for cooperatives under CBIT. Cooperatives would thus be CBIT entities but could deduct patronage dividends.[66] As under current law, patronage dividends would generally be includable in the patron's income.

4.I FINANCIAL INTERMEDIARIES UNDER CBIT

Financial intermediaries include depository institutions, insurance companies, investment banks, and other financial services entities. Although the specific services provided by these institutions vary, financial intermediaries generally solicit funds from investors, depositors, and other lenders and use these funds to make loans or to acquire the debt and equity issues of other companies. Thus, financial intermediaries earn most of their income in the form of dividends and interest and tend to have substantial noninterest expense that is incurred to produce net interest and dividend income and gains on securities.

The following analysis suggests the basic outlines of the taxation of financial intermediaries under CBIT, although further consideration should be given to these issues during the period CBIT is under discussion.[67]

Financial Institutions Generally

CBIT would exempt from tax much of the income received by financial institutions because it is received in the form of dividends and interest from CBIT entities. In addition, if financial institutions were treated as CBIT entities, their interest expense would no longer be deductible. This raises the question of how other operating expenses of financial institutions should be treated. We have generally recommended that IRC § 265(a)(1) and (2), which operate to disallow deductions and interest allocable to tax-exempt income, be extended to cover investment in equity and debt of CBIT entities. Given the large portion of financial institution income that can be expected to come from CBIT investments as well as from tax-exempt State and local government bonds, this general rule would operate to disallow a significant portion of their operating expenses if deductions for such expenses were not allowed.

This effect is likely to be less significant for direct lenders such as banks and finance companies because they would no doubt begin to charge fees (rather than interest) to cover the costs of making a loan (as contrasted with the institution's cost of funds). Indeed, provisions requiring the borrower to pay the lender's transaction costs such as attorney's fees, filing fees, survey and appraisal expenses, inspection costs and similar items are already a common feature of negotiated loan transactions. The advantage of converting interest income into fee income would be that a CBIT borrower could deduct fees but not interest. Although the fee income will be includable in the income of the CBIT lender, the lender will be permitted to deduct operating expenses against such income without disallowance under expanded IRC § 265. Thus, recharacterizing interest income as fees may permit better matching of a financial institution's income and expenses. This strategy, however, is likely to be less successful with respect to publicly traded instruments of CBIT entities, where the intermediary, in many instances, will be unable to negotiate borrower fee payments to cover its operating expenses. Given the prevalence of commissions and fees in the compensation paid to investment banks and securities trading entities, however, it may be that market adjustments in these amounts would solve the problem for these entities.

For revised IRC § 265(a) rules to function as described in this section, mechanical provisions which match operating expenses with related fee, commission, and reimbursement income will be necessary. In particular, a proportional allocation rule such as that found in current IRC § 265(b) would produce inappropriate results if CBIT income were included in the fraction. Instead, financial institutions should be allowed to allocate operating expenses fully to offset fee income. To the extent that fee income is insufficient to cover operating expenses, the residual expenses would be allocated between CBIT and nonCBIT income under the pro rata rule of IRC § 265(b) and the portion allocable to CBIT income could be disallowed under IRC § 265(a).

Alternatively, financial institutions could be exempted from the disallowance rule of expanded IRC § 265(a) with respect to their operating expenses.[68] This approach would increase the incentive for such institutions to generate sufficient nonCBIT income (through investments in Treasuries, home mortgages, consumer debt, and leasing activities) to absorb fully the portion of their operating expenses in excess of their fee income. Our analysis indicates that most financial institutions currently hold enough nonCBIT debt to achieve this result; accordingly, the impact of such an approach on actual investment patterns is likely to be minimal. However, there is no relationship between the nonCBIT income and the expenses related to CBIT investments; hence, the allowance of a full offset may reduce other income, rather than matching nonCBIT income.[69]

Savings and Loan Associations

Savings and loan associations (S&Ls) must invest heavily in home mortgages to maintain their qualification for special tax rules. Assuming these requirements were maintained under CBIT, S&Ls would receive primarily taxable income but receive no deduction for interest paid to depositors. There should be a significant spread, however, between the interest rates paid on home mortgages (because recipients will pay tax on such interest) and the interest rates paid to depositors (because the depositor will not be subject to tax on interest received from the S&L as a CBIT entity). This spread may be sufficient to allow S&Ls to satisfy their CBIT liabilities, and, if so, no special rules will be needed. Again, a gradual transition to CBIT would allow policymakers to study the observed impact of CBIT before finally resolving structural decisions. Because the need for a special rule for S&Ls is not clear, the CBIT prototype does not include such a rule.

If experience proves that the rate differential between interest on home mortgages and interest on CBIT deposits is insufficient to allow S&Ls to operate successfully, consideration could be given to allowing S&Ls to issue certificates of deposit that would bear taxable interest to the recipient and deductible interest to the S&L. Even such a limited provision would undermine somewhat the tax parity between debt and equity achieved by CBIT, however, and should be adopted only if it proves necessary.[70]

Insurance Companies

Under the CBIT prototype, insurance companies would be CBIT entities.[71] Like other CBIT entities, they would not be allowed a deduction for interest paid, but distributions to shareholders and creditors would not be taxed to the recipients.[72] Under CBIT, IRC § 809 (which Congress intended to equalize the treatment of stock and mutual companies' equity returns) would be repealed, since equity returns from both stock and mutual companies would be exempt to the recipient under CBIT. In both types of companies, payment of tax on earnings from surplus would give rise to an EDA permitting distributions free of further tax to investors. Distributions in excess of the EDA would trigger the compensatory tax or an investor level tax, but would preserve the equal treatment of investors.

CBIT will, however, require an adjustment in the deduction permitted insurance companies for annual additions to reserves. Under current law, tax reserves are calculated on a discounted basis. Accordingly, the deduction for reserve additions each year consists of two components: (1) the discounted present value of amounts required to fund future casualty and benefit payments plus (2) the expected return for the year on reserve funds. This system permits companies to claim deductions currently rather than deducting the entire loss or claim when paid. The difference between the present value of such losses or claims and the full (or nominal) value of such payments is deducted each year as expected return until the loss or claim is actually paid. The rate used to compute expected return under current law is based on the applicable Federal rate (AFR), which reflects a taxable rate of return.

Under CBIT, reserves would be calculated with a blended market interest rate, which would be a prorated average of a taxable nonCBIT rate and a non-taxable CBIT rate, according to the mixture of assets held by each insurance company. To the extent that reserve assets are invested in CBIT securities, no deduction to shield expected return on CBIT entity dividends and interest received by an insurance company would be appropriate because such amounts would not be included in its income and would increase the insurance company's EDA. Accordingly, insurance companies would be required to maintain CBIT and nonCBIT income accounts similar to those of pension funds under CBIT. As with pension funds, insurance companies would be required to treat their expected return on reserves as arising pro rata from the CBIT and nonCBIT income accounts. An annual deduction for expected return would be permitted only to the extent attributable to nonCBIT income. As a result of this modification, insurance companies should neither obtain new benefits nor lose current law benefits with respect to their nonCBIT investments. While insurance companies would pay no tax on dividends and interest received from CBIT entities, they would enjoy no advantage over other investors in this respect.

The prototype's preservation of reserve deductions to prevent entity level taxation of the inside build-up (the income earned on reserves held in nonCBIT assets) may be regarded as inconsistent with the neutrality principles underlying CBIT, since the prototype may lead insurance companies to prefer nonCBIT investments which benefit from this advantage. We believe, however, that a different rule is not necessary for CBIT to function effectively and would require reversal of long-standing policies underlying insurance taxation.