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Elimination of the double tax on dividends; Statement of tax policy 3

American Institute of Certified Public Accountants

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Elimination of the Double Tax on Dividends
Statements of Tax Policy of the federal tax division are issued for the general information of those interested in the subject. They present the conclusions of the division, which is the senior technical body of the Institute authorized to speak for the Institute in the area of federal income taxation.

Statements of Tax Policy are intended to aid in the development of federal tax legislation in directions which the division believes are in the public interest.

Statements of Tax Policy do not establish standards enforceable under the Institute's Code of Professional Ethics and are not intended for that purpose.
Elimination of the Double Tax on Dividends

Issued by the Federal Taxation Division of the American Institute of Certified Public Accountants
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Foreword

Statements of Tax Policy represent a conscientious effort by the federal tax division of the American Institute of Certified Public Accountants to explore, comment, and, where appropriate, develop positions on matters of tax policy covering major areas of taxation in which members of the accounting profession have special competence.

The present system of taxing corporate-source income has often been criticized as being a negative factor in the accumulation of capital which makes up an essential element in the economic growth of the United States. This negative influence becomes even more apparent when the system is compared to the tax policies administered in other nations. It is intended that the formal presentation of this study will assist members of the congressional tax writing committees, members of the executive branch of government, and the public in their consideration of this subject.

Statements of Tax Policy are approved by the executive committee of the federal tax division after they are developed by the division's tax policy subcommittee. Other division subcommittees may develop a policy statement if requested to do so. This statement was approved by the 1974-75 tax policy subcommittee and the 1975-76 executive committee.
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1975-76

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Special recognition for the development of this statement must be accorded the task force which was appointed for this project. The members of that task force, which was chaired by William H. Hoffman, CPA, included Leonard A. Rapoport, CPA, and John R. Herzfeld, CPA. These gentlemen were ably assisted in their research and writing by David W. LaRue, graduate tax research fellow at the University of Houston.

JOEL M. FORSTER, Director
Federal Tax Division
Summary of Recommendations

The Institute believes that the present tax treatment of corporate-source income does not measure up to accepted standards of tax equity, and that such treatment inhibits the growth and development of not only the corporate sector but all phases of the U.S. economy. Furthermore, the double-taxation of corporate-source income has added to the complexity of tax law administration.¹ And finally, since the incidence of the corporate income tax is unknown, the present system has hindered the Congress's ability to predict the effect of proposed legislation and to thereby design the legislation that most accurately and effectively accomplishes its social and economic purposes. We believe that some measure of integration of the corporate and individual income taxes would alleviate these problem areas.

Based on our analysis of the various alternatives considered, we urge the adoption of either a dividends-paid deduction for corporations or a "gross-up" method of calculation that would allow a tax credit to shareholders for those taxes paid by the cor-

¹ For example, the whole purpose of the collapsible corporation provisions of IRC Sec. 341 is to preclude the avoidance of the corporate income tax (with attendant recognition by the shareholders of stock appreciation at preferential long-term capital gain rates). Needless to say, IRC Sec. 341 has to be one of the most complex provisions in the Internal Revenue Code.
poration which are attributable to the income distributed as dividends. Properly structured, either alternative would be feasible from an administrative standpoint and would correct many of the shortcomings of the current system of taxing corporate-source income.

Review of the Current System

Under present U.S. law, corporate-source income is subject to a two-tier system of taxation. Income is taxed first when it is earned by a corporation and again upon its distribution to shareholders as dividends representing "current and accumulated earnings and profits." The issues to be considered here are whether such a system impairs the achievement of tax equity among various categories of taxpayers and to what extent the taxing system introduces distortions into the economy which inhibit domestic capital expansion and growth as well as competitive effectiveness in world markets.

Following are some of the major concerns that prompt reconsideration of the present system of taxing corporate-source income.

Lack of Horizontal Equity. A system lacks horizontal equity when it maintains different income tax rates between shareholders and other taxpayers. Since corporate earnings are subject to double taxation, the shareholder of a corporation does not effectively receive the same tax treatment accorded to the partner of a partnership or to the sole proprietor of a proprietorship. The same disparity exists when the tax treatment of corporate-source income is compared with that accorded to other classes of income such as wages, salaries, and interest. As a result of the imposition of such non-neutral corporate income taxes, otherwise economically sound business and investment decisions are distorted, re-

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\(^2\) See Appendix I for a brief review of the history of taxation of corporate-source income in the United States.
sulting in a reduction in the overall efficiency of the market system in the United States.³

**Vertical Equity Is Not Achieved.** Vertical equity refers to the tax burdens levied on persons at different income levels, presumably to reflect societal views on ability to pay.⁴ Corporate-source income may be taxed more heavily at the low-income shareholder level than at the high-income level.⁵ Compare, for example, the effective tax rate imposed on dividend income received by a shareholder in the 20 percent tax bracket with that imposed on a 70 percent tax bracket shareholder. Presuming a 48 percent corporate tax bracket, the corporation pays *each of these shareholders* $520 out of earnings on which it has already paid $480 in corporate taxes. The 20 percent tax bracket shareholder pays an additional $104 of income taxes. This results in an effective tax rate of 58 percent on the dividend income. (Corporate taxes of $480 plus individual taxes of $104, divided by before-tax earnings out of which the dividend was paid ($1000).) This represents a 192 percent increase, (that is, 58 percent/20 percent) in the shareholder's effective tax rate. The 70 percent tax bracket shareholder pays an additional $364 on his dividends or an effective rate of 84 percent. The increase in his effective tax rate, however, is only 20 percent, as opposed to 192 percent for the 20 percent bracket shareholder.⁶ The tables on page 5 illustrate the regressive nature

⁵ As a matter of initial reaction, one might conclude that the observation overstates the problem since the number of low-income shareholders is probably less than those with high incomes. But what about those individuals with low or modest incomes who hold stock indirectly through interests in pension and profit-sharing plans? Needless to say the future value of any such rights has to be affected by the tax treatment presently accorded to corporate-source income. Furthermore, those tax-exempt organizations which benefit lower-income groups derive substantial income through ownership of corporate stock. Thus, vertical equity again suffers when corporate-source income is taxed at the corporate level.
⁶ This illustration does not take into account either the $25,000 corporate surtax exemption or the $100 exclusion applicable to the shareholder’s annual dividend income.
of taxing corporate-source income. The effect of the indirect corporate income tax conflicts with the socioeconomic principle that the tax burden should be at least mildly progressive and certainly not regressive.

**Misallocation Between Corporate and Non-Corporate Sectors.** Capital can be considered to be misallocated between the corporate and non-corporate sectors of the economy. Taxing corporate profits tends to increase the cost of capital to the corporate sector as investors seek to equalize the after-tax rate of return on corporate and non-corporate capital. Consequently, capital (investment) will shift from the corporate to the non-corporate sector and the cost of capital in the corporate sector will rise. The before-tax rate of return will be higher in the corporate sector than in the non-corporate sector, once the after-tax rates are equalized by the reallocation of capital. This difference results in misallocation of capital since before-tax rates of return reflect the relative productivity of capital in various industries (e.g., capital is over supplied to the low-tax industries.) As mentioned previously, the ultimate result is that many situations will be tax-induced distortions of economic decisions.

**Negative Impact on Capital Accumulation.** It can be argued that the present system of taxing corporate-source income has had

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**TABLE 1**

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<th>Tax Bracket of Shareholder (%)</th>
<th>Effective Rate of Tax on Dividend Income (%)</th>
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**TABLE 2**

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<th>Tax Bracket of Shareholder (%)</th>
<th>Increase in Effective Rate of Tax on Dividend Income (%)</th>
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*Computed without regard to the $100 dividend exclusion or the $25,000 corporate surtax exemption.*
a negative impact on capital accumulation and economic growth in the United States. First, since a relatively large fraction of property income is saved, the present system of double taxation has a disproportionately large impact on the overall saving rate (that is, smaller amounts are available for saving than would otherwise be the case). Second, to the extent that heavy taxation of corporate income lowers rates of return, the incentives to save are likely to be further inhibited. Finally, the corporate tax may have a separate effect on the incentive to invest. If corporations have a “target” after-tax rate of return which is necessary to compensate them for the risks inherent in business investments, the corporate tax induces firms to forego marginal investments thereby restricting capital accumulation and raising the necessary pre-


tax return on investment projects. Since after-tax returns (but not pre-tax returns) have been relatively constant before and after the imposition of the corporate tax, this hypothesis appears consistent with the evidence. A significant proposition claims that lower capital accumulation leads to lower levels of plant and equipment per employed worker and hence to lower wages. Studies indicate that the negative long-run effects of reduced capital accumulation are not limited solely to the owners of corporate capital.

**Danger of Weakened U.S. Market Position.** Since many other developed countries have adopted some form of partial integration of corporate and individual income taxes, the argument can be made that the U.S. system impairs our competitive position in world markets. See Appendix 2, page 30.

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12 Integration also could serve as a means of competing for foreign capital. If the primary competitors of the United States introduce integration and/or dividend credits and extend it to nonresidents in order to attract investment, the United States will be at a disadvantage in attracting capital. Not only have capital markets become increasingly more interrelated in recent years but the United States unquestionably is now more dependent on such markets. Other countries have been growing quicker and have been generating a larger share of world savings. Also, the increases in oil prices have transferred a great deal of wealth to Oil and Petroleum Exporting Countries (OPEC) nations. As this wealth will be invested throughout the industrial world, it can be argued that tax-rate differentials no longer are irrelevant for the growth and long-run success of the United States in world markets. However, the benefits of lower tax rates on corporate equity if also extended to foreigners have to be weighed against tax losses. The loss of revenues from profits accrued to residents can be recaptured by other taxes but for foreign residents this may not be possible. Some forms of integration therefore might represent a net withdrawal of resources out of the United States (that is, the additional capital inflow would not be sufficient to offset the loss in tax revenue on foreign residents). See Richard M. Bird, “International Aspects of Integration,” *National Tax Journal*, September 1975, pp. 302-14.
Interest Is Deductible and Dividends Are Not. The tax-induced incentive for debt financing over equity financing is quite apparent. Heavy reliance on debt financing, however, results in fixed interest commitments that aggravate the financial distress of many corporations—especially during periods of recession.\(^\text{13}\)

Retention of Earnings at Corporate Level. The present tax system encourages retention of earnings at the corporate level, particularly for smaller corporations. To avoid the tax imposed on dividend income, shareholders in control of corporate policy are motivated to retain corporate earnings at the corporate level and to eventually convert the stock appreciation attributable to such retention into preferential long-term capital gains.\(^\text{14}\) If the stock is held until death, any such appreciation will escape the income tax entirely by virtue of basis adjustments provided for in IRC Sec. 1014. Thus, encouraged by the operation of the present tax system, substantial amounts of funds are "locked-in" at the corporate level. Whether such accumulations are desirable from an economic standpoint, of course, depends upon how they are used by the corporation.\(^\text{15}\) The penalty tax (IRC Sec. 531) imposed on

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\(^{13}\) An interesting explanation of why corporations have not turned towards debt financing more often can be found in Joseph Stiglitz, “Taxation, Corporation Financial Policy and the Cost of Capital,” *The Journal of Public Economics*, February 1973, pp. 1-34. In substance the rationale is that the double tax effect of the present system is partially avoided by withholding dividend distribution with the expectation that corporate growth will be recognized by the shareholders in the form of preferentially treated long-term capital gains upon a taxable disposition of their stock investment.


\(^{15}\) There are, however, two more somewhat minor points, which represent further criticism of the present system. First, the tax incentives to retain earnings will distort the allocation of capital within the corporation. Mature firms with high rates of profits will retain and reinvest too much
earnings accumulated beyond the reasonable needs of the business, however, is designed to insure that earnings retained by the corporation are motivated by economic, rather than tax avoidance, objectives.

**Tax Avoidance.** The present system of double taxation has propagated countless tax avoidance schemes and has generated many complexities in the Internal Revenue Code designed to combat them. If, for example, double taxation is to be avoided at the corporate level, profits must be distributed in some form other than that of dividends. The choice of "interest" may cause a "thin" corporation problem (IRC Sec. 385), while using "salaries" could raise the unreasonable compensation issue (IRC Sec. 162(a) (1)). On the other hand, if the double tax on corporate-source income is avoided at the shareholder level, withholding dividend distributions may bring into play the penalty tax on unreasonable accumulations of earnings (IRC Secs. 531-537) or, in more limited situations, the personal holding company tax (IRC Secs. 541-547). Needless to say, these complexities add to the administrative burden imposed on the IRS and to the cost of taxpayer compliance. Nor do they establish that type of climate all parties need and deserve to carry on their affairs with tax certainty.

**Uncertainties of the System.** One of the primary drawbacks of the present system is uncertainty about the possible impact of governmental tax policy on the distribution of income and on economic efficiency. While a given amount of tax revenue raised of their after-tax income since they recognize that stockholders prefer capital gains relative to dividends. Unless firms are quick to diversify, to expand their product lines, or to merge, new high-yielding ventures will be ignored while retained earnings will be invested in lower-yielding investments. The corporate income tax when couched with the preferred treatment of capital gains may act as major impediments to the formation of new firms and encourages economic concentration.

Second, the present system will segment the capital market into firms that tend to cater to high-income capital gains-oriented investors and those which will tend to pay out a larger proportion of their dividends to investors who are in lower tax brackets. This segmentation hampers diversification of portfolios of individual investors and complicates the investment and dividend pay-out decisions of corporate managers.
via income taxes on individuals has relatively predictable implications for income distribution and economic efficiency, the same amount of revenue raised via a corporate income tax carries relatively uncertain implications. This uncertainty is attributable both to a lack of knowledge about who owns the stock, and thus who is affected by the corporate tax, and to the possibility that part or all of the burden of the tax is being shifted to nonshareholders.\footnote{As shown by Joseph A. Pechman and Benjamin A. Okner, \textit{Who Bears the Tax Burden?} (Washington, D.C.: Brookings Institution, 1974), the impact of the corporate tax on income distribution and efficiency is highly sensitive to the possibility of a tax shift.} Much of this uncertainty could be eliminated by integrating the two taxes, since improved information about the impact of proposed tax policy fosters better tax legislation. Thus, an important argument exists in favor of integration.

\section*{Alternatives Considered}

Given that the present system of double taxation of corporate-source income is not satisfactory, what alternatives are available? Can a system of complete or partial integration of the corporate and individual income taxes be found which will achieve the objectives of tax equity and neutrality? To determine this, the Institute has reviewed six possible alternatives:

- The Partnership Approach
- Repeal of the Corporate Income Tax
- Expansion of the Dividends-Received Exclusion
- Institution of a Dividends-Received Credit
- Provision for a Dividends-Paid Deduction at the Corporate Level
- The “Gross-Up” Method

Although the ultimate recommendations of the Institute favor the dividends-paid deduction or the gross-up method, each alternative should be explored in order to provide a stronger basis for analysis and comparison.

It should be noted that the Institute is aware of the recom-
mendations for integration proposed by the Honorable William E. Simon, secretary of the Treasury, before the House Ways and Means Committee on July 31, 1975. Referred to as the "half-and-half method" in his report, the proposal envisions a combination of our dividends-paid deduction alternative and the gross-up method. We favor the adoption of either alternative; but, any compromise between the two may solve the integration problem. It should be noted, however, that the half-and-half method is more complex than either the dividends-paid deduction method or the gross-up method. Thus, more difficult compliance and administration problems could be expected with this form of integration. 17 Although the half-and-half method is not discussed as a separate alternative, its effect is shown in Tables 1 and 2 of Appendix 3.

Assumptions Underlying the Alternatives. The analysis and recommendations set forth below are predicated on the following assumptions:

- If the corporate income tax is retained, the rate structure as presently constituted will not change. Although the recommendations made here could be simplified if the corporate income tax were a flat rate (for example, 50 percent of taxable income), elimination of the surtax exemption would not be politically feasible and would work a hardship on small and less profitable concerns.
- Revenue loss estimates resulting from the various alternatives are based upon information obtained from the Department of the Treasury.

The Partnership Approach

The corporate form would be disregarded for tax purposes, if it is presumed that a corporation, like a partnership, is in reality a conduit for its owners. Thus, this approach would eliminate the

17 The Institute agrees with the secretary's recommendation that the benefits of integration not be extended to shareholders who are tax-exempt organizations, but has taken no position as to the tax treatment of foreign shareholders.
corporate income tax, with all corporate-source income being taxed at the shareholder level at an applicable marginal rate. Complete integration would result, with no distortion of vertical or horizontal tax equity. If corporate-source income were treated like any other income from capital, tax-induced investment deterrents in the corporate sector would be eliminated, and tax neutrality as to the choice of business organization could be achieved.

Disadvantages. Although a conceptually perfect alternative to the present tax system, the partnership approach seems almost impossible to implement. Some illustrations of the administrative problems that would be encountered in such a system follow.

• At the corporate level exact records would have to be maintained for every shareholder, regardless of how long the stock was owned.
• Intercorporate holdings would cause a time lag in the determination of the pass-through to the shareholder level unless corporations owning stock in other corporations were required to accrue their share of the income earned by the owned corporations.18
• Different classes of stock would further complicate the pass-through allocation. If, for example, a corporation had both common and preferred stock outstanding, in any one year the excess of earnings attributable to the preferred stock would be allocated to the common shareholders. If the excess were not distributed but, instead, accumulated at the corporate level, it would still be taxed to the common shareholders. What if the excess was distributed to the preferred shareholders in a later year?19
• If partnership treatment is to be carried out in full, the identity of corporate-source income (for example, interest on state and local bonds, capital gains, and so forth) and certain deductions and losses (for example, charitable contribution deductions, capital losses, and so forth) would have to be preserved. Conse-

19 This sort of problem is avoided in Subchapter S corporations by the one class of stock requirement of IRC Sec. 1371 (a) (4).
quently, the pass-through allocation would be further complicated.  
• At the shareholder level, constant adjustment in the basis of the stock investment (for example, increases for pro rata shares of undistributed corporate profits) would impose a serious record-keeping burden on all concerned.  
• The partnership approach suffers from the real possibility that shareholders may be taxed on corporate income not received (that is, the “wherewithal-to-pay problem”). Although this problem exists with respect to the partnership form, partners generally have more control over fund withdrawals than the minority shareholders of a large corporation.

A similar approach can, of course, be found in the Internal Revenue Code of 1954 under the provisions of Subchapter S. One might note, however, that the election is limited to corporations having no more than ten shareholders and possessing only one class of stock. With this precedent as a starting point, the partnership approach might accommodate an even greater number of corporations—but again with marked limitations due to the problems of administration. Surely, were Subchapter S to be used to carry out this limited change, it should be amended to conform more closely to the tax treatment presently in effect for partnerships under Subchapter K of the Internal Revenue Code.

**Repeal of the Corporate Income Tax**

Unlike the partnership approach, which would also eliminate the corporate income tax, repeal of the corporate income tax would continue taxing corporate-source income to shareholders, but *only* as it is distributed. Such an alternative would place a premium on corporate accumulations—which could be good or bad, depending on how these funds are utilized by the corporation. Naturally, the incentive to accumulate would be more of a problem with closely held corporations where control is lodged in the hands of those shareholders in higher marginal individual income tax brackets who would wish to use the corporate form as a tax deferral device.

Though repeal of the corporate income tax would eliminate the double tax on dividend distributions, it could lead to a lessening
of the progressivity of the tax system. "Locked-in" earnings at the corporate level could be converted by a shareholder into preferential long-term capital gains upon a taxable sale or exchange of the stock.

Because of the tax avoidance potential at the shareholder level, the elimination of the corporate income tax would require other changes in the Internal Revenue Code. One change would be to treat any gain from the sale of a corporate stock investment as ordinary income. This could cause undue hardship (in terms of a "bunching" effect) on a taxpayer that realizes appreciation attributable to many years of corporate growth. Provision would have to be made, in the interest of equity, for the annual accruals of increases in stock values. Besides violating the wherewithal-to-pay concept and the notion, present throughout the Internal Revenue Code, that gains should only be recognized as actually realized through some sort of a sale or exchange, the practical difficulty of periodically determining changes in stock value should be apparent to all. However, the bunching of income in the year of sale might be alleviated through some sort of averaging device.

Expansion of the Dividends-Received Exclusion

An expansion of the dividends-received exclusion, if a full exclusion were allowed, would eliminate the double tax treatment of corporate-source income. But instead of approaching the problem from the standpoint of the corporation (that is, eliminating the corporate income tax), the solution concentrates on the shareholder's tax consequences. Stated simply, a shareholder would be allowed to exclude from gross income all qualified dividends received from domestic corporations. This alternative would not be novel in our present tax system, as is evidenced by the $100 exclusion currently provided for by IRC Section 116.

Disadvantages. An expansion of the dividends-received exclusion, even on a limited basis, would have the following major drawbacks.

- It would not entirely resolve the debt-versus-equity problem. Corporations might still be inclined to favor debt financing over
equity issues because interest payments would continue to be deductible while dividend distributions would not. Of course, it is reasonable to anticipate that the distortion between debt and equity financing currently existing would not be as pronounced because of investor pressures favoring equity investments and their nontaxable dividend distributions.

• The lack of vertical equity, inherent in the present system, would continue in an aggravated form. All shareholders, regardless of their marginal tax brackets, would be indirectly subject to a 48 percent tax. This would be true whether or not dividends were paid by the corporation since the corporate income tax would remain in effect. Thus a partial or complete dividend exclusion would have a regressive effect on taxation of individual shareholders. The exclusion would favor those in higher tax brackets, since tax relief would vary in accordance with a shareholder's marginal tax rate.

Although they would be less pronounced than under the present system, horizontal inconsistencies would persist. The disparity between the tax rates imposed on shareholders and those imposed on other taxpayers (partners, sole proprietors, and so forth) is not eliminated under this integration alternative.

• An exclusion at the shareholder level provides no relief for retained corporate-source income.

Institution of a Dividends-Received Credit

IRC Section 34, effective for certain dividends received in taxable years ending after July 31, 1954, provided for a 4 percent credit limited to the shareholder-recipient's taxable income. With a phase-out reduction in the percentage allowed as a credit, IRC Sec. 34 was repealed for dividends received after December 31, 1964. Thus, the dividends-received credit alternative is not a new or untried approach to achieving partial integration of corporate and individual income taxes.

Disadvantages. Although less objectionable from a conceptual standpoint than the dividends-received exclusion, it carries the same major drawbacks (see the discussion in the prior section). Additionally, it would obviously favor high-bracket shareholders, which was the principal justification for the repeal of the 4 percent
version (IRC Sec. 34) in 1964. Tax inequity would further materialize if the credit (as was true with IRC Sec. 34) is limited to taxable income, since this would preclude some shareholders from taking advantage of part or all of the amount otherwise available. This last objection could be negated by allowing the full credit, irrespective of any limitations, even in cases where the shareholder may be entitled to a refund. Alternatively, a system of carryovers could be utilized.

The Dividends-Paid Deduction

Allowing a corporation to claim a deduction for dividends paid to its shareholders would achieve integration but would require corollary modifications in the present tax system.

Adoption of a dividends-paid deduction should carry with it the repeal of IRC Section 243 and related provisions dealing with the dividends-received deduction (85 percent in most cases) allowed to corporate distributees.

Attendant with the repeal of the dividends-received deduction, there appears to be no reason why the tax treatment of property distributions to corporate distributees (IRC Section 301(b)(1)(B) and related provisions) cannot be simplified. Since a step-up in basis can no longer be achieved by only a 15 percent inclusion in gross income, why not treat corporate and individual distributees equally? Thus, the fair market value of the property would be the measure of the dividend income, and such value would become its basis in the hands of the distributee shareholder—whether individual or corporate. The deduction of the distributing corporation should be limited to the corporation's adjusted basis in the property distributed.

The Institute believes that the dividends-paid deduction should be denied with respect to dividends distributed to tax-exempt organizations.

The tax effect on the corporation and shareholders is illustrated in Tables 1 and 2 contained in Appendix 3.

Advantages

• Corporate-source income that is distributed to shareholders would be taxed equitably—both from a horizontal and vertical
standpoint. The tax disparity between debt and equity financing would be considerably eased. Since dividends paid would become deductible, one important reason for choosing the debt route disappears. As dividends become deductible, equity financing becomes more attractive both to corporate management and to potential investors. By shifting to an equity source of funds, corporations can avoid the potentially hazardous commitment that accompanies debt obligations. During periods of low or nonexistent earnings, dividend distributions can be postponed. Interest and debt repayments must continue, however, if the business is to survive.

- Making dividend distributions deductible undoubtedly would increase the flow of funds from corporations to shareholders. With respect to lower-income shareholders, these additional spendable funds would lead to increased consumption power.
- Although the dividends-paid deduction has not had wide application in the United States, it is used with various modifications in other developed countries. For example, the “split-rate” system in effect in West Germany is a partial deduction for dividends paid.20 This does not imply that the United States should pattern its tax laws after other nations. However, in the international market setting, we must remain sensitive to the possibility that our tax system may place domestic corporations at a competitive disadvantage.
- The adoption of the dividends-paid deduction alternative would ease certain tax problems inherent to closely held corporations. Once both dividends and interest become deductible, the motivation leading toward “thin” capitalization weakens, although it does not disappear. Shareholders may still wish to withdraw some of their investment in the corporation without income tax consequences (that is, by means of the repayment-of-debt principal). Perhaps more pronounced will be the resolution of the unreasonable compensation issue. Except for limited situations where excessive salaries may be paid in order to qualify a shareholder-

20 One of the reasons why this system was adopted by West Germany was the hope that it would increase stock ownership by lower and middle income individuals.
employee for the maximum tax on earned income (IRC Section 1348), preference for salaries over dividends would be neutralized. The same can be said for the current practice of shareholders’ leasing property to a corporation in order to generate a rental deduction. At the corporate level it does not matter whether the distribution is characterized as interest, salaries, or rent because all such legitimate expenditures are deductible.

Disadvantages. Several objections can be raised against the adoption and implementation of the dividends-paid deduction as a vehicle toward achieving partial integration.

• Complete integration is not achieved within the dividends-paid deduction alternative as it is in the partnership approach, since the corporate income tax would continue to apply to undistributed corporate profits. It would seem feasible, however, to partially rectify this inequity by allowing some type of carryback and/or carryforward procedure for dividends paid in excess of earnings. Thus, a corporation which chose not to make a dividend distribution in one year and accumulated its profits instead would be penalized only temporarily. The corporation would be able to make excessive distributions in later years with carryback relief against the corporate income tax originally imposed. Obviously, such a procedure would require certain safeguards to prevent manipulation directed toward tax avoidance. If a carryback procedure is established, a cut-off date must be set to preclude dividends in excess of current earnings from leading to the refund of prior corporate income taxes paid. To illustrate, if the enacting legislation is approved in 1976, the carryback could be made applicable only to earnings and profits accumulated for tax years beginning after 1975.

• Another major objection might be that the dividends-paid deduction will penalize growing firms that need funds for expansion and development and accord preference to mature firms that do not. The answer might lie in a consent dividend procedure such as is currently provided for by IRC Section 565 (relating to the penalty tax on the unreasonable accumulation of earnings and the personal holding company tax). Under such a procedure, a shareholder could agree (on a timely basis) to include in gross income as a dividend a pro rata share of current undistributed
corporate profits. As a result, the corporation would be allowed a dividends-paid deduction even though it retains the amount of the consent dividend. The shareholders who agreed to the consent dividend, in turn, would increase the basis of their stock investment by the amount taxed but not received. However, the shareholders would have to use funds from other sources to pay the tax on the dividend.

- The dividends-paid deduction places a premium on distributions to shareholders that could conceivably impede economic growth within the corporate sector. Thus, if corporations maximize the deduction, what is left for capital spending? (The answer involves comments stated above plus a consideration of the vagaries of the securities markets.) First, presuming the inclusion of an effective carryback/carryover procedure, the dividend distribution could be postponed with only interim tax consequences. Second, a consent dividend procedure would permit an immediate tax benefit to the corporation with the advantage of the retention of the funds. Third, with the increase in dividend output that the proposal will generate, further investor interest in equity securities might well be encouraged. There is, of course, no way to know whether the inflow of equity funds would match the outflow of actual dividend distributions.

- Suppose a corporation making a dividend distribution has tax-free and/or preferentially taxed income for the year. Should the dividends-paid deduction be allowed in full or should it be reduced by the portion attributable to the nontaxable or preferentially taxed income? As long as the deduction did not exceed the corporation's taxable income (as determined under present law) for the year, there should be no need to make any such adjustment. If the distribution exceeds current taxable income, a carryback or carryover would be in order.

- Would not the provision for a dividends-paid deduction cause an immediate and severe revenue loss to the U.S. Treasury? That

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21 One can reasonably argue that the dividends-paid deduction will enhance the supply of capital (that is, savings) for corporate investment. Since the deduction will increase after-tax income of shareholders, their propensity to save will increase and a large proportion of such savings might return to the corporate sector in the form of new equity or debt holdings.
there would be a revenue loss can hardly be doubted. But then, any integration scheme, whether partial or complete, by definition must carry a similar effect. The only question is the severity of the loss and what can be done about it.

First, one would expect the deduction to be available only for the distribution of corporate profits earned after the effective date of the enacting legislation. Distributions of earnings accumulated prior to this date would not qualify. It would seem appropriate that the present source of dividend rules continue to apply where current earnings and profits would be deemed to have been distributed first. Second, recall that the dividends-paid deduction alternative does not envision the repeal of the corporate income tax—it would still apply to undistributed corporate profits. Third, the immediacy of any substantial losses might be avoided by some sort of phase-in period. For example, if the deduction is to become operative in 1976 it could be limited to 20 percent of the dividends paid, with progression to 40 percent in 1977, 60 percent in 1978, and so on until 100 percent is reached. Fourth, and perhaps most important, are the long-range effects of the proposal. If it is true that the dividends-paid deduction leads to economic stimulation and growth, any initial revenue loss might well be compensated for once the phase-in effect has passed.

What effect, if any, would the dividends-paid deduction have at the state level? In those states imposing an individual income tax, it is doubtful that the result could be anything but an in-

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22 Department of the Treasury estimates based on 1977 revenue levels reflect that the complete deduction at the corporate level for dividends paid would generate a loss of approximately $15 billion. Alternatively, the gross-up method would generate a revenue loss of $19 billion if the credit were extended to tax-exempt and foreign stockholders, and approximately $12.5 billion if not so extended.

The larger revenue loss for the gross-up method results because more cash is at the shareholder level. This has the same effect as if the total distributions were larger, thus creating a larger revenue loss. Under the dividends-paid deduction method, it is the corporation which will have more cash. If it distributed all that additional cash to its shareholders, the revenue loss would be the same as under the gross-up method (that is, larger dividends would appear at the shareholder level). Over time, it is probable that there will be some increase in the level of dividends under the deduction method and, therefore, a somewhat greater loss than the $15 billion indicated.
crease in revenue. Because the prospect of the federal deduction will stimulate dividend distributions, more income will be subject to state and local taxes in the hands of recipient shareholders. Unless states levying corporate income taxes also permit a dividends-paid deduction, there should be no offsetting loss from this source.

The "Gross-Up" Method

Like the dividends-paid deduction alternative, the gross-up method depends on retention of the corporate income tax. But instead of focusing on the corporation, relief is provided at the shareholder level. Under this proposal a shareholder includes in gross income the net dividends received plus the corporate income tax attributable to such dividends (that is, the dividends would be "grossed up"). The shareholder then computes the income tax in the regular manner but is permitted to claim as a tax credit the amount of the gross-up. In effect, the corporate income tax is withheld by the corporation on behalf of its shareholders then passed through to them as a credit when dividends are distributed. Several observations, both pro and con, can be made about this attractive method of partial integration.

In terms of tax equity, the result would parallel that achieved under the dividends-paid deduction alternative. Thus, vertical and horizontal tax equity would be achieved for distributed profits but not for those accumulated.

Under the gross-up method, dividends would become more attractive to the investor than interest.23 The taxpayer, in addition

23 Although dividend income and interest income are taxed at the same effective rate under the gross-up method, a dollar's worth of interest income received by the taxpayer is not equivalent to a dollar's worth of dividend income. For example, a 30 percent tax bracket taxpayer receives $156 in dividends on which the distributing corporation has paid $144 in corporate taxes ($300 × 48 percent rate). Although the taxpayer's gross income includes both the $156 dividend and the $144 gross-up, the tax credit of $144 (which accompanies the dividend income) is $100.80 greater than the $43.20 tax (at the marginal rate) on the gross-up amount. The economic benefit of the $156 dividend received by the taxpayer is $210 ($156−($156 + $144 gross-up × 30 percent) + $144 credit).
to receiving dividend income, also would receive a tax credit that would more than offset the additional tax liability attributable to the inclusion of the grossed-up amount. Thus, since dividend income is preferred by the investor over interest income, some easing of the preference for debt over equity financing would seem bound to occur. But, because dividends are not deductible to the corporation, those in control of corporate policy are still apt to lean toward debt and the accompanying interest deduction. One might surmise, therefore, that the gross-up method would lessen disparity between debt and equity investments but not to the extent anticipated under the dividends-paid deduction alternative.

In comparing the gross-up method with the dividends-paid deduction alternative, one important advantage in favor of the former is the effect on corporate accumulations. Since the corporate income tax must be paid whether profits are distributed or not, the incentive to distribute dividends would not be nearly as compelling. Thus, the gross-up method would be more advantageous for new and growth corporations planning little or no dividend payout.

The gross-up method should do much to ease the problem of accumulations by closely held corporations which are motivated by the avoidance of tax at the shareholder level (that is, the matter dealt with in IRC Secs. 531-537 and 541-547). In other words, shielding shareholders from dividend income is less apt to occur if the distributions entitle them to a tax credit.

As has been suggested for the dividends-paid deduction, provision should be made to preclude retroactive application to years

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24 One might expect, however, a definite improvement in corporate—shareholder relations and communication. Shareholders will certainly apply pressure on corporate management to account for dividend pay-out potential. Along the same vein, it can be anticipated that corporate policy as to dividend distributions will have a definite impact on investment decisions.

25 A variation of the gross-up method would allow the corporation to allocate dividends to its shareholders without any accompanying distribution. Known as the Carter Commission proposal, such a procedure resembles the consent dividend approach suggested in connection with the dividends-paid deduction but with the tax consequences falling at the shareholder level. For an excellent discussion of the Carter proposal see McClure's article cited in note 18, pp. 569-74.
prior to the effective date of the enacting legislation. Thus, corpo-
rate taxes paid and attributable to profits accumulated before that
date would not be eligible for gross-up and credit treatment.

Some form of the gross-up method has been adopted by other
developed countries (for example, France, Canada, and The
United Kingdom. See Appendix 2).

If the United States denies integrated tax treatment (except on
a treaty basis) to foreign shareholders, the gross-up method
would be preferable to the dividends-paid deduction alternative.
This is true from a compliance and administration standpoint,
since the corporation, under the gross-up method, would be
spared the burden of having to determine the citizenship status of
each of its shareholders.

One problem posed by the gross-up method arises with respect
to determining the corporate tax attributable to the dividend dis-
tribution. An exact allocation approach, seemingly the most
equitable in terms of its result, could become very complex if ad-
justments are to be made for income from tax-free sources.

In the interest of taxpayers in similar situations, the credit al-
lowed for the amount of the gross-up should not be limited to
the shareholder's tax liability generated by the dividends or by his
overall tax liability. Any other approach would penalize share-
holders in low marginal tax brackets. Although certain policy
considerations may dictate otherwise, the gross-up procedure
should not be available to shareholders that are tax-exempt
organizations.27

The withholding alternative could cause some instability at the
shareholder level when determining the final income tax in any
one year. Later modifications of corporate income tax liability,
either by action of the IRS or through other events, might well

26 If corporate profits are retained and distributed in later years it would, of
course, be necessary to keep track of the attributable corporate tax. In
terms of the order of distribution, one would anticipate the use of the
LIFO approach where distribution would be deemed paid from most re-
cent earnings. This is akin to the present structure where distribution first
originates from current earnings and profits.

27 Quite simply, the gross-up method offers greater flexibility than the divi-
dends-paid deduction approach in controlling the tax consequences to tax-
exempt and foreign shareholders.
change the gross-up computation of previous distributions. In such cases, affected shareholders may be required to file amended returns. In this regard, the dividends-paid deduction would create less difficulty, since only the corporation is affected by subsequent adjustments to prior tax years.  

28 The problem is somewhat similar to the situation under present law when a shareholder treats a distribution as a return of capital and such distribution later turns out to be covered by adequate earnings and profits.
History of the Taxation of Corporate-Source Income in the United States: 1909 to 1975

Beginning in 1913 with the ratification of the Sixteenth Amendment, the United States has maintained two distinct systems of taxing corporate-source income. Corporations have been subject to an income tax on their net earnings, while individual shareholders have been subject to an income tax on corporate distributions. The taxing statutes have provided little relief at the individual shareholder level to take into account the taxes paid by the corporation.

The Corporate Income Tax

The federal government has taxed the income of corporations continuously since the enactment of the Payne-Aldrich Act of 1909. This first tax was not an income tax as such, but rather an “excise” tax imposed upon the exercise of the privilege of doing business in the corporate capacity. The tax was one percent of net income in excess of $5,000.

This excise tax on corporate income was superseded in 1913 following the adoption of the Sixteenth Amendment which empowered Congress to tax income “from whatever source derived.” In its place was substituted a bona fide “income” tax on the net earnings of the corporation. Then, as now, the tax was imposed directly upon the corporation under the notion that it is a distinct, judicial person—a taxing entity separate from its shareholders. Except for one brief two-year period in its 63-year history (1936-1938), the tax has not discriminated between earnings retained by the corporation and earnings distributed to its shareholders.

Federal corporate income tax rates have shown a general upward trend since their first enactment in 1913. From 1913 to the end of the first World War in 1918, rates were gradually increased to 12 percent. During the 1920s they ranged from 10 to 13.5 percent. Graduated cor-
porate tax rates, first introduced in 1936, ranged from 8 percent to 15 percent and were supplemented by a graduated surtax ranging from 7 percent to 27 percent on undistributed profits. In 1938, the surtax on undistributed profits was removed, and the graduated rates were limited to corporations with net earnings of $25,000 or less.

Tax rates of 25 percent to 40 percent were imposed throughout World War II. During those years a special excess profits tax brought the maximum combined effective tax rate on corporate earnings to 80 percent. Effective rates for the remainder of the decade ranged from 21 percent to 38 percent.

In 1950 the graduated tax rates for corporations with taxable incomes of $25,000 or less were replaced with a single normal tax rate applicable to the full amount of taxable income and a surtax applicable to all taxable income in excess of $25,000. From 1950 to 1953 (the Korean War period) the normal tax rate was 30 percent and the surtax rate was 22 percent. Those were supplemented by a 30 percent excess profits tax, which expired at the close of 1953. It wasn't until the Revenue Act of 1964 that the normal and the surtax rates were changed. The normal rate was reduced to 22 percent and the surtax rate was increased to 26 percent, and both rates have continued in effect since 1965. In 1968 and 1969, however, an additional 10 percent surcharge was imposed. It was reduced to 2.5 percent in 1970 and subsequently eliminated altogether. For 1975 only, the normal tax was 20 percent for the first $25,000 and 22 percent for taxable income in excess of $25,000. The surtax rate continued to be 26 percent but, again, in 1975 only, the surtax exemption was temporarily increased to $50,000.

The graph opposite shows the standard rates imposed by the federal government on taxable corporate income over $25,000 between 1909 and 1975 inclusive. No account was taken of excess profits taxes.

**Taxation of Corporate Distributions**

*Individual shareholders.* Prior to 1954, dividend income (that is distributions out of the “earnings and profits” of a corporation) was taxable as income to the individual stockholder in the same manner as any other item of gross income. No effect was given to the fact that corporate earnings, out of which the dividend was distributed, had been previously subjected to the corporate income tax. The 1954 Code, by the enactment of IRC Secs. 34 and 116, introduced two forms of

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* The 1975 rate applies to income in excess of $50,000.
limited relief from this “double taxation” of corporate profits. Those provisions represented the nation’s first attempt at “integration” of the corporate and individual income taxes, and their expressed purpose was to halt the trend toward debt financing and to encourage investment in the equity capital of corporations.

As introduced in 1954, the integration scheme had two components—a limited exclusion from gross income and a limited credit against tax. The exclusion provision (Sec. 116) permitted an individual to exclude from his gross income the first $50 of dividends received during the taxable year. This provision applied to the dividend income received by each taxpayer. A husband and wife were each entitled an exclusion of up to $50 if they both had dividend income, whether filing jointly or separately.

The credit provision (IRC Sec. 34), on the other hand, let an individual taxpayer reduce his gross income tax liability by an amount equal to 4 percent of all the dividends received from domestic corporations which had been included in his or her gross income (that is, the credit was computed on the amount of dividend income net of the amount of the dividend exclusion). However, the credit reduction in tax liability could not exceed 4 percent of taxable income, and in no event could it exceed his income tax liability for that year. Thus, there was no carryover or carryback of any excess credit, nor was the taxpayer entitled to any refund due to excess credit. Unlike the exclusion (computed on the basis of separate ownership), the credit for married taxpayers was computed on the basis of combined dividends, combined taxable income, and combined income tax liabilities.

The Revenue Act of 1964 retained, and even enlarged, the exclusion (from $50 to $100) but eliminated the credit. The credit was reduced to 2 percent in 1964 and no credit was allowed for dividends received after 1964. The reasons for the credit repeal, (as stated in the related congressional committee reports) were these:

• The notion that the dividend credit would encourage investment was not borne out by events that had occurred since its enactment in 1954.
• From the standpoint of making funds available for investment in corporate enterprises, it was felt that the reduction (in 1964) of the corporate income tax rates, plus the recent enactment of the investment credit, could be expected to have a more important impact than any reduction directed solely toward distributed corporate income.
• The credit reduced any double taxation by a much larger amount for higher income bracket shareholders than it did for those in the lower income brackets.

Neither the exclusion nor the credit have ever been allowed with respect to dividends received from tax-exempt organizations, foreign corporations, corporations in business in possessions of the United States, China Trade Act corporations, or (for years prior to 1958) insurance companies. The so-called dividends of mutual savings banks, cooperative banks, and building and loan associations are also ineligible.

Corporate Shareholders. Relief from double taxation has long been granted to intercorporate dividends. If this were not the case, such dividends might become subject to taxation any number of times
prior to their ultimate distribution to individual shareholders. Under the 1918, 1921, 1924, 1926, 1928, 1932, and 1934 Revenue Acts, corporations were allowed a deduction for 100 percent of dividends received from most domestic corporations. The 1934 Revenue Act was amended in 1935 to reduce the amount of the deduction to 90 percent. The deduction was changed to a credit in 1936 and continued through the 1939 code at a rate which was further reduced to 85 percent.

Currently, corporate shareholders are entitled to a deduction of 85 percent of dividends received from most domestic corporations. Where the dividends are received from other members of "affiliated" groups (that is, corporations at least 80 percent of whose stock is owned by a common parent corporation), the allowable deduction is generally 100 percent of such dividends. As in the past, special rules and limitations apply to dividends received from certain corporations, such as tax-exempt corporations and foreign corporations.
Corporate-Source Income: A Comparative Summary of Current Tax Systems in Selected Countries*

Many countries maintain a two-tier system of taxation with respect to corporate-source income. Corporate net income, or profit, is first taxed at the corporate level, and any dividends paid to shareholders are again taxed at graduated individual rates. Such a system gives rise to full economic double taxation in that little or no relief is granted at either the corporate or the shareholder levels for the tax imposed on the other. No effect is accorded the notion that the corporation is nothing more than the aggregate of its shareholders and thus has no纳税ability beyond that of its shareholders. The corporation is a distinct, legal, taxpaying entity, separate from its shareholders.

An important exception to the double taxation treatment, however, is generally accorded to corporate shareholders. Intercorporate dividends are exempted, in whole or in part, from the corporate income tax. If this were not the case, corporate earnings could be taxed two or more times prior to being taxed at the individual shareholder level.

In contrast to the two-tier, or “unintegrated,” system of taxing corporate profits, many countries in recent years have adopted taxing provisions designed to mitigate the incidence of full economic double taxation. Such integrated systems have directed the relief in some cases, to the corporate level by using some sort of “split rate” device (analogous to the dividends-paid deduction alternative). In other instances, by means of a gross-up mechanism, the shareholder level be-

comes the focal point of such relief. A few countries effect integration by directing partial relief to each level.

Under a split-rate system, the tax rate imposed on distributed earnings is substantially less than the rate applicable to earnings retained by the corporation; since it is only the distributed earnings or dividends that will be taxed [at graduated rates] to the shareholders upon receipt. In some countries, this treatment is modified by allowing the corporation a full or partial “dividends-paid” deduction. All, or a portion of the amount of earnings paid out as dividends is deducted from the corporation’s net income and the remainder is taxed at standard rates.

The “gross-up” method (sometimes referred to as the “withholding” or “credit” method) taxes all corporate income at standard rates. The shareholder generally includes in his gross income the full amount of the dividend received plus all, or in most cases a portion of, the tax paid by the corporation on such distributed earnings (that is, the grossed-up amount). The amount of the gross-up is then allowed as a credit against his personal income tax liability. In theory, where the corporation and shareholder are residents of the same taxing jurisdiction, either a “credit” method or a “split-rate” method could be implemented to achieve the same tax results.

The following table briefly summarizes the various systems of corporate-source income taxation currently employed in Germany, Japan, Finland, Norway, Canada, France, the United Kingdom, and Greece. The scope of this review is limited to the taxation of dividends paid by a domestic corporation out of non-foreign-source income to its domestic shareholders.

**Germany**

Resident corporations are eligible for a reduced tax rate of 15 percent on earnings distributed to shareholders. Retained earnings are taxed at a rate of 51 percent. The earnings used to pay either tax are treated as retained earnings and are thereby taxed at the 51 percent rate. Constructive dividends or “hidden distributions” are not eligible for the split-rate treatment.

The split rate applies equally to dividends paid to individual and corporate shareholders. Dividends received by individuals are subject to the graduated personal income tax. Dividends received by another domestic corporation are taxed as income to that corporation unless—

- The recipient corporation directly holds at least 25 percent of the share capital of the distributing corporation.
• The recipient corporation redistributes such dividends to its shareholders in the same year. However, to the extent these dividends are retained by the corporation, they are taxed at the 51 percent rate.

Year of adoption: 1953.

Japan

Integration is directed toward relief at both the corporate and the shareholder levels, although the credit system (at the shareholder level) is of less importance today than in previous years.

A split-rate system applies the following tax rates to corporations on their net earnings.

<table>
<thead>
<tr>
<th>Corporation Capitalization</th>
<th>Rate on Income Earmarked for or Retained Earnings</th>
<th>Rate on Income Earmarked for or Distributed as Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporations capitalized at more than Y100,000,000 (U.S. $330,000)</td>
<td>40%</td>
<td>30%</td>
</tr>
<tr>
<td>Corporations capitalized at less than Y100,000,000—</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Income of more than Y7,000,000 annually</td>
<td>40%</td>
<td>30%</td>
</tr>
<tr>
<td>b. Income of not more than Y7,000,000 annually</td>
<td>28%</td>
<td>22%</td>
</tr>
</tbody>
</table>

On the individual shareholder level, the full amount of the dividend (cash received plus the amount of a 15 percent tax on the dividend withheld at source) is includable in the individual's gross income. Gross income is reduced by allowable deductions to arrive at taxable income against which graduated rates are applied. The 15 percent tax withheld at source plus a special 10 percent dividend-received credit are applied against the individual's gross tax liability. When the taxpayer's taxable income is greater than Y10,000,000 (U.S. $33,000), the amount of the dividend-received credit is reduced, but never below 5 percent of dividends received. Domestic corporate shareholders are not taxed on dividends received provided their dividend distribution is equal to the dividends received. If a lesser amount is distributed, then 25 percent of the difference (between the amount of dividends actually paid and the amount of the minimum distribution required
to avoid the tax) is included in the corporate shareholder's income and taxed as retained earnings.

*Year of adoption: 1961.*

**Finland and Norway**

Both countries direct integration relief to the corporate level by allowing the corporation a deduction for dividends paid.

Finnish law allows a deduction in the amount of 40 percent of cash dividends declared (100 percent for dividends declared on newly issued stock), which reduces the corporate tax rate on distributed earnings from 43 percent to, at most, 25.8 percent.

Norway permits a 100 percent deduction for dividends paid. Thus, only retained profits are subjected to the 27 percent corporate tax rate. Significant local taxes, however, are levied at the same rate upon both distributed and undistributed income.

In both countries, dividends received are fully taxed to the ultimate individual shareholder.

*Year of adoption: Finland—1965 or earlier; Norway—1970.*

**Canada**

Integration relief is achieved at the shareholder level by means of a dividend tax credit applied against the individual shareholder's personal income tax. Intercompany dividends, in most cases, are entirely exempted from taxation. The corporate income tax rate in Canada is 47 percent (46 percent in 1976 and subsequent years). Lower rates are available to small businesses and other corporations with respect to their net manufacturing and processing income.

The individual taxpayer must include in his gross income four-thirds of the cash dividend received. He may then claim an amount approximately equal to the gross-up (one-third of the dividend) as a credit against his individual income tax otherwise due. If the credit results in an overpayment, a cash refund is available.

*Year of adoption: 1972.*

**France**

France achieves integration at the shareholder level by employing an imputed credit system. Both individual and corporate portfolio shareholders (that is, corporations with less than a 10 percent share-
holding) receive a credit against income tax of 50 percent of dividends received. These shareholders include in their gross income the full amount of dividends received plus 50 percent of that amount (the amount of the credit). The tax liability is reduced by the amount of the credit. If the credit results in a tax overpayment, an individual shareholder is entitled to a cash refund. Such a refund is not available to corporate portfolio shareholders, who lose the benefit of any excess credit.

The corporate tax rate is 50 percent. Intercompany dividends, net of expense incurred by the corporate shareholder in relation to deriving such income, are exempted from the tax if—

- The corporate shareholder owns at least 10 percent of the issued shares of the corporation from which the dividends are received.
- The corporate shareholder either subscribed to the shares at the time of issue or promises to hold them (or has held them) for at least two years from the time of purchase.

The effect of extending the exemption to “net dividends” rather than total dividends is to impose a tax of about 4 percent on the total amount of intercompany dividends received. See R. M. Hammer, cited in note on page 30, for a derivation of this percentage.

*Year of adoption: 1965.*

**United Kingdom**

The United Kingdom integrates at the shareholder level. Under this system, the dividend-paying corporation must make an “advance payment” against its current-year corporate income tax liability in an amount equal to 49 percent of any dividends it distributes. The individual shareholder must gross up the dividend by including in his gross income the full amount of the dividend plus the corporation’s related advanced payment. He then reduces his tax liability by the amount of the advanced payment. Cash refunds are available.

Distributions received by domestic corporate shareholders, including the related advanced payment credit of 49 percent, are fully exempted from the recipient’s corporate tax (52 percent). No minimum shareholding in the distributing corporation is required of the recipient corporation. Furthermore, the advance payments made by the distributing corporation (with respect to the dividends paid to the recipient shareholder corporation) are used as credits against the amount of advanced payments owed by the recipient corporation.

*Year of adoption: 1973.*
Greece

Double taxation is entirely avoided; income from corporate sources is taxed only once. Distributed dividends are totally exempt from taxation at the corporate level but are taxed in full to shareholders. Retained earnings are taxed to the corporation (at a generally applicable effective rate of about 38 percent), but the tax is refundable when the earnings are subsequently distributed.

Year of adoption: 1958.
Comparison of Consequences Under Various Approaches

The following tables illustrate the mechanics of taxing $300 of corporate net earnings under the current U.S. law, and the proposed full "dividends-paid" deduction method, the "gross-up" method, and the "half-and-half" method. In each case, it is assumed that the corporation distributes to its shareholders the full amount of its after-tax earnings. Neither the $25,000 corporate surtax exemption, nor the $100 exclusion applicable to the shareholders' annual dividend income is taken into account.

Table 1, below, describes the tax consequences of an individual shareholder in the 30 percent tax bracket, while table 2, page 38, pertains to such consequences of a 70 percent tax bracket shareholder.

**Table 1: 30 Percent Tax Bracket Shareholder**

<table>
<thead>
<tr>
<th>Corporate Level</th>
<th>Present Law</th>
<th>Full Dividend Deduction</th>
<th>Full Stockholder Credit</th>
<th>Half-and-Half Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(taxable income)</td>
<td>$300</td>
<td>$300</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>Dividends-paid</td>
<td>156</td>
<td>300</td>
<td>156</td>
<td>205.26</td>
</tr>
<tr>
<td>Dividend-deduction</td>
<td>—</td>
<td>300</td>
<td>—</td>
<td>102.63</td>
</tr>
<tr>
<td>Taxable income</td>
<td>300</td>
<td>—</td>
<td>300</td>
<td>197.37</td>
</tr>
<tr>
<td>Tax (48%)</td>
<td>144</td>
<td>—</td>
<td>144</td>
<td>94.74</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

| Individual Level          |             |                         |                         |                      |
| Dividend received         | $156        | $300                    | $156                    | $205.26              |
| Gross-up                  | —           | —                       | —                       | 102.63               |
| Taxable income            | 156         | 300                     | 300                     | 307.89               |
| Tax—before credit (30%)   | 46.80       | 90                      | 90                      | 92.37                |
| Credit                    | —           | —                       | 144                     | 102.63               |
| Tax—after credit          | —           | —                       | (54)                    | (10.26)              |

| Total Tax                 | $190.80     | $ 90                    | $ 90                    | $ 84.48              |
| Effective rate            | 63.6%       | 30%                     | 30%                     | 28.16%               |
Under the "half-and-half" method, the corporation is entitled to a deduction for one-half of the dividends paid to its shareholders. The individual shareholder would gross up his dividend by adding to his taxable income an amount equal to one-half of the dividends received and would then take a tax credit equal to the gross-up. The corporate and individual income taxes in this illustration are computed as follows:

Corporate level
Dividends-paid $205.26
Dividends-paid deduction (50% of $205.26) 102.63

| Taxable income ($300-$102.63) | 197.37 |
| × Tax rate (48%) | × 48% |
| Tax: | 94.74 |

Individual Level
Dividends received 205.26
Plus: gross-up (50% of $205.26) 102.63
Taxable income 307.89
× Tax rate (30%) × 30%

| Tax—before credit | 92.37 |
| Less: gross-up | 102.63 |
| Tax—after credit: | (10.26) |

The total tax paid on the $300 of corporate net earnings is 84.48

Thus, the effective rate of tax imposed on dividend income received by a 30% tax bracket taxpayer is 28.16%

As can be seen from this example, the combination of a 50 percent dividends-paid deduction and a 50 percent gross-up and credit, when combined with the 48 percent corporate rate, would more than eliminate the double tax. One or the other would need to be adjusted slightly.
Table 2: 70 Percent Tax Bracket Shareholders

<table>
<thead>
<tr>
<th></th>
<th>Present Law</th>
<th>Full Dividend Deduction</th>
<th>Full Stockholder Credit</th>
<th>Half-and-Half Method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate Level</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Taxable Income)</td>
<td>$300</td>
<td>$300</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>Dividends-paid</td>
<td>156</td>
<td>300</td>
<td>156</td>
<td>205.26</td>
</tr>
<tr>
<td>Dividend-deduction</td>
<td>—</td>
<td>300</td>
<td>—</td>
<td>102.63</td>
</tr>
<tr>
<td>Taxable income</td>
<td>300</td>
<td>—</td>
<td>300</td>
<td>197.37</td>
</tr>
<tr>
<td>Tax (48%)</td>
<td>144</td>
<td>—</td>
<td>144</td>
<td>94.74</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Individual Level</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend received</td>
<td>$156</td>
<td>$300</td>
<td>$156</td>
<td>$205.26</td>
</tr>
<tr>
<td>Gross-up</td>
<td>—</td>
<td>—</td>
<td>144</td>
<td>102.63</td>
</tr>
<tr>
<td>Taxable income</td>
<td>156</td>
<td>300</td>
<td>300</td>
<td>307.89</td>
</tr>
<tr>
<td>Tax—before credit (70%)</td>
<td>109.20</td>
<td>210</td>
<td>210</td>
<td>215.52</td>
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<tr>
<td>Credit</td>
<td>—</td>
<td>—</td>
<td>144</td>
<td>102.63</td>
</tr>
<tr>
<td>Tax—after credit</td>
<td>—</td>
<td>—</td>
<td>66</td>
<td>112.89</td>
</tr>
<tr>
<td><strong>Total Tax</strong></td>
<td><strong>$253.20</strong></td>
<td><strong>$210</strong></td>
<td><strong>$210</strong></td>
<td><strong>$207.63</strong></td>
</tr>
<tr>
<td>Effective rate</td>
<td>84.4%</td>
<td>70%</td>
<td>70%</td>
<td>69.21%</td>
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</tbody>
</table>