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CORPORATE TAX POLICY FOR THE TWENTY-FIRST CENTURY: INTEGRATION AND REDEEMING SOCIAL VALUE

GLENN E. COVEN*

The past seven years have witnessed the culmination of a series of dramatic changes in our income tax policies towards corporations and their shareholders. Relationships among the principal provisions of the individual and corporate income taxes that had prevailed for the preceding one-half century, and the expectations that those relationships created, were quite abruptly turned on their heads. One might expect that such a mini-revolution in income tax policy would be succeeded by a prolonged period of relative calm during which vaguely conceived modifications were rationalized and structural gains consolidated.¹ That, however, seems most unlikely to occur. The major elements of the current statutory approach to corporate taxation have not gained general acceptance and the political equilibrium that produced and briefly sustained that statutory pattern has been destabilized by the change in political administrations. The prescription is for further change, and even now serious proposals are piling up before Congress. That continuing change is not to be regretted; the statutory pattern that emerged primarily in the 1986 legislation was far too economically irrational to deserve greater longevity.

While further modification to our corporate tax policy seems both inevitable and imminent, the direction in which that policy now will move is far from clear. It is therefore an appropriate time to reflect upon corporate tax policy for the twenty-first century. As in other human endeavors, the look forward is illuminated by the light of the past.

A. THE ABOLITION OF AD HOC TAX INTEGRATION

At least since 1936, the United States nominally has imposed a separate and cumulative tax on the incomes and profits of both individuals and corporations. While that general statutory pattern is deeply entrenched in our taxing system, the resulting potential for the "double" taxation of profits derived by incorporated business has discomforted virtually all students of income taxation. Over the history of the dual system of taxation, that discomfort produced a variety of statutory provisions designed to ameliorate the nominal income tax burden in greater or lesser degree.²

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1. A recurring but evidently fruitless wish. See David F. Bradford, *The Possibilities for an Expenditure Tax*, 35 NAT'L TAX J. 243, 243-44 (1982) (discussing volatility in tax legislation under Presidents Carter and Reagan).

2. See Carl S. Shoup, *The Dividend Exclusion and Credit in the Revenue Code of 1954*, 8 NAT'L TAX J. 136 (1955).

Perhaps more importantly, other less calculated but equally effective policies and practices which further mitigated double taxation were widely tolerated throughout this period.

As corporate taxation entered 1986, a wide range of features of the taxing system served to reduce the effective rate of tax at either the corporate or the shareholder level, in many cases eliminating one or the other level of tax all together. The more significant of those elements of the taxing system might include the following.

At the corporate level:

1. *Corporate Tax Rate.* In general, the maximum rate of income tax applicable to corporations was substantially lower than the maximum rate of tax that might be applicable to individuals. For example, during much of the period following World War II, the corporate tax rate was less than seventy-five percent of the maximum individual rate.³ In addition, relatively small, closely held corporations benefited from further rate reductions at the corporate level through the progressive rate structure which, in its various manifestations, had the general effect of halving the tax rate on very low corporate incomes.⁴

2. *Exemption from Tax on Certain Distributed Income.* The income tax on income or gain inherent in property distributed to shareholders was entirely forgiven under the so-called *General Utilities* doctrine.⁵ That peculiar feature of prior law opened numerous avenues for elimination of double taxation. Thus, in its most abusive application, the double taxation of closely held corporations could be essentially eliminated by confining dividends to distributions of appreciated property, including inventory.⁶ Any corporation, large or small, might eliminate tax on the appreciation in corporate properties, again including inventory, by purporting to sell all of its assets to a second corporation, even one partly owned by the shareholders of the transferor.⁷

3. In 1968, for example, the maximum rate applicable to corporations was 52.8%, including a 10% surcharge, while the maximum rate applicable to individuals was 75.5%, including a 7.5% surcharge. HOUSE WAYS AND MEANS COMM., 102d Cong., 1st Sess., OVERVIEW OF THE FEDERAL TAX SYSTEM 55-57, 72 (Comm. Print 1991).

4. See I.R.C. § 11(b) (1988) (providing 15% tax rate for corporate taxable income not in excess of \$50,000 and 34% rate for corporate taxable income in excess of \$75,000).

5. The doctrine associated with the decision in *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935), was embodied in several now-repealed sections of the Internal Revenue Code of 1954.

6. That avenue, however, was being closed by the judiciary. See *Bush Bros. & Co. v. Commissioner*, 668 F.2d. 252 (6th Cir. 1982) (holding gain on sale of property received as dividend imputed and taxed to corporate distributor).

7. See *Commissioner v. Berghash*, 361 F.2d 257 (2nd Cir. 1966) (holding cash distributions to shareholders pursuant to liquidation were taxable at capital gains rates where operating assets of old corporation were transferred with business to new corporation 50% owned by shareholders of old corporation); see also *Stevens Pass, Inc. v. Commissioner*, 48 T.C. 532 (1967) (dealing with purchase of stock of target corporation followed by liquidation of target).

3. *Broad Tolerance for Expensing Profits.* The judiciary and, to a large extent, the Internal Revenue Service always has manifested a surprisingly broad tolerance for the deduction of distributions of corporate profits through a wide range of relatively transparent artifices. Thus, publicly traded corporations, leveraged far beyond the dictates of common sense, might substantially reduce the corporate income tax through the distribution of earnings cast in the form of interest payments. Or, bonus compensation in the millions or tens of millions might be paid to the executives of public corporations in lieu of or in addition to compensation in the form of an equity interest. In the closely held corporation, all of those techniques might be enhanced through the creative use of nepotism. The judicial tolerance for schemes such as the leasing by minor children of office buildings to the business of their parents is both enlightening and depressing.⁸

4. *Preferential Allowances.* Over the decades of corporate taxation a bewildering array of provisions which had the general effect of reducing the effective average rate of tax applicable to corporate profits were added, and, far less frequently, subtracted from the corporate income tax. Whether enacted for good reason or bad, the accumulative effect of all such tax preferences was to reduce materially the double tax burden.

At the shareholder level:

1. *Reduced Rate of Tax on Deferred Distributions.* Under the general scheme of Subchapter C, the distribution of retained corporate earnings in the form of a repurchase of the corporation's stock would be treated as a sale and thus eligible for the reduced rate of tax applicable to capital gains as well as a pro rata recovery of basis. While in form the Internal Revenue Service had available a variety of statutory and nonstatutory weapons designed to prevent the recasting of ordinary dividend distributions as capital gain redemptions, those weapons were surprisingly ineffective.

2. *Forgiveness of Tax on Death.* In one of the best known and least defensible erosions of the double tax burden, the gain in corporate stock, whether in the form of a portfolio investment in a publicly traded corporation or the sole ownership of a family business, was entirely excused from tax upon the death of the holder of the stock. In some measure, that utter exemption from tax was compensated by the imposition of the estate tax, but the ability to avoid that levy was so notorious that some commentators referred to the tax as a voluntary one.⁹

The net effect of this complicated pattern of taxation under prior law was well understood at the time. While the relief from taxation was uneven and nonrational, the net overall effective burden imposed by the nominal double tax system was often no greater than the income tax burden that would have been imposed had the business been conducted in unincorporated

8. See *Lerner v. Commissioner*, 71 T.C. 290 (1978) (discussing tax treatment of rental payments made by taxpayer's corporation to trust for taxpayer's children).

9. George Cooper, *A Voluntary Tax: New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 162 (1977).

form. Indeed, as Professor Warren once so cogently illustrated, during many years earnings derived by an incorporated business were actually subject to a lower burden of tax than earnings derived by an unincorporated business.¹⁰ Under such circumstances, the closely held corporation, rather than being punished by double taxation, functioned as a tax shelter.

Viewed more broadly, prior to 1986 a variety of statutory and nonstatutory features of the income tax system produced an ad hoc form of corporate tax integration. While the overall burden of taxation achieved prior to 1986 under the dual tax system may thus have been acceptable, the rationale of the techniques through which that burden was achieved were not. In 1986, a temporary populist uprising captured the annual process of extensively amending the Internal Revenue Code (Code) and, with little warning or forethought, thoroughly altered the relationship between the individual and corporate income taxes.¹¹ The revolution was accomplished in four decisive victories:

1. *Rate Relationships*. The lower rate of tax historically applicable at the corporate level was eliminated with a vengeance. The 1986 legislation produced a rate inversion; the corporate tax rate of thirty-four percent was higher than the maximum rate applicable to individuals.¹²

2. *Elimination of the Zero Rate on Distributed Earnings*. The crumbling *General Utilities* doctrine was wholly overturned. Henceforth, the gain inherent in corporate properties could not escape the corporate level tax either through current distributions or the disposition of all the assets of the business.

3. *Capital Gains Preference*. The preferential rate of tax applicable to gain on the sale of corporate securities (and other property) was eliminated. Henceforth, the only income tax benefit from the deferred distribution of corporate earnings was the modest ability to reduce the amount of taxable gain by the basis of the stock retired. While the complete elimination of the preferential capital gains rate of tax did not long survive, the rate differential that persisted until 1993 was trivial relative to the disparity prevailing during the pre-1986 era.¹³

4. *Elimination of Preferences*. Finally, the ability of corporations to reduce income tax liabilities through the use of preferential allowances was sharply restricted through the enactment of a variety of rules ranging from

10. Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 723 (1981).

11. See Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839 (1988).

12. Just how much higher is debatable since the marginal rate of tax applicable to individuals is not easy to determine. See Glenn E. Coven, *Congress as Indian-Giver: "Phasing-Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505 (1987).

13. While the nominal maximum marginal rate of tax on individuals is currently 31%, the rate applicable to capital gains is limited to 28%. I.R.C. § 1(h) (1988). Immediately prior to 1986, capital gains were taxed at only a maximum marginal rate of 20% compared to a maximum 50% rate on the ordinary income of individuals.

extensive capitalization requirements¹⁴ to the imposition of an alternative tax on income as computed for book accounting purposes.¹⁵

While the 1986 legislation certainly did not eliminate all the elements of prior law that served to mitigate the effect of the nominal double taxation of corporate profits, the reach of the 1986 legislation was unprecedented. For perhaps the first time in the three-quarters-of-a-century history of income taxation in the United States, virtually complete double taxation was imposed upon the profits derived by incorporated business.

The statutory result achieved in 1986 was a most peculiar beast that few thought would long survive yet was inescapably intriguing. The simplification benefits generated by these reforms cannot be overstated. The application of an essentially uniform rate of tax to income derived by both corporations and individuals, and to income derived as either ordinary income or capital gain, quite substantially eliminated the incentive to engage in a wide range of unproductive tax reducing behavior. The tax reduction gained from converting ordinary dividends into redemptions in many cases became less than the cost of the tax advice needed to arrange the transaction. The cumbersome liquidation-reincorporation technique for avoiding dividends, recently attacked by legislation,¹⁶ became a foolish maneuver. Indeed, the very notion of incorporating a business, or worse, a wage-earner, to reduce or defer taxation became obsolete. And, a whole range of complex Code provisions designed to retard tax avoidance behavior, such as the collapsible corporations rules, the accumulated earnings tax and the personal holding company rules, while retained out of uncertainty over the course of future tax legislation, were rendered superfluous in the post-1986 era.

On the other hand, the rigorous application of a substantially greater burden of taxation on income derived through the use of corporations was not appealing either from the perspective of horizontal equity or market efficiency. First, taxing income derived through the use of corporations so much more heavily than income derived from alternative sources was both inequitable and distortive of economic behavior. Indeed, almost immediately following the adoption of the 1986 solution, Congress was forced to adopt new Code section 7704 to treat publicly traded partnerships as corporations for income tax purposes in order to stem the "disincorporation of America."¹⁷ Second, the rigorous double taxation of the return on equity investments contrasted too sharply with the single¹⁸ level of taxation imposed

14. I.R.C. § 263A (1988) (imposing uniform capitalization rules).

15. I.R.C. § 56(f) (repealed 1990) (including 50% of excess of adjusted net book income over alternative minimum taxable income (AMTI) in AMTI). See I.R.C. § 56(g) (1988) (replacing 50% book income adjustment with 75% adjusted current earnings adjustment for tax years beginning after 1989).

16. I.R.C. § 368(a)(2)(H) (1988) (dropping control requirement from 80% to 50% in liquidation-reincorporation transactions in order to promote D reorganization treatment).

17. Louis S. Freeman, *Some Early Strategies for the Methodical Disincorporation of America*, 64 TAXES 962 (1986).

18. Corporate earnings paid out as interest to the tax exempt sector, of course, are not subject to even a single level of tax.

upon the return to debt investments. The enormous difference in income tax consequences placed too much stress on the fragile distinction between debt and equity. Worse, corporate managers, rushing to replace overtaxed equity with more attractive debt, appear to have over-leveraged too many businesses—on the eve of a prolonged recession, regrettably. For these and related reasons, the bottom line impact of the 1986 legislation was simply too economically irrational to survive—its simplification notwithstanding.

Moreover, that compromise rested on the most tenuous of political foundations. The maximum rate of tax applicable to individuals was surprisingly low by reference both to our own history¹⁹ and to the taxing system of the other developed economies of the world. A return to an even slightly more progressive tax structure could well dissolve the entire 1986 compromise. It seems unlikely that corporate tax rates could climb as rapidly as individual tax rates and even less likely that the rates of tax on capital gains could rise with a more progressive general income tax rate structure.

The dissolution of the 1986 reform could lead corporate tax policy in either of two directions. We could, of course, return to the pre-1986 system of ad hoc integration, relieving the double tax burden through a somewhat randomly adopted series of rate reductions and base contractions. Or, we could move forward towards the adoption of a rational and systematic form of partial integration along the general lines of the systems employed by our principal trading partners in Europe and elsewhere. Regardless of our ultimate destination, however, it seems most unlikely that we will adopt a very direct path to either result.

Under the crushing burden of the federal budget deficit, the Clinton Administration, hardly a month into the presidency, proposed retreating in the direction of, if not "to," the pre-1986 system. The selection of that option is eminently understandable and may even, under our regrettable circumstances, be appropriate. The classical system of double taxation of corporate profits, even when deeply eroded by mitigating provisions, provides the appearance and perhaps the reality of both revenue generation and progressivity, two objectives that presently are of paramount importance. Thus, the President has proposed: (1) a restoration of the old rate relationship by increasing the maximum rate of tax applicable to individuals to a level materially in excess of the maximum rate of the corporate income tax; (2) a restoration of the incentive to avoid dividend distributions by increasing the rate differential between ordinary dividend income and capital gains on stock dispositions; and (3) a restoration of tax preferences, particularly an investment tax credit, that erode the corporate tax base.²⁰ While some of the President's proposals are targeted on small business, which

19. See Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 619 n.32 (1990).

20. See *Clinton Relies More on Taxes than Spending Cuts to Reduce Deficit*, TAX NOTES, Feb. 22, 1993, at 999-1001.

pays little corporate tax in any event, whether the final legislation will remain so limited is uncertain.

While retreat, therefore, is both predictable and understandable, a permanent return to the pre-1986 format of ad hoc integration, with its enormous premium on complex, advance tax planning, is ultimately no more acceptable than the retention of the status quo. It would seem inevitable, therefore, that the future of corporate tax policy lies in the adoption of an explicit system of integrating the corporate and individual income taxes.²¹

While corporate tax integration may be inevitable in the long run, integration will not become a reality in the United States until it is widely believed that integration can be achieved consistently with the fundamental goals and requirements for income taxation held by the American public. At any time, legislation of the visibility and impact of integration would have to attain a substantial measure of popular acceptability before it could be enacted. Today, when so much attention is focused on government finances by commentators ranging from talk show hosts to retired billionaires, demonstrating that integration at least does not undermine important social values is essential to the success of the concept.

To date, both the public and private debate over integration has focused almost exclusively on the technical superiority of one or another form of partial integration over the distortional effects of the existing classical system. Insufficient attention has been paid to whether integration in any form is compatible with the several objectives that this country has for income taxation, or to which form of integration will best further those objectives. That omission in the current debate is doubly unfortunate. On the one hand, integration cannot gain acceptance until it is shown to possess redeeming social value. On the other hand, there is much to be gained from an evaluation of the consistency of integration with the values and objectives that underlie the federal income tax. Because of the pervasiveness of corporations in our economic lives, the corporate income tax intersects with every material contour of the income tax system. The broad revision of the corporate tax, therefore, would invite, if not demand, a re-evaluation of many of the most fundamental features of the income tax—some of which are long overdue for reconsideration. The insights and perspectives that such an inquiry might provide would extend far beyond integration and its desirability. That inquiry, therefore, is to be embraced, not avoided. The following pages, while offering few answers, explore some of the principal social and economic policies reflected in our taxing system that would be affected by integration. A place should be found for the re-evaluation of

21. For closely held business, integration, at least as an option, has become a present reality. The combination of the IRS acceptance of the liberalization of Subchapter S, see Glenn E. Coven, *Making Subchapter S Work*, TAX NOTES, July 21, 1986, at 271, and the IRS retreat from the attempt to treat limited partnerships and limited liability companies as associations taxable as corporations, see Rev. Proc. 89-12, § 1, 1989-1 C.B. 798; Rev. Rul. 88-76, 1988-2 C.B. 360, has meant that nearly all closely held businesses can escape double taxation under Subchapter C if their management so desires.

those policies on the agenda of corporate tax reform. Before turning to those policies, however, it will be useful to encapsulate the basic outline of the competing approaches to integration.

B. FORMS OF INTEGRATION

In the broadest sense, any reduction in the tax paid by a corporation or its shareholders serves to mitigate the effects of double taxation and can thus be viewed as a form of partial integration. From that perspective, the number of approaches to integration are infinite. The range of possible approaches to the systematic and comprehensive elimination of double taxation, however, is far more limited. While differences in the details of the approaches to integration have resulted in a substantial number of integration plans, all are merely variations on four basic themes.

1. *The Exclusion Method.* The corporate level tax would be retained but the shareholder level tax repealed, either entirely or to the extent that distributions are of income taxed at the corporate level. The net result of the extreme version of this approach is the collection of a single tax at the corporate rate while the shareholders exclude corporate distributions and gain on the sales of stock from income. The Treasury has proposed the adoption of a more limited version of this method. Under the final Treasury proposal,²² shareholders would exclude from tax all dividend distributions but would remain subject to tax on gains from the sales of stock.

2. *The Shareholder Tax.* The shareholder level tax would be retained, but the corporate level tax repealed. Shareholders would be taxed currently either on the earnings of the corporation, similar to the taxation of S corporations, or on the appreciation in the value of their ownership interests, a full accrual approach to integration. Both of these approaches are of great theoretical but little practical interest and are not considered further here.

3. *The Deduction Method.* Both levels of tax would be retained, but the corporation would be permitted to deduct the full amount of dividends paid. The net effect of this approach is to impose a single level of tax on distributed income at the shareholder rates, which may be zero. If a withholding tax is imposed upon the distribution of dividends at a rate approximating the corporate tax rate, the distinction between the deduction method and the credit method begins to blur.²³

4. *The Credit Method.* Again, both levels of tax would be retained, but the shareholders would be entitled to a tax credit equal to the tax paid by the corporation on the earnings distributed or deemed distributed. If desired,

22. U.S. TREASURY DEPARTMENT, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992), reprinted in DAILY TAX REP. (BNA), Dec. 14, 1992, at L-7 [hereinafter FINAL TREASURY REPORT].

23. A compromise approach to partial integration is a split-rate system under which distributed income is subject to a lower rate of tax at the corporate level than is retained income. A split rate system is comparable to a partial deduction system.

credits may be withheld from selected shareholders such as zero rate shareholders. The general effect of the credit method is not unlike the effect of the deduction method in that the ultimate tax on distributed earnings is computed at the shareholder rate—if the credit can be used to offset other income. However, the credit method is inherently more complex than are other methods. The income includible by a shareholder attributable to a distribution is not simply the amount of the distribution but that amount “grossed-up” by the tax paid with respect to that amount. In the most simple case, the amount included in income will equal the amount of the distribution divided by one minus the corporate tax rate.²⁴ The credit will then equal that grossed up amount times the corporate tax rate, although the credit is often expressed as a fraction of the dividend paid.²⁵

While sometimes viewed as the elimination of the shareholder level tax, the tax paid by the corporation under the credit method may also be viewed as a withheld shareholder tax and thus the credit system may also be viewed as the elimination of the corporate level tax. Versions of the credit method are commonly employed in Europe, but the Treasury rejected the approach, apparently because of its complexity.²⁶ A Reporter’s Study for the American Law Institute has recommended the adoption of a form of credit method.²⁷

Beyond the selection of the primary mechanical approach to integration represented by these four approaches, any plan for integration must address a number of secondary issues. Should the benefit of corporate level preferences pass through to the shareholders? What about the foreign tax credit? Should the benefits of integration be extended to foreign investors, by law or by treaty? What tax burden should be imposed on the tax-exempt sector? How should sales of stock be taxed? And so forth. In general, each broad approach to integration can accommodate any answer to each of these configuration issues. In that respect, selecting an approach to integration is much like buying a car: first you select the model and then add the desired options!

Some approaches to integration, however, fit better with some options. The dividend deduction method, for example, complicates withholding the benefits of integration from foreign investors. The dividend exclusion method complicates the maintenance of progression. The imputation credit method complicates, well, everything—but nevertheless may be the best compromise. The selection of the broad approach to integration, therefore, depends in some measure on the selection of the ancillary options to be added to the system. But, the selection of those options first requires the identification

24. If the corporation earned \$100, paid a tax of \$30 and distributed \$70, the shareholder would include in income \$70 divided by $(1-.30)$ or $0.7 = \$100$.

25. The credit will equal the distribution times the fraction equal to one divided by one minus the corporate tax rate $(1/1-c)$.

26. U.S. TREASURY DEPARTMENT, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 15 (1992) [hereinafter PRELIMINARY TREASURY REPORT].

27. ALLI, FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, Reporter’s Study (Warren) (1993) [hereinafter ALI PROJECT].

of the values and objectives that integration must preserve or further before it gains acceptance.

C. SOCIALLY AND POLITICALLY ACCEPTABLE INTEGRATION

Which, if any, of these approaches to integration, and which of the several ancillary policy options, ought to be adopted in the United States depends upon their relative compatibility with the fundamental objectives of income taxation held by the tax policy makers and tax paying public in the United States.

1. *Horizontal Equity*

The theoretical definition of income associated with the name of Henry Simons²⁸ and others has been a fundamental component in the analysis of income tax issues by two generations of students of taxation. The essence of Simons' views lies in the fungibility of receipts. Income is to be defined in terms of the impact of financial transactions upon net worth, and source distinctions are to be ignored, because all gains are fungible and should bear an equal income tax burden. Given that principle for the configuration of an ideal income tax, the myriad of specific tax law provisions can be characterized as proper or preferential. In testing for consistency with ideal income taxation, whether a preference assumes the form of a rate reduction or a base erosion is wholly irrelevant; the taxation of capital gains is preferential whether the provision is viewed as a rate reduction or as an exclusion of a portion of the gain from tax.

In the taxing systems employed by many other countries, this conception of financial receipts as fungible does not always prevail. Many countries, to varying degrees, employ a "schedular" approach to the computation of income tax liability under which income, gain and loss from different types of activities are computed separately and even may be reported in separate returns.²⁹ The rules and definitions applicable to the several schedules may differ, much like the differences between the United States income and estate taxes. The rate of tax and the manner in which the tax is collected may vary for different categories of income. One normal effect of the schedular approach to the computation of income tax liability is that gains and losses may not be netted across different categories of activities.

In its studies of integration, the Treasury has indicated a distinct preference for a schedular approach to the computation of income from capital.³⁰ That approach evidently is preferred, because it would allow for the imposition of a uniform rate of tax on all returns to capital that did

28. H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

29. For a description of the British system, see BUTTERWORTHS, *UK TAX GUIDE 1992-93* 54-57 (11th ed. 1992).

30. The Treasury is not alone in this desire; other countries have adopted such an approach. See Timo Viherkentta, *A Flat Rate Tax on Capital Income: The Nordic Model*, *TAX NOTES INT'L*, Mar. 15, 1993, at 659.

not bear a necessary relationship to the taxation of income from labor. Such a levy would be efficient in the sense that the taxing system would not favor or discourage different forms of investment or investments in different types of activities. However, such an approach to taxation presumably would impose different rates of tax on different components of a taxpayer's income solely as a function of the source of the income. Thus, a given taxpayer deriving an added one hundred dollars of capital income might be subject to the uniform tax at a twenty-eight percent rate although the taxpayer would have been subject to a fifteen percent or a forty percent rate if the added income had been compensation for services. Such a dismissal of the fungibility concept would be a marked departure from the tradition of income taxation in this country.

Presumably in part because of its predisposition for a flat rate of tax on capital income, the Treasury has endorsed the dividends exclusion approach to integration. Under that approach, a flat rate of tax is imposed on corporate earnings at the corporate level and no tax is imposed at the shareholder level. The dividend exclusion approach obviously falls far short of imposing a uniform rate of tax on capital income; interest payments by a corporation, for example, would remain deductible and thus ultimately subject to tax at the varying rates applicable at the shareholder level. Nevertheless, the dividend exclusion approach does impose a uniform rate of tax on corporate net earnings and is the approach to integration that is most compatible with the Treasury's economic preferences.³¹ By contrast, under either the imputation credit approach or the dividend deduction approach, the ultimate tax on corporate earnings is imposed at the shareholder level and thus reflects the varying rates imposed upon income at that level.

In minor yet material ways, the United States income tax system has moved in recent years towards a schedular approach to income. The passive activity loss rules, for example, effectively require the reporting of gain and loss from passive investments in business activities under a schedular system.³² Gains and losses from all such activities may be netted against each other but not against other income; income and loss from passive activities is no longer fungible with income and loss from other sorts of income producing activities. While passive activity income nominally remains subject to the single rate schedule used in this country, that income is effectively taxed at a higher rate than other income because of the disallowance of the tax benefit attributable to passive activity losses.

These passive activity rules were not an effective vehicle for stimulating public debate over the relative merits of schedular reporting. The passive

31. Moreover, the exclusion approach would be the easiest method of integration to convert into a uniform tax on capital income along the lines of the CBIT option contained in the preliminary report.

32. See Michael A. Oberst, *The Passive Activity Provisions—A Tax Policy Bloop*, 40 U. FLA. L. REV. 641, 674 (1988).

activity loss rules are an expedient; the rules are best viewed as merely a mechanical technique for shutting down out-of-control tax shelters and not as possessing a defensible intellectual content. Moreover, the extent to which those rules inject a schedular approach into our income tax system was minor. Integration, however, is different. It is inconceivable that the United States would adopt, or even seriously consider, an approach to integration that had been shaped by a commitment to schedular reporting, without first exploring and accepting in principle the concept of schedular reporting. Accordingly, the debate over integration in the United States will provide an opportunity to re-examine our traditional belief in the fungibility of financial receipts.

In any such debate, it is not at all clear what philosophy would prevail. Even if the economic efficiency of a schedular computation of income and a uniform taxation of income from capital is conceded, that benefit might not, in the minds of many, outweigh the real and perceived equity gains produced by the elimination of source distinctions in income taxation. For those valuing horizontal equity over economic efficiency, the imputation credit or dividend deduction methods will appear superior to the approach urged by the Treasury. More importantly than the outcome, however, is the debate itself. The United States should not move further towards schedular reporting without a careful and deliberate evaluation of whether that approach to the distribution of the income tax burden is consistent with the nation's expectations for income taxation.

2. *Preference Income*

Integration interacts with the horizontal equity of the taxing system in a second way. It is no secret that most of the Internal Revenue Code is not devoted to raising money but to spending it. Through countless provisions designed to induce or reward some sort of behavior, the tax law discounts tax liabilities. Under the classical approach to corporate taxation, these tax preferences are a source of enormous complexity, disturbing inequity, and harmful misallocation of resources. Under integration, they are far worse.

Under the double tax system, corporate preferences reduce the first level tax but, in general,³³ not the shareholder level tax. That is as it should be. The preferences are designed to affect corporate behavior, not shareholder behavior. Under integration, it is not at all clear what effect preference income should have. In the taxation of partnerships and S corporations, preferences "pass through" to the owners in the sense that they reduce the single level of tax imposed upon the economic activity of the entity. However, the treatment of closely held entities, in which there is a substantial

33. If the preference income is not included in earnings and profits, the distribution of that income is "stacked" after the return of the shareholder's investment and may only be taxed at capital gains rates. That deferral effectively gives the shareholder some direct benefit from the preference.

identity of interest between owners and managers, may not provide an appropriate model for taxing publicly held corporations.

If the preference income of publicly held corporations can pass to their shareholders free of tax, a material proportion of business income generated in the United States will be permanently exempt from all taxation. That exemption not only will affect tax revenues adversely but also will affect horizontal equity. Because the general effect of passing corporate preferences to shareholders under integration would be to convert a corporate preference into an individual preference, the general effect of the pass through would be to place a substantial amount of wholly tax-exempt income in the hands of all corporate investors—a highly undesirable result. The creation of a broad class of wholly untaxed income, which will disproportionately find its way into the hands of the relatively wealthy, would be an unfortunate byproduct of integration.

If, however, corporate preferences are not to pass to shareholders under integration, then the distribution of preference income will have different income tax consequences than the distribution of fully taxed income at either the corporate or the shareholder level or both. That, in turn, will require the development and administration of an accounting mechanism that will distinguish between these two categories of income. And *that* will constitute the single major source of complexity in both the design and implementation of integration.³⁴

The choice presented by the existence of corporate preferences, therefore, is between the substantial complexity of seeking to prevent the pass through of preferences to shareholders and the substantial inequity (and revenue loss) of allowing the pass through—not a happy or easy choice. In its preliminary report, the Treasury concluded that preferences should not pass through to shareholders for much the same reasons as rehearsed here.³⁵ However, in its final report, the outgoing administration elevated simplicity over revenue cost (in other words, practicality) and recommended the full pass through of preference income.

If it is clear that integration does not fit well with the extensive use of preferences that has been traditional in the United States, another solution presents itself. It has been suggested that in some substantial degree, corporate preferences function to mitigate the ill effects of double taxation.³⁶ To the extent that the classical system overtaxes equity investments, for example, preferences may be needed to attract adequate levels of new capital investment. With the adoption of integration and the substantial elimination of that bias, the need for those preferences that have the most dramatic effect upon the computation of taxable income will also be eliminated—or so it might be hoped.

Reconsideration of the role of tax preferences in income taxation is not exactly a new sport. However, if integration is otherwise desirable but its

34. For an impressive airing of the issues, see ALI PROJECT, *supra* note 27, at 58-90.

35. PRELIMINARY TREASURY REPORT, *supra* note 26, at 64.

36. ALI PROJECT, *supra* note 27, at 60.

implementation is greatly complicated by the excessive use of tax preferences, Congress may be presented with the best opportunity yet to curtail sharply the array of preferential allowances and achieve a real simplification of the tax rules. Were that to be a result of integration, the byproduct would be more important than the change itself! On the other hand, if Congress still regards the wide use of preferences as more important than rationalizing the taxation of income from capital, perhaps the United States should not adopt integration. Preferences are more tolerable within the classical system. In all events, the consideration of integration necessarily renews the question of whether Congress and the Clinton Administration can muster the political will to reduce their reliance on tax preferences.

3. *Progression*

A progressive income tax rate structure has been a part of the tax since its inception in 1913 and would appear to be a permanent feature of the taxing system. Of course, the merits of progression have been widely debated, quite likely throughout the entire history of the income tax, and that debate most certainly continues to the present day. Because the winner of the debate cannot be objectively determined, and because the debate itself is entertaining, it will most likely continue for eternity.

As a matter of popular appeal, support for progression may be equivocal. Former President Ronald Reagan sold a tax package in which the effective tax rate on the Chief Executive Officer of General Motors was *reduced* to a level below the rate facing a high school teacher. However, when current President Bill Clinton desired an increase in tax revenues, he found it necessary to *increase* the rate of tax on the most wealthy more than the tax on middle income taxpayers. Equivocal or not, at least while the nation is struggling to control the federal budget deficit, any adjustment in income taxation that materially reduced the tax on the wealthy, relative to the tax burden on the less wealthy, would be widely regarded as unfair if not a violation of the electoral mandate. To that extent, at least, a popular mandate for progression exists.

Integration intersects progression at two points. Excluding corporate stock held by nontaxpayers, such as pension trusts, the distribution of stock holdings is progressive.³⁷ That is, as one's net worth increases, the proportion of taxable income attributable to corporate earnings increases. Accordingly, any reduction in the net tax imposed upon corporate earnings will reduce the progressivity of the taxing system. Relative to the rigorous double tax scheme adopted in 1986 and currently in place, therefore, any approach to integration will be regressive. That consequence of eliminating the double tax is simply unavoidable. As a result, integration conflicts with whatever

37. See John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process*, 8 VA. TAX REV. 57, 58-59 n.7 (1988), and authorities cited therein.

desire for progression, if not increased progression, currently exists.³⁸

All approaches to integration, however, do not have the same impact on progression. If the ultimate tax is determined at the shareholder level, as under the credit and deduction approaches, the taxation of corporate earnings will remain as progressive as is the taxation of other sources of income. However, under the dividend exclusion approach favored by the Treasury, under which a flat rate of tax is applied at the corporate level, corporate earnings would not be taxed as progressively as other income. For much the same reasons that the Treasury approach would undermine the horizontal equity of the taxing system, it would reduce the progressivity of the system.

Whether the impact of the dividend exclusion system on progression is material depends upon the present and future degree of progression in the taxing system. If, as was the case when the Treasury's preliminary study was released, the rate structure is essentially flat for upper-middle and upper income taxpayers, a uniform rate of tax on corporate earnings that approximated the rate applicable to the other income of upper bracket taxpayers would not in fact diminish the progressivity of the tax system. However, a flat tax on corporate earnings would be inconsistent with a rate structure that contained even a more modest degree of progression than prevailed prior to 1986. Under those circumstances, for example, an individual otherwise in the forty percent marginal bracket would be taxed at a rate of, say, twenty-eight percent on her share of corporate earnings while an individual in the fifteen percent bracket would be taxed at the same twenty-eight percent rate on his share of corporate earnings. Indeed, in its preliminary report, the Treasury noted that the dividend exclusion system might not be appropriate if greater progression were reintroduced.³⁹

The contemplated adoption of corporate tax integration thus renews the question of the extent of our national commitment to a materially progressive tax structure—for the present or for the future. The more committed we are to accomplishing a measure of income redistribution through the taxing system, the less appealing become approaches to integration that are more difficult to combine with a progressive structure.

4. *The Tax-Exempt Sector*

According to the Treasury, approximately thirty-seven percent of all corporate equities and forty-six percent of all corporate debt securities are owned by tax-exempt organizations, chiefly pension trusts.⁴⁰ Obviously, consideration of corporate tax integration cannot proceed far without resolving exactly how tax-exempt organizations should fit into the integration

38. To maintain or increase progression under integration would require the adoption of additional, unrelated changes to the taxing system. That fact may in part explain the Treasury's further proposal to dramatically increase the size of the personal exemptions.

39. PRELIMINARY TREASURY REPORT, *supra* note 26, at 12.

40. *Id.* at 67.

scheme. Unfortunately, that meshing of integration and our public policies towards tax-exempt organizations could well prove to be the most politically difficult of all issues that arise.

Under current law, neither pension trusts nor charitable organizations are generally subject to tax on the receipt of passive investment income, such as interest or dividends. Of course, the net corporate earnings allocable to stock owned by the tax exempt organizations will have borne its share of the corporate level income tax. As a result, it may be said that the "tax-exempts" are subject to a single level of tax on their share of corporate income. On the other hand, because interest paid to a tax-exempt creditor normally remains deductible by the corporate borrower, corporate earnings distributed as interest to tax-exempt organizations are not subject to taxation at any level.

The policies that support the adoption of integration only support the elimination of the double tax burden that normally attaches to the distribution of corporate earnings. Those policies most certainly do not support the elimination of all income taxation on corporation earnings and thus would not justify eliminating the single level of tax that is currently imposed upon corporate earnings distributed to pension trusts and other exempt organizations as dividends. In fact, to the extent that integration is justified by the desire to eliminate the disparate treatment of debt and equity, the policies that underlie integration would support increasing the tax burden imposed on the tax-exempt sector by imposing one level of tax on the distribution of corporate earnings in the form of interest.

On the other hand, if the second level of tax is eliminated on taxable investors but the existing pattern of taxing exempt investors is retained, the tax-exempt organizations will have lost their preferred position. Indeed, with respect to returns on equity investments, taxable and tax-exempt persons will be taxed identically; the income tax subsidy would have been entirely eliminated. Thus, the logic of integration directly conflicts with the long standing treatment of the tax-exempt sector.

Consideration of corporate tax integration, therefore, forces us to reconsider our policies towards that sector of the economy. That compulsion may be all to the good. A powerful case can be made for the proposition that the United States has dealt far too generously with tax-exempt organizations of all stripes and that those policies are long overdue for revision.

Under a system of integration that imposes the ultimate tax at the shareholder level, the treatment of the tax-exempt sector must be addressed directly. If the corporate tax is effectively forgiven, collecting any tax on corporate earnings distributed to tax-exempt organizations would require the explicit imposition of an income tax on those organizations.⁴¹ By

41. The taxation of the exempt organizations could be approached with some measure of indirection. The shareholder level tax almost certainly would be withheld by the payor corporation, producing a tax credit available to offset the shareholder level tax. That credit might not be refundable to the exempt organizations. In that event, however, nonrefundability rather than taxability would have to be specifically addressed by the enabling legislation.

contrast, under the dividend exclusion system, a single level of tax will automatically be collected at the corporate level under the normal operation of this method of integration and without the necessity of explicitly imposing a tax on the tax-exempts. Thus, under the system proposed by the Treasury, the simple failure to address the taxation of the tax-exempts produces the same result that the shareholder level tax system could achieve only after a political battle that not only might prove bloody but could well delay the adoption of integration.⁴²

Nevertheless, the question of the appropriate level of tax on pension trusts and other tax-exempt organizations on their investment income—whether under an integrated system or under current law—is better addressed by direction than by omission. The level of taxation of these organizations raises substantial and important social issues that deserve airing and explicit resolution. Moreover, the maintenance of a version of the status quo through the adoption of the dividend exclusion approach does not appear to result in an ideal or, presumably, permanent solution to the treatment of the tax-exempts. Under that approach, corporate earnings either distributed as dividends or retained by the corporation would remain subject to a single level of tax at the corporate level, while earnings distributed as interest would remain wholly exempt from tax at any level. That widely disparate treatment of debt and equity owned by the tax-exempt organizations would materially undermine one of the principle objectives of integration: the minimization of exactly that disparity. Furthermore, the relationship between the taxation of tax-exempt organizations and the taxation of taxable persons would be rendered irrational. The tax-exempts would be taxed at the same rate on distributed earnings, far more lightly—not at all—on distributions of interest, and somewhat more lightly on retained earnings.⁴³

If the question of the proper tax burden of the tax-exempt organizations were thoughtfully addressed, their exemption from taxation on investment income would be substantially curtailed, if not eliminated, regardless of the integration of the corporate tax. Under existing law, funds contributed to a qualified plan compound free of federal income taxation and thus accumulate at a far faster rate than would normally taxed retirement savings.⁴⁴ That subsidy has been thought necessary to encourage private industry to

42. The exempt organizations, of course, might strenuously resist being so “ignored.” However, the exclusion system places the tax exempts at a powerful tactical disadvantage. Because the integration system would not alter the existing pattern of taxing those organizations at either the corporate or shareholder levels, the tax-exempts would be forced into the position of requesting a favorable change in what would be perceived to be an already favorable pattern of taxation. Undoubtedly, one of the reasons that the Treasury prefers this exclusion approach is that it places the exempt organizations in the weakest possible position to sustain their preferential position.

43. The exempt organizations presumably would not be taxed on gains from the sale of stock while taxable persons would be taxed, perhaps at a preferential rate, on any gains remaining after basis adjustments for undistributed earnings.

44. For a fuller explanation, see Daniel I. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506 (1986).

contribute in a material way to the retirement savings of their employees. However, the wisdom of that income tax subsidy has been seriously questioned.⁴⁵ The quite substantial revenue loss that results from the permanent exemption from tax of the income of a broad range of statutory retirement plans disproportionately benefits the relatively high income taxpayers. It seems probable that many, if not most, of the most benefitted taxpayers would provide adequately for their retirement even in the complete absence of the income tax subsidy. Similarly, many of the same large employers that now contribute most of the funds to qualified plans could be expected to establish retirement plans for their employees in the absence of the tax subsidy in order to obtain the non-tax benefits, such as employee loyalty and longevity, that retirement plans are thought to provide. Indeed, if freed of the definitional and compliance burdens that Congress has deemed appropriate complements to the tax subsidy, it is not inconceivable that more employers would establish retirement plans than have under the existing regime.

It might, in short, be argued that the revenue loss occasioned by the subsidy for retirement plans is not well spent. Indeed, a case can be made for the conclusion that social welfare would be enhanced if the revenue currently dedicated to the subsidization of middle income retirement planning were redirected to the low income elderly. To that end, the argument follows, pension trusts ought to become subject to income taxation on their investment income.⁴⁶ If so, the apparent conflict between integration and the treatment of the tax-exempts is readily solved: both the logic of integration and a sound national retirement policy would dictate the taxation of the investment income of pension trusts. At the very least, it seems plain that our existing policies towards retirement savings are deserving of meaningful review—regardless of whether integration is adopted. Encouraging that review would be a useful byproduct of the debate over integration.

Just as integration conflicts with the tax exemption of the pension trusts, it conflicts with the similar exemption granted charitable organizations and requires the re-examination of that preference. Under current law, donors are entitled to income tax deductions for amounts donated to charitable organizations and little attention is paid to the use to which the

45. See, e.g., Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851 (1987); Alicia H. Munnell, *Are Pensions Worth the Cost?*, 44 NAT'L TAX J. 393 (1991). But see Edward A. Zelinsky, *Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988).

46. If the complete elimination of the income tax subsidy for retirement plans would result in an unacceptably large reduction in the level of retirement savings, it does not follow that the existing levels of subsidy are thereby justified. Even if some tax subsidy is required to obtain the desired level of retirement savings, at some point, the social benefit from increased retirement savings will be outweighed by the social cost of the tax subsidy. The identification of that point requires information of the causal connection between subsidy and savings, which we do not have, and the political judgment that the savings are worth the subsidy, which we have not made. Certainly there is no basis for concluding that existing levels of subsidy are optimal.

gift is put. In particular, that the proceeds of the gift will be invested in the stock market is not thought to be inconsistent with the donor's charitable contribution deduction—although the charitable nature of that use of funds is hardly self-evident. Moreover, the charity will not be subject to income taxation on either the receipt of the gift or the receipt of income attributable to the investment of the gift. While those rules are as old as the tax laws themselves, they are not compelled by any logical imperative of the general exemption from tax extended to charitable organizations.⁴⁷ Rather, the exemption merely reflects our collective policy judgment concerning the degree and nature of the subsidy we wish to extend to the charities. By exempting investment income from tax, the subsidization of charities is focused upon the older, larger and richer charities that have accumulated an endowment to invest and away from the newer, smaller and poorer charities that spend all of their receipts on the charitable purposes. Indeed, the exemption of investment returns from tax may encourage charities to retain and invest contributions and discourage the pursuit of more charitable objectives.

On a careful reconsideration, Congress might conclude that the industry comprising the tax-exempt sector would be better served by the imposition of tax on investment income than by the current exemption. In all events, like the broad exemption from tax currently enjoyed by the pension trusts, the scope of the charitable exemption is deserving of the reconsideration that must accompany any appraisal of integration.

5. *Taxing Cross-Border Trade*

The international tax rules of the United States serve two important functions: to assist in the world-wide allocation of the available income tax base and to influence the allocation of world trade. Those rules, however, are out of date in many respects.⁴⁸ Of present concern, those rules were fashioned when corporations were uniformly subject to double taxation. The relative abundance of revenue source produced by the existence of two separate tax bases under the classical system greatly facilitated the allocation of the overall corporate tax base among the various jurisdictions that asserted a claim to tax revenue. The adoption of an integrated system, with its single level of tax, would seem to invite, if not require, the fundamental reconsideration of how that remaining available corporate tax base should

47. See Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976); Thomas J. Gallagher, III, *The Taxation of Investments by Pension Funds and Other Tax-Exempt Entities*, 67 TAXES 981, 989 (1989).

48. See Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, TAX NOTES, Mar. 15, 1993, at 1511 (arguing current U.S. international tax rules reflect now defunct notion of complete U.S. dominance of international trade and calling for update of these tax rules).

be allocated among nations.⁴⁹ Although most of the other principal trading nations of the world have turned to integration, little international progress has been made towards such a realignment of the rules governing the allocation of the corporate tax base.⁵⁰ Were the United States to adopt integration, however, it seems unlikely that the obsolescence of the existing framework could continue to be ignored.

Under established international practice, the two tax bases available under the classical system are allocated among the three or more jurisdictions that have a legitimate claim to tax the economic activity of the corporation under widely accepted principles. Consider income generated by economic activity in Country *A* undertaken by a corporation resident in Country *R*, some of the stock of which is owned by an individual resident in Country *I*. The corporate level tax base is shared by Countries *A* and *R* but the source jurisdiction of Country *A* is permitted to trump the residence jurisdiction of Country *R*. Even though Country *R*, like the United States, might nominally tax the worldwide income of its corporations, because this income is sourced in Country *A*, Country *R* would cede primary taxing jurisdiction over the activity to Country *A*.⁵¹ The net result is that Country *A*, which has the stronger claim to tax the activity, obtains the first slice of tax revenue from the activity, but Country *R* may impose an additional layer of tax in the exercise of its residual residence-based jurisdiction.

The shareholder level tax base is shared by Countries *R* and *I* on the basis of a different compromise. Country *R* typically will extract the smaller portion of the total tax on this second tax base while residence country *I* obtains the balance. Country *R*'s concession of the major portion of the second level tax to residence Country *I* is based in part on the assumption that Country *R* imposed the first level tax. That concession is not altered merely because Country *R* in fact conceded the first level tax to Country *A*.

Under this approach to the allocation, Countries *A* and *I* are treated as having the strongest claims to the available tax base and collect most of the tax revenue. Country *R* may derive little or none of the tax revenue from this economic activity. Somewhat oddly, however, the taxing system whose rules are most central to this allocation is that of Country *R*, the taxpayer's residence.

In moving from the classical system to an integrated system of taxing corporate profits, a number of difficult questions of international tax policy

49. See David R. Tillinghast, *Corporate-Shareholder Integration as an Obstacle to the International Flow of Equity Capital: A Proposal*, TAX NOTES, Aug. 31, 1992, at 1215 (proposing very different solution).

50. See ALI PROJECT, *supra* note 27, at 186-88.

51. That concession can take different forms. If Country *R* were the United States, that concession would be accomplished by, first, imposing a tax on the income from the activity but, second, through the foreign tax credit mechanism allow the tax paid to Country *A* to be applied in reduction of the tax liability to Country *R*. I.R.C. §§ 11, 901-904 (1988).

are presented.⁵² Primary, of course, is the question of the ultimate burden of tax to be imposed upon multinational business in an otherwise integrated world. Simply because only a single level of tax would be collected if Countries *A*, *R* and *I* were all the same country does not mean that only a single level of tax will be imposed if three different countries are involved in the activity. One of the historical reasons for replacing the classical system with an integrated system has been said to have been the desire to shift the burden of the corporate tax to nonresidents by limiting the full benefit of integration to residents.⁵³ While that approach may not result in an optimum level and allocation of international trade, protectionist concerns have always played an important role in the realities of international taxation. Accordingly, nations may determine to retain some measure of double taxation on cross-border investment in an otherwise integrated world.

Second, assuming some reduction in the two levels of taxation of international trade under integration, how the attenuated income tax base is to be shared among the several jurisdictions laying claim to the tax revenue must be resolved. While the ultimate answer to that question may not yet be at hand, many would argue that all nations of the world, on balance, would be best served by taxing international trade at the same rate as domestic trade. In an integrated world, that measure of capital export neutrality would require that only a single level of tax be imposed on the corporate tax base. If the pattern of taxation produced by integration is to prevail, it would seem essential that the initial source country, Country *A* in our illustration, cede some of its primary taxing jurisdiction to other downstream jurisdictions. At the very least, it seems evident that such a single level of tax cannot be equitably shared by Countries *A*, *R* and *I* unless Country *A* cedes taxing jurisdiction to Countries *R* and *I*—much like under the classical system, Country *R* cedes jurisdiction to Country *I*.

Different approaches to integration are more adaptable than others to this sort of realignment of the corporate tax base. Country *I*, the residence of the owner of the capital invested in the enterprise, for example, will not share in the tax revenue if it does not impose a tax at the shareholder level, presumably on the receipt of dividends. In this respect, the somewhat more complex imputation credit system might prove to be the most flexible because, under that approach, a tax is directly imposed on the final distributee of the corporate earnings, permitting a credit for all prior impositions of tax.

In all events, the adoption of an integrated approach to corporate taxation by the United States and the countries of the European Community will not be complete until corporations engaged in trade among those

52. The resolution of those questions, in turn, is complicated by the fact that the resolution must be satisfactory to the United States when it is in the role of Country *A* or Country *R* or Country *I* or any combination of those capacities. Moreover, any combination of Countries *A*, *R* and *I* may employ an integrated or a classical corporate tax system.-

53. See Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1194 (1981).

countries are subject to a fully integrated regime. That, in turn, will require the evolution of new international norms governing the allocation of the world-wide corporate tax base among nations. Unless the trading nations of the world can agree upon a new system for making that allocation, international trade will remain burdened by a heavier income tax burden than domestic trade and that may not further our national interests.

D. CONCLUSION

To describe the future of corporate taxation as exciting would surely risk the admonition to "get a life." Nevertheless, the coming decade promises to be very interesting—if not downright exciting. Just as other elements of our economy have responded to international pressures and opportunities, the evolution of our taxing system will not be able to ignore the nature of the taxing systems of our trading partners. Under that competitive pressure, the United States will almost certainly move toward the adoption of some form of corporate tax integration in the not very distant future. That movement, in turn, will require a fresh reconsideration of a wide range of policy choices that have become embedded in our taxing system over its three-quarters of a century of existence. Some long-standing choices will be reaffirmed but others will be abandoned. The system as a whole will emerge greatly improved. That is excitement enough.