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# INTEGRATION IN AN INTEGRATING WORLD

YARIV BRAUNER\*

## INTRODUCTION

During the second half of the last century, many countries gradually replaced their so-called classical corporate tax regimes, under which corporate earnings were taxed twice – once in the hands of the corporation, and again when distributed to corporate shareholders as dividends – with an integrated regime (imputation), which taxed such earnings only once.<sup>1</sup> The driving force behind this trend was the expectation of significant efficiency gains. This clear and gradual trend has been abruptly reversed with the turn of the century. The phenomenon we call globalization, and in particular the proliferation of cross-border business and investment, has materially contributed to this dramatic sea change in the corporate tax world. The conventional wisdom was that imputation is unsustainable in a world whose markets integrate. This article argues that the abandonment of imputation is partly a consequence of our essentially non-cooperative world in terms of tax policy coordination. It concludes that imputation does not have to be the victim of globalization – it can be retained to the benefit of many countries, but only through enhanced international cooperation and coordination of tax policies.

The goal of integration is to alleviate the over (“double”) taxation of corporate profits, consequently reducing the effective tax rates on returns on investments through corporations.<sup>2</sup> Perhaps the most popular method used for this pur-

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\* Associate Professor of Law, Arizona State University College School of Law. I thank Reuven Avi-Yonah, Adam Chodorow, Zohar Goshen, Jennifer MacDonald, John Steines and the participants of tax policy workshops at the Universities of Michigan and Tel Aviv Law Schools for their useful comments, assistance and support – All mistakes and inaccuracies are mine.

1. Any method that results in less than full double taxation could be considered an integration method, however, this article focuses on imputation, both as a proxy for full integration (one level of tax) and because it was the most dominant method of integration throughout the last century.

2. This could be achieved in various ways, with some different achievements, advantages and disadvantages in practice. This article focuses on the method that was considered the most accurate and popular of all integration

pose was the imputation method, which extended credits to shareholders for the corporate income tax paid by a distributing corporation “on their behalf.”<sup>3</sup> The expectation of significant efficiency gains from its adoption was comfortably supported by economic theory.<sup>4</sup> However, in less than five years, most of the countries that had adopted integration have reintroduced a second level of taxation on corporate profits.<sup>5</sup>

This *volte face* does not reflect a rejection of the underlying economic principles supporting integration, but rather reflects a market change. In particular, increased international trade has created pressure to eliminate cross-border discrimination by extending, *inter alia*, the benefits of integration to foreigners and foreign investments.<sup>6</sup> The imputation method, which was popular in a domestic context, could not be sustained as a purely domestic measure in a global economy, and countries were not willing to extend its benefits across-borders.<sup>7</sup> This pressure was primarily significant in the European Union (hereinafter “E.U.”), whose institutions support harmonization (not only non-discrimination based reciprocity) of

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methods – full imputation, as elaborated below. See MICHAEL J. GRAETZ & ALVIN C. WARREN, JR., INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS (1998) (an extensive review and analysis of the various integration methods).

3. For example, with respect to their shareholding in the corporation and the distributions made to them out of corporate profits.

4. CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979); Deborah H. Schenk, *Foreword: Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992); Graetz & Warren, *supra* note 2. Note that most of the analysis was conducted assuming relatively closed markets, which was appropriate at the time. See, e.g., Robin W. Boadway, The Economic Rationale for Integration, Address Before the Corporate Tax Management Conference (1998), in BUSINESS TAX REFORM 21:1-26 (analyzing the international aspects of integration in the context of a Canadian tax reform evaluation).

5. See *infra* Part II.C.

6. See Richard Vann, *Trends in Company/Shareholder Taxation: Single or Double Taxation*, 88a CAHIERS DE DROIT FISCAL INTERNATIONAL 21, 24 (2003); Reuven Avi-Yonah, *Back to the 1930s? The Shaky Case for Exempting Dividends*, 97 TAX NOTES 1599 (2002).

7. This unwillingness arose from the conventions of the international tax regime, which were premised on the classical system, and therefore did not require such an extension, and from the understanding of some integration countries that unilateral extension of such benefits would amount to a transfer to the treaty partner’s fisc rather than the investors. See examples *infra* Part II.B.

member states' tax systems<sup>8</sup> – a difficult task with the present (allegedly discriminatory) integration rules in place.<sup>9</sup>

Most imputation countries<sup>10</sup> chose therefore to replace imputation with a hybrid system – a system which taxes dividends separately and without reference to the corporate tax paid on corporate profits (similar to a classical system),<sup>11</sup> yet at a reduced rate (below the normal individual tax rate).<sup>12</sup> This

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8. See, e.g., Joe Kirwin, *Marks & Spencer Case Demonstrates Need for Common Tax Base in EU*, Official Says, BNA's INT'L TAX MONITOR (Feb. 3, 2005) (citing, on the condition of anonymity, an E.U. commission official supporting tax base harmonization, and evaluating whether it would be better to get there directly, through member states' negotiation or with the pressure of an ECJ decision to that effect).

9. See, e.g., Uwe Illhi et al., *Trends in Company/Shareholder Taxation: Single or Double Taxation*, 88a CAHIERS DE DROIT FISCAL INTERNATIONAL 71, 73 (2003).

10. See *infra* Part II.C.

11. This separate taxation of corporate earnings and corporate distributions is at the core of the classical system, which simply treats corporations as "legal persons" separate from their shareholders for tax purposes. It accepts this (corporate law) fiction, probably with the view that one of the obligations of a corporation as such is to pay taxes like any other (flesh and blood) person. I find this acceptance quite odd, and I could not find any serious discussion in support of such acceptance. It is, however, a widely-accepted feature of tax law throughout the world, and its analysis and potential criticism are beyond the scope of this article. It is a worthwhile future project. The formalistic justification was supplemented with various, more sophisticated justifications, which are, in fact, attempts to justify the corporate tax itself as having a stand-alone justification, such as the capture of government benefits that only corporations enjoy (See, e.g., Herwig Schlunk, *I Come Not To Praise the Corporate Income Tax, But To Save It*, 56 TAX L. REV. 329 (2003)), of certain corporate specific rents, and of corporate governance controls (Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004)). None of these, in my opinion, justifies the corporate tax that countries actually employ, and surely cannot justify the high rates of the separate corporate tax. Therefore, they cannot justify the classical system.

12. At first glance the United States fits into this picture quite oddly. Its corporate tax policy experienced a relevant sea change as well, but in the opposite direction. For the first time, despite a notorious and long lasting resistance to depart from the classical system, it effectively did just that in 2001. Prior to 1938, the U.S. tax system was not primarily classical, and included various levels and forms of integration. For the best and most concise review of these developments see John K. McNulty, *A Brief Look at the Early History of the Unintegrated Corporate and Individual Income Taxes in the USA*, in INTERNATIONAL AND COMPARATIVE TAXATION – ESSAYS IN HONOUR OF KLAUS VOGEL 163 (Kees van Raad ed., 2002). Like any other operating classi-

“reduced rate” system survives the scrutiny of nondiscrimination and preserves “some” integration, thereby creating a reduced overall tax burden on corporate profits.<sup>13</sup> The acceptance of the hybrid system proves that integration as a concept was not rejected, but rather the particular use of imputation for achieving integration was considered unsustainable.

The advent of this rough-justice integration method was explained primarily by the aforementioned nondiscrimination pressures, particularly in the E.U. context. This article offers an additional, complementary explanation to this conventional wisdom, namely that integration, and particularly imputation, is indeed not sustainable in a globalizing world economy only so long as countries do not sufficiently cooperate in coordination of their tax policies. It argues further that the benefits of integration may be preserved through enhanced international cooperation and coordination of tax policies. Such an effort should, however, be made within the existing international tax regime,<sup>14</sup> which has evolved with globalization, but has always been largely premised on the classical sys-

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cal system, the U.S. System had various optional or partial regimes that resulted in at least partial integration for some income or some taxpayers. *See, e.g., id.* at 174-75. Additionally, various so-called self-help integration evolved, most notably since the enactment of the “check-the-box” regime. This is a very significant turn in U.S. tax policy but, as demonstrated below, it is not inconsistent with the global trend described above, and – it adopted a similar policy measure – a reduced dividend rate system. The U.S. policy change is noteworthy also because integration has been on the U.S. International tax policy agenda for almost half a century now but, despite a strong consensus among experts and sometimes expectedly potent political support, the classical system remained a cornerstone of the U.S. federal income tax. The resilience of the classical system was explained primarily by political and political economy reasons. *See* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 *YALE L.J.* 325 (1995). In addition, the inherent conservatism among tax experts and legislators often lead to additional difficulties in any attempt to reform tax laws. This is especially true when the practice in question is as deep-rooted in practice as the classical system. The new U.S. rules were relatively easy to adopt, *inter alia*, because their “halfway” system may be perceived as very similar to the classical system; it still taxes corporate distributions without any reference to the corporate (earnings) tax, albeit at a different rate.

13. *See, e.g., infra* Table II(A).

14. The international tax regime is embodied primarily in bilateral tax treaties following the Organization for Economic Cooperation and Development (hereinafter “OECD”) model.

tem.<sup>15</sup> Despite the prominence of imputation systems in the second half of the twentieth century, the international tax regime remained undeveloped and one-dimensional as far as corporate taxation was concerned.

The choice of reduced dividends tax rate reflects a belief that it was less difficult to coordinate tax policies this way, particularly because no reference between the corporate tax and the tax on corporate distributions, which may be imposed in different countries, was required. It also demonstrates a pre-occupation of policy makers with the classical system as a logical "baseline," or default system despite the fact that it is really just one pole of many reasonable policy options. These explanations for the hybrid system are not satisfactory, especially as the effect of the interplay between different countries' tax policies on each other's policy choices is becoming increasingly powerful. It would be desirable hence to rethink the disposition of the international tax regime with the classical system anyway – preferably adjusting it to accommodate imputation and the capture of its efficiency benefits.

The article first identifies and elaborates on this contemporary trend of conceding integration.<sup>16</sup> Part II discusses the recent moves away from integration in some major economies, and analyzes the reasons for such moves. It tracks them to the international dimension of integration which has never been comprehensively explored even in the golden era of imputation, a neglect which came back to haunt these economies at the turn of the century.<sup>17</sup>

Part III analyzes the international aspects of integration and its affect on tax policies to date. It sets forth the argument that current tax policies arise from the non-cooperative funda-

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15. Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565 (1992).

16. See Vann, *supra* note 6, at 23 (the first significant statement of this trend has probably been Professor Richard Vann's general report at the Congress of the International Fiscal Association on the subject).

17. The international aspects of taxation were neglected in the bulk of the analysis of integration, which concentrated primarily on domestic aspects. See *id.* at 24. The few authors who explored the international aspects of integration include: Richard M. Bird, *International Aspects of Integration*, 28 NAT'L TAX J. 302 (1975); Richard Vann, *International Implications of Imputation*, 2 AUSTL. TAX F. 451 (1985); Ault, *supra* note 15; Douglas R. Fletcher, *The International Argument for Corporate Tax Integration*, 11 AM. J. TAX POL'Y 155 (1994).

mental features of the current international tax regime. As retaliation and undesirable spillovers became more significant and material, it was not sufficient that integration was considered the most desirable policy from a domestic perspective, since the potential revenue flight that resulted from integration made it an undesirable policy overall.

Part IV concludes with a suggestion that enhanced international cooperation and coordination of tax policies may allow countries to pursue integration while minimizing the problems of revenue flight risk or retaliation that plagued the imputation systems. Such cooperation could enable countries to capture many of the efficiency gains associated with the lower effective tax rates under integration regimes.<sup>18</sup>

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18. This exposure is an interesting, but not unique example of a fundamental tension in international tax policy that globalization brought to the center stage, namely the revenue flight tension; the other is the multinational enterprise (hereinafter "MNE") tension. I elaborated on these tensions elsewhere. Yariv Brauner, *Taxing Cross-Border Mergers & Acquisitions*, 2004 FLA. TAX REV. 953 (2004). The revenue flight dilemma arises from the non-cooperative features of the international tax world. Professor Avi-Yonah has compared this problem, in the context of withholding tax on interest, to a "stag hunt" game, where all the participants avoid initiating cooperative action through unilateral measures to the detriment of them all. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1583 (2000). A country may wish to promote certain policies, but it is not completely free to do so since other countries may respond in a way that will either circumvent such policies or result in a revenue flight from that country. Countries try therefore to optimize their policies and adopt "coherent" tax rules that ameliorate the risks of retaliation and circumscription, including some limited coordination efforts, mainly through BIT. The MNE tension arises from the fiction of the corporation as a separate legal personality and our inability to identify the incidences of the corporate income tax. In the economic reality MNEs perform as single firms, doing business (worldwide) in the global market. The legal reality ignores this economic reality and attributes "separateness" to the (economically) inseparable parts of this firm, and only to these parts that the firm itself elected to present as separable. Very little legal scholarship has been written about this tension. In a recent working paper, Professor Avi-Yonah lays a conceptual model for analyzing the application of national laws to MNEs. He does not, however, focus on tax in the version available at the time this article is written. See Reuven S. Avi-Yonah, *National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization* (U. Mich. Public Law and Legal Theory Research Paper No. 00-01, 2002), available at [http://papers.ssrn.com/sol3/delivery.cfm/SSRN\\_ID323224\\_code020812630.pdf?abstractid=323224](http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID323224_code020812630.pdf?abstractid=323224). Tax law, in particular, is primarily domestic, and severely suffers from this tension. I find it useful to ex-

## II.

## THE RISE AND FALL OF INTEGRATION

A. *Integration in Theory*

A considerable amount of economic and legal writing has explored the advantages and disadvantages of integration in its various forms.<sup>19</sup> The focus of this literature has been unequivocally on the efficiency benefits of integration, arguing that integration relieves some major distortions that arise from the fiction that corporations are separate legal “persons” and the extension of this fiction to tax law through a separate corporate income tax. Without integration, i.e., under a “classical” system, the corporate tax imposes a “double tax” (which is a popular name for the economic distortion created by the separate taxation of corporate earnings and corporate distributions; “double tax” because such a tax system over-taxes such investments in comparison to equivalent investments through non-incorporated entities, such as partnerships and sole-proprietorships) on income from investments through corporations. This distortion creates a bias against the use of the corporate form and a disincentive to invest in new corporate equity.<sup>20</sup> The bias is not one dimensional, however, since it depends on the tax rates involved and other rules that may affect one’s choice of business form, such as the exclusive permission for corporations to not distribute their profits annu-

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plain the effects of globalization on international taxation with these two fundamental tensions. In the case of integration, the tension is between the intention to adopt the most desirable policy domestically (integration) and the reluctance to do so due to an increased risk of revenue flight, to which it exposes the adopting country. Vann, *supra* note 6, at 24. The MNE tension is more complex. The redeployment of cash and property within the enterprise may be desirable on efficiency grounds, and dividends are the most straightforward way to do that. Nonetheless, the home country of the enterprise and the country in which the cash or property arose (the “source” country in the international tax lingo) divide the rights to tax any income related to these cash and property on bases other than efficiency. The international convention in this regard follows the “separateness” fiction, totally ignoring the existence of MNEs.

19. And, therefore, it is not for this article to comprehensively review it. Most of the conclusions of this literature, however, are mentioned in this article where it is appropriate to make its point. Good reviews of the economic and legal literature regarding integration include: GRAETZ & WARREN, *supra* note 2; Vann, *supra* note 6.

20. See MCLURE, *supra* note 4.



ally, namely deferral, which encompasses timing benefits. Deferral and the additional layer of corporate income tax, together with other, less significant rules, distort the choice of business form in opposite directions and deliver a schizophrenic "tax message" to the relevant decision makers.<sup>21</sup> The other side of this message is that taxpayers turn it into an opportunity and exploit these opposing rules for their own tax planning purposes.

Another major distortion of the classical system resulting from the same mixed signals is that it encourages inefficient retention of profits by the corporation.<sup>22</sup> This distortion of the choice between retention and distribution of corporate earnings has been particularly popular in the debate, used by integration proponents as an argument in the context of economic stimulation and growth.

Selective deferral and the additional layer of corporate tax do not begin to describe the schizophrenia of present corporate tax systems. For instance, dividend distributions are typically not deductible for the distributing corporation, whereas interest is. This fact makes dividends even less popular. This differential treatment distorts the financing decisions of corporations, encouraging them to retain earnings or raise capital in debt rather than equity form, which may result in over-leveraging of corporations, increased borrowing costs, and the potential risk of excessive collapses and bankruptcies.<sup>23</sup>

The effect of these distortions was considered to be material. The U.S. Treasury Report of 1992 estimated that moving to integration would result in welfare gains of approximately

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21. In reality, the system may be even more complex, as iterated by Graetz with respect to the U.S. classical system in which "corporate income is sometimes taxed twice in the U.S., sometimes once, and sometimes not at all." GRAETZ & WARREN, *supra* note 2, at 53.

22. See MCLURE, *supra* note 4. The incentives in this regard depend also on the relative tax rates on corporations, shareholders and capital gains. If the latter are low, as they have traditionally been in the U.S., and corporate tax rates are also low relatively to the individual tax rates, a strong incentive to retain earnings is created.

23. *Id.* Other tax-advantaged forms of corporate distributions may also be preferred to dividends in a classical system. The classic example for this distortion in the U.S. has been the preference of stock repurchases resulting in lower-taxed capital gains rather than ordinary income (dividends).

\$2.5 billion to \$25 billion per year in 1992 dollars.<sup>24</sup> A word of caution is due, however, since these estimates are very difficult to make and are highly sensitive to the modeling methods, the methods of integration to which the classical system is compared, and their specific details.<sup>25</sup> Moreover, the “new” view of dividends in the finance literature cast doubt over these results, since according to this view (at least most of) the corporate income tax is capitalized into share prices by the capital markets, and therefore, the efficiency gains mentioned above should be significantly lower.<sup>26</sup> Additionally, the classical system alone is not responsible for these distortions.

Although fewer discussions were devoted to the effect of the corporate tax system on corporate governance, a few scholars commented on the potential benefits of integration in that context. The most obvious benefit is that integration removes the tax incentive (or excuse) for retention, resulting in a likely increase in management discipline.<sup>27</sup> Professors Arlen and Weiss argued that the resilience of the classical system can only be fully explained by the different objectives of managers and shareholders – the former pursuing primarily new investments and use for the retained earnings trapped in the corporation as a result of the double taxation of corporate profits rules, and the latter also pursuing higher returns on old investment, which are not fulfilled due to the above tax trap.<sup>28</sup> Integration should remove this trap and consequently align the interests of managers and shareholders. Professor Zohar Goshen noted that integration would eliminate the tax distortion of dividend policy (essentially the bias resulting from the deferral opportunity and the effective preferential taxation of capital gains),

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24. GRAETZ & WARREN, *supra* note 2. *But see* Reed H. Shuldiner, *Commentary, Corporate Integration: Do the Uncertainties Outweigh the Benefits?* 47 *TAX L. REV.* 653 (doubting the magnitude of these efficiency gains).

25. But, the treasury report mentions that “one striking feature of the calculations is that within each model, and for a given financing assumption, structurally different [integration] prototypes often have similar overall effects on economic well-being.” GRAETZ & WARREN, *supra* note 2.

26. *See, e.g.*, Auerbach *infra* note 133.

27. An interesting recent perspective of this behavior pattern is given by Mihir A. Desai et al., *Dividend Policy Inside the Firm* (EFA 2002 Berlin Meetings Presented Paper, Working Paper, March 2003), available at <http://ssrn.com/abstract=317040> (exploring dividend policies of foreign affiliates to multinational parents – hence “inside the firm”).

28. Arlen & Weiss, *supra* note 12, at 327.

ensuing in reduction of agency costs through the shift of control over dividend policy to the capital markets.<sup>29</sup>

Despite the focus of the literature on efficiency, integration may have other important consequences. Although not inevitable, most switches to integration resulted in revenue losses, as predicted. The distributional aspects of the switch to integration were also cast in doubt. Distributional consequences of integration are difficult to determine, particularly because a comparison must be made with the distributional consequences of the classical system, which themselves are controversial. A Treasury integration report found only slight distributional effects in the switch to integration.<sup>30</sup> For the purposes of this article, I take these results at face value since the question of distribution should be addressed locally, considering traditions and social policies that differ from one country to another. These effects should not affect the principal question of whether to adopt integration, but rather the actual method and level of integration chosen.

Finally, some countries had additional reasons to adopt integration, as elaborated on later in this section.<sup>31</sup> In general, it is fair to say that some imputation systems partially succeeded in achieving their goals.<sup>32</sup> This less than hoped for success was often attributed to unrelated, contradictory government policies, which negated the effects of integration.<sup>33</sup> As explored below, countries were not typically discouraged by integration in general, but instead replaced imputation with a reduced-rate system, and some major countries preserved imputation despite the global trend away from it.

### B. *Integration in Numbers – Current Rules*

Some benefits of integration are easy to identify in the following simplified numeric example. In Table I, two prototypical integration methods – imputation and dividend ex-

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29. Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 915 (1995).

30. GRAETZ & WARREN, *supra* note 2, at 19.

31. *See infra* Part II.C.

32. For a recent study see Andrew Prevost, Ramesh P. Rao & John D. Wagster, *Dividend Imputation and Shareholder Wealth: The Case of New Zealand*, 29 J. BUS. FIN. & ACC. 1079 (2002).

33. *See infra* Part II.C.

emption<sup>34</sup> – are compared to each other and to the baseline classical system, using tax rates roughly equivalent to the current relevant U.S. Tax rates:<sup>35</sup>

TABLE 1

	Classical	Imputation	Div. Exemption
<u>Corporation level tax</u>			
Corporate income	100	100	100
Corporate tax (35%)	35	35	35
Corporate income after tax	65	65	65
<u>Shareholder level tax</u>			
Dividend distribution	65	65	65
Gross-up for corporate tax paid	—	35	—
Individual income	65	100	0
40% Individual tax	26	40	—
Imputation credit	—	35	—
Net shareholder tax	26	5	0
Total tax:	61	40	35
Shareholder income after tax	39	60	65

It is clear from this example that there is no difference between these methods at the corporate level.<sup>36</sup> It is also clear that the overall tax burden that the classical system imposes on investment through corporations, as long as earnings are not retained, is significantly higher than the burden imposed by the other methods, or the burden on investment in non-incorporated entities, which should be similar to that of the imputation system. Most corporations, however, take advantage of deferral opportunities (not available to non-incorporated entities), so the difference in burden may be, in reality, much smaller, or even reversed.<sup>37</sup> This fact, however, does not make the comparison useless because deferral also potentially repre-

34. These are also the methods recommended in the two major U.S. integration proposals prepared in the early 1990's. GRAETZ & WARREN, *supra* note 2.

35. Note that these rates are not far from the normal level in most important economies, as will be further emphasized below.

36. In the past, another method, usually called the split-rate method was in use, notably in Germany, with respect to which that would not be true. See *infra* Part II.C.1.

37. It depends on the relevant corporate and individual tax rates and the duration of deferral.

sents the distortion of the choice between retention and distribution of earnings; it does make the differences in the nominal tax burdens less significant than the raw numbers above. Finally, the difference between imputation and dividend exemption simply represents the difference between the corporate tax rate and the shareholder tax rate used in the example.<sup>38</sup> The core difference between these methods is that imputation ensures taxation at the individual tax rate and dividend exclusion ensures taxation at the corporate tax rate.

In most countries, (domestic) dividend income in the hands of foreigners, as well as income from investments of (domestic) residents in foreign enterprises, faced the classical system even in countries where integration was used domestically.<sup>39</sup> Table II(A) illustrates the tax consequences of investment in a corporation organized and operating in a classical system country:

A classical source country collects, therefore, its full corporate tax and acceptable<sup>40</sup> withholding tax regardless of the method of taxation used in the residence country. Moreover, all investment in domestic corporations, including domestic investment, faces the same tax. All shareholders face at least 44.75% tax, and imputation country investors even face the 61% tax, equivalent to classical system countries' investors. Note that a new method is introduced in this table – the reduced tax rate on dividends, which is a relaxed version of the dividend exclusion method, and whose consequences in the table above are identical to a dividend exclusion method, excluded here for brevity. In policy terms, the classical country ensures, under current policy, capital export neutrality (here-

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38. If, for instance, we used an individual tax rate equal to the corporate tax rate, which is a standard policy advice – to make the top marginal rate equal to the corporate tax rate in order to ameliorate incentives to do business or invest through a corporate or a non-incorporated form – there would really be no difference between the consequences of these two methods.

39. See Seppo Kari & Juoko Yla-Liedenpohja, *Classical Corporation Tax as a Global Means of Tax Harmonization* 1-2 (Ctr. for Econ. Studies & Ifo Inst. for Econ. Research, Working Paper No. 665, 2002), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=301501](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=301501).

40. The normal treaty rate for portfolio investment is 15%. See Organisation for Economic Cooperation and Development, *Articles from the Model Convention with Respect to Taxes on Income and on Capital*, art. 10, Jan. 28, 2003, <http://www.oecd.org/dataoecd/52/34/1914467.pdf>.

TABLE II(A)

Investor country	Classical	Imputation		Reduced rate (15% on dividends)
		Foreign investment	Domestic investment	
<u>Source country (classical)</u>				
Corporate income	100	100	100	100
35% corporate tax	35	35	35	35
After-tax corporate income	65	65	65	65
Withholding tax if distributed (15%)	9.75	9.75	—	9.75
<u>Residence country</u>				
Dividend (grossed up)	65	65	100	65
40% Individual tax	26	26	40	65*15%=9.75
Imputation credit	—	—	35	—
Foreign tax credit	9.75	9.75	—	9.75
Residual residence country tax	16.25	16.25	5	0
<u>Result</u>				
Total tax	61	61	40	44.75
Shareholder income after tax	39	39	60	55.25
<u>Revenue split</u>				
Source country	44.75	44.75	—	44.75
Residence country	16.25	16.25	40	0

inafter “CIN”)<sup>41</sup> – completely with respect to imputation countries and at least minimally as far as dividend tax relaxation methods are concerned.<sup>42</sup>

Table II(A) presents a portfolio investment scenario. The consequences are conceptually identical, however, with respect to direct investment (investment in a residence, rather than a source country corporation doing business in the source country). In that case, the residence country tentatively taxes the same corporate income, yet provides relief – typically

41. The goal of CIN is to eliminate tax wedges between domestic and foreign investments domestically. See, e.g., Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 270-71 (2000).

42. I call it minimal CIN because it can only ensure CIN regarding the investment in the domestic corporation. There will most probably be differences in effective tax rates on the investment as a whole due to full taxation of the dividends in the residence countries using classical or imputation methods and no or partial taxation of such dividends in the countries using dividend tax relaxation methods.

through an indirect foreign tax credit. There is usually a difference in withholding tax rates (5% rather than 15%)<sup>43</sup> and in corporate tax rates that could result in additional tax in the residence country but which do not change any of the policy consequences.<sup>44</sup>

Switching to the investor (residence) country perspective, it is apparent that current rules provide a disincentive to invest abroad.<sup>45</sup> An investor from a classical method jurisdiction faces the same level of tax in another classical jurisdiction, but she relinquishes most of that tax in a foreign country.<sup>46</sup> An investor from an imputation country clearly faces a much higher tax than she would have faced at home even if no distribution is made, most of which is paid to a foreign country. An investor from a reduced-rate country faces similar levels of tax, all or most of which are paid to a foreign country. The difference between domestic investment and investment in a classical country for such investor depends on the level of dividend taxes used. Complete dividend exemption would leave the consequences unchanged, yet the burden higher (by the WHT rate) than that of a domestic investment. Any effective tax on dividends makes this difference smaller, and if the rate equals or exceeds the WHT rate, then there is no difference between domestic and foreign investment. In conclusion, from a capital export neutrality (hereinafter "CEN")<sup>47</sup> perspective, the biggest effect of the current rules is on imputation country investors in a classical country corporation. Other classical countries, as well as reduced-rate countries, are essentially unaffected. The latter are able to both maintain CEN and capture at least some of the benefits of integration by reducing

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43. See Organisation for Economic Cooperation and Development, *Articles from the Model Convention with Respect to Taxes on Income and on Capital*, art. 10, Jan. 28, 2003, <http://www.oecd.org/dataoecd/52/34/1914467.pdf>.

44. Additionally, the withholding tax may be replaced by a branch tax or any equivalent version.

45. That is true from out narrow perspective, ignoring phenomena such as: deferral, tax rate differences, tax evasion and tax havens.

46. This may, or may not matter to her. There may also be other, unrelated, reasons why it may be desirable to such investor to invest domestically or not.

47. Aiming at eliminating tax incentives from a decision to export or not to export capital (invest abroad). See, e.g., Graetz, *supra* note 42, at 270-72 (containing a good discussion of this standard).

the effective tax rate on these investments (from 61 to 44.75 in the above example).

The next example, in Table II(B) illustrates the tax consequences of investments in a corporation organized and doing business in an imputation system country (compared with domestic investment):

TABLE II(B)

Investor country	Classical		Imputation	
	Foreign investment	Domestic investment	Foreign investment	Domestic investment
<u>Source country (Imputation)</u>				
Corporate income	100	100	100	100
35% corporate tax	35	35	35	35
After-tax corporate income	65	65	65	65
Withholding tax if distributed (15%)	9.75	—	9.75	—
<u>Residence country</u>				
Dividend (grossed up)	65	65	65	100
40% Individual tax	26	26	26	40
Imputation credit	—	—	—	35
Foreign tax credit	9.75	—	9.75	—
Residual residence country tax	16.25	26	16.25	5
<u>Result</u>				
Total tax	61	61	61	40
Shareholder income after tax	39	39	39	60
<u>Revenue split</u>				
Source country share	44.75	—	44.75	—
Residence country share	16.25	61	16.25	40

An imputation source country does not follow CIN. In most cases it collects more tax from foreign investors than the total tax imposed on its own investors (44.75% v. 40% in our example).<sup>48</sup>

A classical country investor in an imputation country corporation faces the same tax consequences she would have faced at home or in an equivalent investment in another classical country. The revenue split is no different from the one in another classical (or relaxed dividend tax) method country. The classical residence country, therefore, preserves CEN

48. The only case where that would not be true is when the individual tax exceeds the corporate tax significantly. Even then it is likely that the investor faces additional tax at home which will increase the effective tax on the investment.



under current rules regardless of the method used by the source country.

An imputation country investor is not better off investing in another imputation country – she faces similar tax consequences to investment in a classical or other (reduced dividend rate) countries. Consequently, current rules are CEN inconsistent from an imputation country perspective regardless of the method used in the source country. Similarly, for a reduced-rate country, the method used in the source country is not a concern – its investors face the same consequences and it faces the same revenue split regardless of that method, which is why a column that duplicated these consequences (see Table II(A)) was omitted from Table II(B).

In conclusion, as was explored and demonstrated earlier, the current international tax norms, and particularly the bilateral tax treaties based international tax regime are conceptually constructed on the premises of the classical system.<sup>49</sup> As long as corporate tax rates are relatively similar among treaty partners,<sup>50</sup> classical countries maintain CEN relatively well. They also by and large maintain CIN – they succeed, at least, in collecting a large portion of the tax at source – corporate tax, plus withholding or branch tax rates, according to acceptable treaty norms. Imputation countries do not maintain CEN under current rules regardless of the method used by the source country. Their investors are leaving more tax in the source jurisdiction than they would have paid at home on domestic investments, and overall, they basically face classical system tax burdens. In most cases, imputation countries also do not maintain CIN under current rules. They often collect more taxes from foreigners at source than they would have collected from their investors on the whole investment, “showing” all foreign investors its “classical face.”

Finally, the consequences of investment in country employing a reduced-rate method, the adoption of which is the trend explored in this article, are demonstrated in Table II(C):

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49. Vann, *supra* note 6.

50. Corporate tax rates show tendency to converge worldwide. The classic example was the global adjustment to the U.S. dramatic reduction of its corporate tax rates in 1986.

TABLE II(C)

Investor country method: Source country (reduced rate (15%))	Domestic investment	Foreign investment		
		Classical	Imputation	Reduced rate
Corporate income	100	100	100	100
35% corporate tax	35	35	35	35
After-tax corporate income	65	65	65	65
Withholding tax (15%)	—	9.75	9.75	9.75
<u>Residence country</u>				
Dividend (grossed up if relevant)	65	65	65	65
Individual (dividend) tax	9.75	26	26	9.75
Direct foreign tax credit	—	9.75	9.75	9.75
Residual residence country tax	—	16.25	16.25	0
<u>Result</u>				
Total tax	44.75	61	61	44.75
Shareholder income after tax	55.25	39	39	55.25
<u>Revenue split</u>				
Source country share	—	44.75	44.75	44.75
Residence country share	44.75	16.25	16.25	0

A reduced-rate country ensures, therefore, that all investment through domestic corporations leaves the same (44.75% in our example) tax at source. Investors from other reduced-rate countries should not incur additional tax at home, except from differences in individual (dividend) tax rates. Under current rules, investors from other countries face higher levels of taxation – those typical in a classical system. So, within its jurisdiction, CIN is well maintained, and only imputation countries' investors face an inherent disincentive to invest in reduced-rate countries in comparison to domestic investment. This disincentive is not, however, unique to reduced-rate countries as demonstrated in Tables II(A)&(B). CEN is also basically maintained by reduced-rate countries, yet they typically do not collect much tax from such foreign corporate investments of their residents. Under current rules, the policies of reduced rate countries reflect strong adherence to source taxation.

Because reduced rate does not require linkage between the corporate and shareholder level taxes, it fits well into the scheme of the current classical system based international tax rules, yet it succeeds in achieving integration both at the domestic and international levels. These simplistic examples demonstrate the appeal of this method for countries that

found integration desirable, but could not cope with the difficulties that imputation faced under current rules – also demonstrated in the above examples. Theory becomes reality in the next section, which reviews the actual trend away from imputation.

### C. *The Rise of Integration in the Second Half of the 20th Century*

This section puts the above theoretical literature in a chronological and country-specific context in order to demonstrate the prominence of integration and the widespread belief in its merits – especially the efficiency merits of imputation systems – in the second half of the 20th century. The purpose of this concise, and by no means comprehensive, comparative survey is to concretize and establish appreciation for the rise of integration, as it is essential for appreciating the significance of its abrupt fall at the turn of the century.

#### 1. *Germany*

Germany first introduced modern<sup>51</sup> integration in 1953, enacting its unique split-rate system, which taxed corporate earnings designated for distribution more lightly than retained corporate earnings.<sup>52</sup> This remains the primary example for integration at the corporate level despite its subsequent repeal – an apparently unpopular method of integration regardless of its theoretical efficiency appeal.<sup>53</sup> The source of this method is in post-war Germany, whose stock market was at a very low point. Integration, especially at the corporate level,

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51. Older forms of income taxes included some forms of integration as well, for various reasons that will not be analyzed in this article. See, e.g., McNulty, *supra* note 12, at 163 (explaining the case of U.S. income taxes).

52. Harry G. Gourevitch, *Corporate Tax Integration: The European Experience*, 31 TAX LAW 65, 68-69 (1977).

53. Integration at the corporate level eliminates or reduces the additional level of tax on earnings of the legal fiction we call corporation. It provides a better chance of achieving complete integration – equal taxation of all investors in corporations at the investors' rates. It is unpopular because the adoption of this method reduces the corporate tax burden to all investors, domestic and foreigners, and there is no reciprocal adjustment required from the foreign residence country. The concern is that such a system will result in a sheer transfer from the source country's fisc to that of the residence country and no additional benefits.

was believed to have the potential to revive investors' interests in German corporate equity.<sup>54</sup>

In 1976 (effective as of January 1, 1977), Germany conceded corporate level integration and switched to a full imputation, shareholder level integration. This major policy reform was not backed with clear goals except for the general belief in the need to relieve double taxation on distributed earnings.<sup>55</sup> The reform came in response to certain shortcomings of the split-rate system: the (tax) bias in favor of debt financing over equity financing, the possible reluctance of majority shareholders to distribute earnings (which were still taxed at more than 50%, in sharp contrast to the interests of minority shareholders, therefore, having no interest to invest, similar to the non-rich parts of the population), and the different tax treatment of incorporated and unincorporated businesses.<sup>56</sup> The imputation credit was not extended to foreign investors. Germany continued to tax foreign investors on dividends received from German corporations through withholding tax imposed at the relevant treaty rates. In general, integration achieved little more than its direct consequence of reduction of tax rates on (mainly German) investments in German corporations.<sup>57</sup> It is possible that this lack of success should be attributed to unrelated, but contradictory in consequence, government policies. As demonstrated below, this is a common pattern in many of the jurisdictions reviewed here.

The different treatment of foreign shareholders in German corporations caused some difficulties, especially with Germany's non-discrimination obligations toward other European member states. Germany addressed these difficulties by allowing residents of these countries to apply for a refund of the corporate tax equal to the imputation credit. This refund,

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54. Gourevitch, *supra* note 52, at 69.

55. *Id.* at 69-70 (citing the Ministry of Finance technical memorandum which accompanied the legislation specifically rejecting a general theory that it is unjustified to tax business entities separately). See also Paul Franken, *The Germany Report*, in INTERNATIONAL FISCAL ASSOCIATION, IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES, at 36 (IFA Congress Seminar Series No. 7, 1982). Other goals mentioned were: the improvement of debt-to-equity ratios of German corporations and the performance of the stock market.

56. Gourevitch, *supra* note 52, at 70-71.

57. Franken, *supra* note 56, at 40.

nevertheless, was principally subject to a withholding tax of 25%. This meant that the discrimination was ameliorated, but not eliminated. In 2001, the imputation system was repealed in Germany as part of a large corporate tax reform, and it returned to a supposedly classical system; in fact, a 25% flat-rate corporate tax with 100% dividend exclusion for corporate shareholders and 50% dividend exclusion for (German) individual shareholders – effectively a reduced (half) rate system. No comprehensive explanations or studies accompanied this amendment, although it is believed to be the product of the difficulty of adapting imputation to international business and the perceived complexity of the system.<sup>58</sup>

## 2. *France*

France introduced integration in 1965, when it replaced its classical system with a partial imputation system, granting shareholders a tax credit of half the dividend amount (“Avoir Fiscal”).<sup>59</sup> The original principal objective of this reform was (similarly to Germany) to revamp the French stock market.<sup>60</sup> Moreover, the high corporate tax rate in France compared to other major European countries resulted in an incentive for French investors to invest in foreign corporations and deter foreigners from investing in French corporations. The resulting low valuations of French corporations exposed them to foreign takeover.<sup>61</sup> The 1965 reform effectively reduced the corporate tax on distributed earnings to comparable levels with France’s competitors (mainly Germany).<sup>62</sup> The reform did not change distribution patterns, resulting in what seemed

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58. The amendment is reported to be generally favorably accepted in Germany despite its undesirable expected efficiency and distributional consequences. See generally Dieter Endres & Andreas Oestreicher, *2001 Tax Reform in Germany – Planning for a New Era*, 28 INTERTAX 408 (2000); Christiana Djanani & Ralf Herbener, *Trends in Company/Shareholder Taxation: Single or Double Taxation*, 88a CAHIERS DE DROIT FISCAL INTERNATIONAL 399, 434-35 (2003).

59. This was complemented by an equalization tax (precompte mobilier) paid by corporations whose incomes had not been subject to the corporate tax. For the best review of this law see Gourevitch, *supra* note 52, at 67.

60. *Id.*

61. *Id.* at 68.

62. *Id.* Other measures were taken to assist French corporations to build up their retained earnings, which allegedly eliminated a tax bias between them and distributions. See Pierre F. Fontaneau, *France’s Report*, in INTERNA-

to be satisfactory reduction of the tax burden on investments in French corporations.<sup>63</sup>

One of the major proponents of integration, France also extended integration to foreign interests through its tax treaties.<sup>64</sup> Towards the end of the last century it became apparent that, with economic globalization, both the amount of imputation credits extended to foreigners and equalization tax collected increased significantly, and the administrative costs of maintaining the system became considerable.<sup>65</sup> This created pressure for reform, where the administrative costs and industry's dislike of the equalization tax played a major role.<sup>66</sup> As a result, as of 2001, France began, in a sequence of tax bills, to reduce the corporate tax burden and the rate of the imputation credit allowed (though in a gradual manner), and finally abolished the credit (and the equalization tax) as of 2004.<sup>67</sup> The imputation system has been replaced by a reduced (half) dividend tax rate system, none of whose benefits are extended to foreigners.<sup>68</sup>

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TIONAL FISCAL ASSOCIATION, IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES, at 33 (IFA Congress Seminar Series No. 7, 1982).

63. See Gourevitch, *supra* note 52, at 68; see also Fontaneau, *supra* note 62, at 34 (An ancillary objective – to attract more investment in corporate stock by small (family) investors – has not been successful despite additional incentives, such as tax exemption for capped amounts of dividends paid to individuals. The reasons for this failure, similarly to other countries, are other, unrelated government policies that created opposite incentives).

64. See, e.g., Ault, *supra* note 15, at 585 (this practice included the treaty with the U.S; however, in some treaties, France effectively eliminated the withholding tax on dividends – for example, the France-Bahrain treaty included a refund of the equalization tax to Bahrainian shareholders).

65. Philippe Derouin, *Trends in Company/Shareholder Taxation: Single or Double Taxation*, 88a CAHIERS DE DROIT FISCAL INTERNATIONAL 375, 376 (2003).

66. Interestingly, the extension of the credit to foreigners was not considered to be a major concern. *Id.* at 395.

67. See, e.g., Ambroise Bricet, *France's 2004 Finance Act, Amended 2003 Finance Act Change Tax Rules for Businesses, Shareholders*, TAX ANALYSTS: WORLDWIDE TAX DAILY (Jan. 7, 2004) (LEXIS, 2004 WTD 4-5).

68. See, e.g., *id.* (no structured reduction of withholding tax rates on dividends).

### 3. *The United Kingdom*

The British corporate tax system adopted its modern integration method in 1972.<sup>69</sup> This was an imputation system where corporations were obliged to pay an advanced corporate tax ("ACT") on distributed earnings. This ACT was granted as a credit to the shareholders and also deducted from the corporation's general (corporate) tax liability, which was collected separately.<sup>70</sup> Despite a strong opposition, the conservative government promoted this reform in the name of efficiency, believing it to remove the well-known distortions of the corporate tax, and revive the capital markets.<sup>71</sup> These goals have not been achieved generally, due mainly to contradictory effects of other, unrelated government policies.<sup>72</sup> The U.K. was really the leader of the reversal trend, repealing ACT as of 1999 and reducing the credit granted significantly, and practically eliminating most of the benefits of integration from foreigners.<sup>73</sup>

### 4. *Italy*

Italy adopted a full imputation system in 1977 primarily for efficiency reasons.<sup>74</sup> Early reports attributed partial success to the system. Similar to other countries, some of the failure was attributed to reasons unrelated to integration itself. As of 2004, Italy replaced its imputation system with an (almost full) dividend exemption system. The stated reasons for this reform has been the other E.U. members' pressure on the basis

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69. It had had an integration system prior to 1966 as well, replaced by a classical system until 1972.

70. Gourevitch, *supra* note 52, at 71-72.

71. *Id.* at 71. It is interesting to mention that the U.K. had adopted a classical system just 7 years prior to that, under a labor government, in support of a build-up of retained earnings.

72. Stanley H. Wright, *The U.K. Report*, in INTERNATIONAL FISCAL ASSOCIATION, IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES, at 51-52 (IFA Congress Seminar Series No. 7, 1982).

73. *See, e.g.*, Rev. Proc. 2000-13, 2000-6 I.R.B. 515.

74. Siegfried Mayr, *Italy's report*, in INTERNATIONAL FISCAL ASSOCIATION, IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES, at 43 (IFA Congress Seminar Series No. 7, 1982).

of non-discrimination (the E.U. free movement of capital principle), and the complexity of the imputation system.<sup>75</sup>

### 5. *Norway and Finland*

Finland was late to adopt integration because of some distinct structural characteristics of its markets and the role of corporate taxation until the 1980's.<sup>76</sup> In 1990, it introduced a full imputation system, and consequently, significantly reduced the corporate tax rate.<sup>77</sup> Despite expectations that the imputation credit would be extended across borders, this has been done only sparingly and through tax treaties.<sup>78</sup> Other treaties resulted only in a reduction or elimination of the withholding tax on dividends,<sup>79</sup> which was, it is important to note, a halfway extension of integration across-borders. Finland found it difficult to coordinate its imputation system with other countries in a more fine-tuned way.<sup>80</sup> In 2002, however, the Finnish Supreme Administrative Court asked the ECJ whether this non-perfect extension of the imputation system across borders violated Finland's E.U. obligations.<sup>81</sup> The background for this referral was in other cases that successfully challenged a domestic application of integration in Europe.<sup>82</sup> The Finnish government expected to lose this case, which it did, and was ready with a study and a reform proposal to abol-

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75. Giuseppe Marino & Andrea Ballancin, *The International Effects of Italian Corporate Tax Reform*, 2004 WTD 150-14, Aug. 4, 2004.

76. Matti Halén, *Trends in Company/Shareholder Taxation: Single or Double Taxation*, 88a CAHIERS DE DROIT FISCAL INTERNATIONAL 351, 351-52 (2003).

77. Implementing what is known as the dual income tax system typical to the Scandinavian countries. See Alessandro Bavila, *Moving Away from Global Taxation: Dual Income Tax and Other Forms of Taxation*, 41 EUR. TAX'N 211, 211 (2001).

78. Halén, *supra* note 76, at 359 (the Finland-Ireland treaty).

79. See, e.g., 1953 Income Tax Convention, U.K.-Greece, art. XIV June 25, 1953, 190 U.N.T.S. 281.

80. Halén, *supra* note 77, at 359-60. This is a good source for exploring the practical reasons for the difficulty of extending imputation credits across-borders because the author was a government official.

81. Case C 319/02, *Manninen*, [2004] 3 C.M.L.R. 40 (2004).

82. Case C 35/98, *Staatssecretaris van Financiën v. B.M.G. Verkooijen*, 2000 E.C.R. I-4071, I-4130 to 33, which did not involve an integration system, but rather a Dutch (the prototypical classical system country) dividend exemption provision and Case C 334/02 *Commission v. French Republic*, [2005] 2 C.M.L.R. 24 (2005).



ish the imputation system and replace it with a reduced dividend tax rate system.<sup>83</sup>

Norway, though not an E.U. member, went through a very similar experience. It originally introduced the imputation system in 1992, without apparent success beyond the reduction of the tax burden on investments through corporations. A recent case challenged the validity of this system, whose benefits were not extended to foreign investors in Norwegian corporations, and was directed (for advice) to the EFTA court, which predictably ruled the Norwegian withholding tax on dividends paid by Norwegian corporations to foreigners (without imputation credits) discriminatory.<sup>84</sup> The Norwegian government, similar to the Finnish government, predicted the outcome and proposed to abolish the imputation system and replace it with a reduced dividend tax rate system.<sup>85</sup> Taken together, the *Manninen* and *Fokus Bank* cases reject all aspects (outbound and inbound) of a purely domestic imputation system in the European (E.U./EEA) context.

Several other countries, European, such as Ireland and Belgium, and non European, such as Japan and Singapore, also replaced imputation with various versions of partial (or full) dividend tax exemption systems.

## 6. *The E.U.*

Although not another "country," the E.U. played a central role in the current trend away from imputation, as apparent from the above review. There is no European harmonized income tax, *a minori ad majus* a corporate tax. Nonetheless, as early as 1966, an expert group recommended the extension of imputation credits to foreign income,<sup>86</sup> and in 1975, the European Commission proposed a directive, never adopted and

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83. See, e.g., Gunnar Westerlund & Tomi Karsio, *Finnish Government Introduces Major Tax Reform Package*, 2004 WTD 102-2, May 26, 2004.

84. Case E-1/04 Fokus Bank Judgment of November 23, 2004, available at [http://www.dinesider.no/customer/770660/archive/files/Decided%20Cases/2004/e\\_1\\_04decision-e.pdf](http://www.dinesider.no/customer/770660/archive/files/Decided%20Cases/2004/e_1_04decision-e.pdf).

85. Frederick Zimmer, *EFTA Court Strikes Down Norwegian Withholding Tax on Dividends*, 2004 WTD 229-3, Nov. 29, 2004, and Frederick Zimmer, *Norwegian Government Proposes Tax Reform Legislation*, 2004 WTD 201-1, Oct. 18, 2004.

86. Memorandum of the Commission to the Council of 26 June 1967, BULL. OF THE EUR. ECON. COMMUNITY, Supplement to Bulletin No. 8-1967.

withdrawn in 1990, to harmonize the corporate tax in Europe through a partial imputation system.<sup>87</sup> A 1970 study, however, recommended to the commission to prefer the classical system as the basis for E.U. tax harmonization due to its neutrality and simplicity.<sup>88</sup> Although none of the above has ever been acted upon, the latter approach effectively prevailed through the jurisprudence of the ECJ, culminating in its *Manninen* decision,<sup>89</sup> which effectively prohibits the use of an imputation system if it is not extended in full across-borders. As previously mentioned, this approach, based on non-discrimination logic, has been a material factor in the trend away from imputation explored by this article.

### 7. *Canada, Australia & New Zealand*

Finally, some countries did not get discouraged by the difficulties of implementing imputation across-borders.<sup>90</sup> Canada, for instance, adopted integration as early as 1949. A modern partial imputation system, not available for cross-border investments, was introduced in 1972, and extended as of 1978, with efficiency benefits as its primary objective.<sup>91</sup> Despite the lack of strong evidence supporting the effectiveness of this system in Canada, which, in part was due to reasons unrelated to integration itself, the partial integration system has been retained. The benefits of integration are generally not extended across borders, and nevertheless, are not impacted by the nondiscrimination provisions in Canada's tax treaties.<sup>92</sup>

Australia is still one of the keenest devotees of integration. In 1987 it adopted a full imputation system,<sup>93</sup> which employs a

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87. Proposal for a Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends of 5 November 1975, 1975 O.J. (253) 2. .

88. A. J. Van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities*, Commission Studies, Competition – Approximation of Legislation Series no. 15, Brussels, 1970.

89. *Manninen*, *supra* note 82.

90. There are even new adoptions of imputation systems, such as in Taiwan's.

91. Satya N. Poddar, *Canada, in IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES*, 36TH CONGRESS IFA MONTREAL 22 (1983).

92. Mark Brender & Penny J. Woolford, *Canada*, 86A *STUD. ON INT'L FISCAL L.* 235, 238 (2003).

93. Taxation Laws Amendment Act, No. 2 (1987) (Austl).

corporate tax at a flat rate equal to the top marginal individual rate, with any distributions out of taxed corporate earnings "franked" (i.e. Reflect the tax paid at the corporate level) and carry a credit for the use of the distribute shareholder against her basic tax liability.<sup>94</sup> The only benefit for foreign shareholders is the elimination of the withholding tax on franked dividends. Non-portfolio foreign dividends are largely exempt. Australia does not typically include a nondiscrimination article in its treaties, so it was not under pressure to equalize dividend tax treatment across borders on this ground.

Together with Mexico and New Zealand, Canada and Australia provide examples of important international players<sup>95</sup> that did not join the trend and hanged on to imputation. Of course, it was easier for them to do that because they were not exposed to the internal E.U. Pressures. Such pressures unquestionably accelerated this trend; yet, this article argues there were other reasons to this trend, primarily the insufficient coordination of international tax policies. The next section begins to explore this argument.

#### D. *A Turn of Events with the Turn of the Century*

Neither the adoption of imputation, nor its recent reversals were universal.<sup>96</sup> Moreover, despite the dominance of the leading European countries in both these trends, they were not alone generating them. At the same time that most of their trade partners adopted integration, both the U.S. And the Netherlands resisted reform. In the U.S., several studies have recommended integration,<sup>97</sup> mainly for efficiency rea-

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94. See Graeme S. Cooper & Sandra M. Lanigan, *Australia*, 86A *STUD. ON INT'L FISCAL L.* 131 (2003), for a more comprehensive description of the system.

95. Especially from U.S. perspective.

96. As the last paragraph indicates.

97. The most important of which are: the 1977 Treasury proposal on imputation system (See McLure, *supra* note 2, at 227-230); the 1981 Prof. Andrews ALI dividend deduction proposal (See William D. Andrews, *The ALI Reporter's Proposal on Corporate Distributions and Corporate Taxation with a Personal Consumption Tax*, 22 *SAN DIEGO L. REV.* 333 (1981)); the 1992 Treasury and the 1993 ALI proposals (See GRAETZ AND WARREN, *supra* note 2); and the former proposals reviewed by David Tillinghast (See David Tillinghast, *The USA Report*, in *INTERNATIONAL FISCAL ASSOCIATION, IMPUTATION SYSTEMS – OBJECTIVES AND CONSEQUENCES*, at 51, 52 (IFA Congress Seminar Series No. 7, 1982)).

sons, but it had never materialized. The main reasons for the political resistance were the predicted revenue losses and the resistance of the corporate sector.<sup>98</sup> There was also the general perception that integration was hard to sell to the public since it was perceived as a break for the rich and fat, non-tax paying corporations.<sup>99</sup> The Dutch resisted for similar reason, mainly taking into account the major foreign shareholding in the large Dutch corporations. They figured out that such a large group of investors could not be denied a benefit their own residents enjoyed. Granting imputation credits to all shareholders was out of the question, both because of sheer revenue loss reasons and reluctance to transfer the real benefit to foreign fiscs. This is still the, somewhat unique, Dutch position. The U.S., however, in a surprising move, adopted a reduced dividend tax rate system, equalizing it to the tax rate for capital gains and setting it at 15%.<sup>100</sup> The reduced rate applies also to dividends paid by most foreign corporations.<sup>101</sup> The declared goals of this reform were economic stimulus and growth (through the capture of, *inter alia*, the efficiency benefits of integration).<sup>102</sup>

As mentioned in section II.C., other reforms, reaching similar ends, although opposite in direction, were passed in the last five years by most of the prominent imputation jurisdictions: the U.K., Germany, France, etc.<sup>103</sup> In short, imputation abruptly lost its appeal as the favorite integration method and has consistently been replaced by the less accurate reduced dividend tax rate system, which, in a way, is a hybrid of

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98. See, e.g., Lee A. Sheppard, *Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 639 (May 6, 1985).

99. Fletcher, *supra* note 17, at 187.

100. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, I.R.C. § 302 (2003).

101. Notice 2004-70, 2004-44 I.R.B. 724.

102. *But see* Lee A. Sheppard, *News Analysis: Have I got a Deal for You! Analyzing the Dividend Exclusion*, Tax Analysts, Doc. 2003-2527 (quoting, among others, Paul Krugman, calling the reform: "The Tax Complication Act of 2003," and arguing that it will provide "stimulus for lawyers"). The desirability of the Act or the candor of the administration promoting it are beyond the scope of this article.

103. See *supra* Part II.C., and Avi-Yonah, *supra* note 6, at 1600. (The author criticizes the Bush administration's tax reform; an appendix, authored by Yoram Keinan provides an excellent review of some of the relevant developments).

dividend exclusion and the classical system. This raises the question whether a progression towards convergence of these tax systems is on the horizon.<sup>104</sup> Although answering this question in full is beyond the scope of this article, some developments in this direction laid the ground for this article's argument that revival of imputation through enhanced international cooperation is feasible.

Note also that in many cases the benefits of integrations could not be captured due to negating policies (Germany, France, Italy, etc.), such as deferral and strict foreign currency controls. Although not explicitly articulated, it is not hard to understand that imputation suffered due to its sensitivity to the effects of such extraneous policies. One may argue that this supports the argument that imputation is inferior to other methods and should therefore be replaced. This, of course, is not an inevitable conclusion – if integration benefits exceed the benefits of these other policies it may be reasonable to prefer its retention rather than an awkward “survival of the fittest” mode of norms coordination. There is no indication that such a benefits-evaluation study had been made in any of these countries prior to their repeal of imputation. Moreover, some of these contradicting policies, such as foreign currency controls, have been phased out in recent years for other reasons anyway.

### III.

#### THE INTERNATIONAL DIMENSION OF INTEGRATION AS A PRIMARY EXPLANATION OF CURRENT TAX POLICY TRENDS

It is sometimes hard to comprehend that international constraints force us to change our long-standing policies, especially when we do not have reason to believe that these policies are wrong “for us.” This is particularly true in the tax discourse, since tax has always been perceived as a major factor in the sovereignty of nation states as we know them. However, the power of these international constraints in the international tax area, most notably in the more open economies, is significant, and may become decisive with economic globalization. The constant decline (and convergence) in worldwide corporate tax rates in the last twenty years is a classic example for that – governments with different needs and priorities feel

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104. See Vann, *supra* note 6, at 69.

bound by the current range of acceptable rates.<sup>105</sup>

### A. Introduction: The International Dimension of Imputation

This article argues, as aforesaid, that a very similar process played a major role in the reversal of the almost universal trend of adopting integration in general and imputation in particular in the 21st century. The following tables depict the difficulty of plainly extending the benefits of imputation across borders. Table III(A) uses the same basic example used in Part II to demonstrate the consequences of unilaterally extending imputation credits to foreign taxes borne by domestic investors, and some policy options that may assist in alleviating these consequences.

TABLE III(A)

Investor country	Imputation			
	Domestic investment	Credit granted to foreign investments	Plus no withholding tax at source	Plus gross-up for foreign corporate tax
<u>Source country<sup>106</sup></u>				
Corporate income	100	100	100	100
35% corporate tax	35	35	35	35
After-tax corporate income	65	65	65	65
Withholding tax if distributed (15%)	—	9.75	0	0
<u>Residence country</u>				
Dividend (grossed up)	100	65	65	100
40% Individual tax	40	26	26	40
Imputation credit	35	35/65=22.75	35/65=22.75	35
Foreign tax credit	—	9.75	0	0
Residual residence country tax	5	0	3.25	5
Excess credit	—	6.5	—	—
<u>Result</u>				
Total tax	40	44.75	38.25	40
Shareholder income after tax	60	55.25	61.75	60
<u>Revenue split</u>				
Source country share	—	44.75	35	35
Residence country share	40	0 (plus 6.5 excess credit)	3.25	5

105. See, e.g., KPMG, *Press Release, KPMG Corporate Tax Rate Survey for 2004 – Rates Still Falling* (May 3, 2004), available at <http://www.kpmg.ca/en/news/documents/CorpTaxRateSurvey2004.pdf> (hereinafter “KPMG report”).

106. 106. For these purposes it does not matter whether the source country has a classical, imputation or reduced rate system – all result in similar consequences.

The comparison of the first and second column demonstrates the most direct and acute consequence – simply extending (unilaterally) imputation credits for foreign taxes results in no revenue to the imputation residence country. It may even result in a transfer to the fisc of another country if excess credit, similar to the one in the example, is allowed to be used. Moreover, even now CEN is not typically met because the source country's share is larger than the total level of domestic taxation in an imputation country (44.75 v. 40 in the above example). The results are less harsh if the source country agreed to elimination of the withholding tax on dividends. In that case, the source country keeps just its corporate level tax, and the imputation residence country collects the difference between the source country's corporate tax rate and its individual rate. For that to work, the residence imputation country needs to gross-up the dividend amount to reflect the foreign corporate tax paid as demonstrated by the third and fourth columns above. If that were the case, the imputation residence country could maintain CEN and potentially collect some tax in these circumstances. Note, however, that for this to be realistic source countries must give up their withholding tax on dividends<sup>107</sup> and cooperate with the residence imputation system at a level that would make the above gross-up mechanism feasible. Effective sharing of information – more effective than anything we have at the present – is crucial for this mechanism to succeed.

Table III(B) complements Table III(A) with the consequences of extending imputation benefits to foreign investors in domestic (imputation country) corporations. One possible way of achieving that is for the imputation country to unilaterally eliminate its own withholding tax on dividend income. The consequences of that are demonstrated in the first two columns:

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<sup>107</sup> As elaborated on below, this is not a far-fetched possibility. See *infra* Part IV.A.

TABLE III(B)

Investor country	Classical		Imputation	
	WHT elimination	WHT elimination	Plus Credit granted to foreign investments	Plus gross-up for foreign corporate tax
<u>Source country (Imputation)</u>				
Corporate income	100	100	100	100
35% corporate tax	35	35	35	35
After-tax corporate income	65	65	65	65
Withholding tax if distributed (15%)	0	0	0	0
<u>Residence country</u>				
Dividend (grossed up)	65	65	65	100
40% Individual tax	26	26	26	40
			35/	
Imputation credit	—	—	65=22.75	35
Foreign tax credit	—	—	0	0
Residual residence country tax	26	26	3.25	5
Excess credit	—	—	—	—
<u>Result</u>				
Total tax	61	61	38.25	40
Shareholder income after tax	39	39	61.75	60
<u>Revenue split</u>				
Source country share	35	35	35	35
Residence country share	26	26	3.25	5

Under current rules, this policy option works well with classical (or reduced rate)<sup>108</sup> country investors,<sup>109</sup> but not with imputation country investors. If, however, the residence imputation country implemented the relief rules described in Table III(A), potentially acceptable results could be achieved.<sup>110</sup> Neutrality would basically be achieved (ignoring rate differences)<sup>111</sup> for both residence and source countries. Again, this is not the result under current rules, which creates a (tax) bias

108. Reduced rate country investors face similar consequences to classical country investors, only their residence tax level is lower, and consequently the residence country share is lower.

109. CEN is basically maintained in the classical country, and its share of tax acceptably reflect its individual (dividend) tax rate.

110. Of course, for that to be possible, both elimination of withholding taxes on dividend income and an effective sharing of information are required. See Ault, *supra* note 15, at 581-82.

111. Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q. J. ECON. 793, 796 (1980).



against cross-border corporate investment involving imputation countries.

As already explored, the purpose of integration is to enhance the neutrality of the tax system, by removing tax wedges from decisions to invest or do business through corporations or otherwise. In the international setting, however, integration, and especially its most popular form, the imputation system, actually frustrated the neutrality of tax systems from an allocative efficiency perspective by favoring domestic investment over foreign investment, as demonstrated in the above simple example. This difficulty has been known for some years now.<sup>112</sup>

### B. *Nondiscrimination and Imputation*

An extremely interesting footnote written by Professor Richard Bird twenty years ago states: "there is no case for concluding that the international tail (nondiscrimination) should necessarily wag the domestic dog (integration)."<sup>113</sup> As should be apparent by now, while this article supports this conclusion in principle, reality proved it wrong, at least for now – nondiscrimination international obligations of countries crippled imputation, almost eradicating it in Europe. Professor Bird made the above conclusion in a discussion of international equity implications of integration. Without ruling one way or another regarding the significance of international equity considerations or whether imputation should be affected by such considerations, this article takes nondiscrimination obligations of countries to be what they are – international obligations of all the countries involved. It is quite straightforward that by extending the benefits of integration to domestic investment by domestic investors only, these countries violate their international obligations. These obligations meant much more in the E.U., where they were important structural fundamentals

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112. See, e.g., Richard M. Bird, *International Aspects of Integration*, 28 NAT'L TAX J. 302, 306-09 (1975); Robin Boadway & Neil Bruce, *Problems with Integrating Corporate and Personal Income Taxes in an Open Economy*, 48 J. PUB. ECON 39, 56-62 (1992); Richard J. Vann, *International Implications of Imputation*, 2 AUSTL. TAX F. 451, 496 (1985) (acknowledging these difficulties in the context of Australia's contemplation of adopting its imputation system).

113. Bird, *supra* note 113, at 310 n.26.

in the creation of the single market, and indeed, as is well-known by now, the European assault succeeded.

In most countries, the technical nature of the nondiscrimination obligations contributed to the repeal of imputation and the adoption of the reduced rate system. The reduced rates system has been successful in maintaining neutrality, yet at the expense of overall higher tax rates on both domestic and international investment. Two immediate results of these higher tax rates could be the loss of some efficiency gains and an increased incentive to take advantage of deferral opportunities.<sup>114</sup> All the distortions attributed to the classical system persist under this system, even if in a lesser form.

These results cannot be desirable. Nevertheless, the conventional wisdom is that the above effect of nondiscrimination was the primary reason for the repeal of imputation in so many countries. This conventional wisdom cannot, however, explain the abruptness and the extent of the policy moves away from imputation. Nominally, only the Finnish (2003) and Norwegian (2004) systems were officially condemned, whereas the major European economies began their reforms earlier. Moreover, while it is true that the ECJ has only recently started to expand its activism to tax matters, non-discrimination provisions have not changed for many years, and technically could have been used for many years to assert some pressure on imputation countries to either extend them across-borders or to abandon them; this did not happen due to the lack of sufficient interest for other countries to compel imputation countries to change their policies – capital importing countries collected their share of tax anyway and capital export countries attempted to solve some of the situations at the bilateral level with important counterpart. These attempts were not very successful in general; in some cases, countries, such as France, developed certain mechanisms to extend the benefits of their imputation systems to foreigners in an attempt to attract investments. These attempts, however, were the exception rather than the rule.

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114. This is due to the increased disparity between the corporate tax rate alone and the effective tax rate (corporate + individual (residual) dividend tax rate).

### C. *Imputation in a Non-Cooperative World*

Another explanation for the development described thus far is that, until the late 1990s, international investment was not voluminous enough for countries to concede what they considered a desirable policy (imputation). Since countries acknowledged that the unilateral extension of the benefits of integration to foreign investment and foreign investors would amount to a transfer to a foreign fisc,<sup>115</sup> they simply kept imputation as a purely domestic policy. This is a classic example of the revenue flight tension so typical in our globalizing world – a desirable policy was exposed to risk of cannibalization (of revenues) by trade partners, and countries therefore preferred a safer, but less desirable tax policy.<sup>116</sup>

Except for some attempts, in certain narrow circumstances, no cooperative efforts were made to accommodate imputation at the international level.<sup>117</sup> The rules of the international tax regime were, and still are, based on the classical system, and the regime itself was premised on reciprocity rather than coordination of policies – a version of cooperation through retaliation, so typical to non-cooperative settings.<sup>118</sup> There were basically two alternatives to the exclusive application of imputation: reduction or elimination of dividend withholding taxes by imputation countries in the inbound context or the implementation of a clearing mechanism that would govern some agreed-upon revenue sharing in the outbound context.<sup>119</sup> The former was generally unfair (and therefore unacceptable) to the imputation country since it gave up revenue that it deserved under the basic principles without any reciprocal concession by its treaty partner. The latter was considered impossible in the uncooperative environment.<sup>120</sup>

Imputation countries began to realize that even in the exclusively domestic application of imputation world they could not win. Their investors faced in other countries, even prior to the application of the domestic tax system, taxes higher

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115. See, e.g., *supra* Table III(A) (“Credit granted to foreign investments”).

116. See Brauner, *supra* note 18 (discussing the revenue flight tension).

117. See Ault, *supra* note 15, at 581.

118. See, e.g., ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 118-23 (1984).

119. Ault, *supra* note 15 at 579.

120. *Id.*

than the overall effective tax on domestic investment, and they collected from foreigners taxes higher than those on domestic investors, thus deterring such (especially portfolio) foreign investment. This imbalance was unbearable to both capital exporters and capital importers.

#### IV.

#### CONCLUSION: THE BENEFITS OF INTEGRATION COULD BE CAPTURED THROUGH ENHANCED INTERNATIONAL COOPERATION

##### *A. Revising Imputation Through Enhanced Coordination is Feasible*

To this point, the discussion portrayed the future of integration in quite gloomy colors. This does not have to be the case. As demonstrated above, and explored for some years now in the tax literature, the international dimension crippled imputation, and the resurgence of non-discrimination (particularly of the European expansive version) completed the assault, making it an exceptional oddity in just five years. The inability of countries to extend the benefits of imputation across borders was the Achilles heel of the system. The demise of imputation did not imply the demise of integration, however, as practically all of the countries who repealed imputation replaced it with another tax regime that is designed to eliminate (alas not completely) double taxation of corporate profits.<sup>121</sup> The logical conclusion from these developments is, as acknowledged earlier,<sup>122</sup> that imputation could be saved if it could be extended across-borders. The purpose of this article was to explore this possibility. It concludes, next, that some international tax developments, together with a general (independent of integration) necessity to enhance international tax policy coordination may present an opportunity for that to happen.<sup>123</sup>

One such development, which is not particularly new, is the convergence of corporate tax rates in most major and

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121. *Id.* (replacing it with either a reduced dividend tax rate system or dividend expansion).

122. *But see* Avi-Yonah, *supra* note 6, at 1600 (concluding that imputation could not be saved).

123. *See* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 *TAX L. REV.* 259, 291-93 (2003).

other important economies.<sup>124</sup> This convergence of the constantly declining rates presents an opportunity for integration<sup>125</sup> because taxing international income in a rational way is much easier when international corporate tax rates are at roughly the same level.<sup>126</sup> In our case, it ensures a certain minimum level of taxation for the source country (35% in our example, which should be generally realistic, if not a bit high); minimal level does not imply a low tax share, since this "bite" should generally be very significant in comparison to the maximal level of taxation which an imputation country wishes to impose on investment in corporations overall (40% in our example). Further, it means that the country in which the business is conducted primarily taxes its profits, and the investor (residence) country is left only with a small margin of potential taxation *if* it wishes to adhere to integration. Finally, any reference to the tax collected at the corporate level by the source country should be easier once rates and maybe even base rules converge.

A more recent development is the willingness of some countries, primarily the U.S., to eliminate (reduce to zero) their withholding tax on dividend income paid to foreigners. Such elimination is gradual, applied only to direct investors (not portfolio) through a handful of reciprocal bilateral tax treaties. However, these treaties now "cover" a significant portion of international investment.<sup>127</sup> The effect of elimination of dividend withholding taxes can be seen in Tables III(a) and III(b). Reciprocal elimination of withholding taxes alone does not reduce the total tax – it just changes the revenue share, leaving more revenue to the residence country. This mere revenue flight cannot be acceptable, standing alone, and is not desirable as it does not integrate the systems; however, it presents an opportunity for imputation countries to extend imputation benefits across-borders. This ensures that the overall tax does not exceed its top individual rate and still even collect a minimal tax. A classical country gives away withhold-

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124. See KPMG report, *supra* note 105, at 1.

125. This article assumes that integration, if adopted, will be at the shareholder rather than the corporate level.

126. Ault, *supra* note 15, at 566; see also *supra* note 103 and accompanying text.

127. See Ault, *supra* note 15, at 567, 568 (referencing in the U.S. context, the treaties with the U.K., Australia, the Netherlands, and Mexico).

ing tax on inbound investments, yet it benefits from the reciprocal elimination of withholding taxes in the imputation country, resulting in a larger share of revenue on outbound investment. A cost/benefit analysis of each bilateral situation should result in different balances, yet adjustments could be made in each case without much complication if the countries cooperate at a high enough level. A major difficulty for this article is that some countries, including the U.S., do not currently eliminate the withholding tax on dividends to portfolio investors. Several commentators in various occasions exposed the futility of this policy.<sup>128</sup> Although not clear, it is not inconceivable that countries will eventually abolish this withholding tax or reduce it from its OECD recommended level of 15% through enhanced international cooperation.

To complete the picture, economic globalization challenges the currently stable international tax regime to adapt to the proliferation of international business and investment as economies open. Enhanced cooperation and coordination of tax policies is the key for successful evolution of this regime and the maintenance of its stability.<sup>129</sup> Specifically for the purposes of this article, the current international tax regime is premised on the basis of the classical system, as demonstrated above.<sup>130</sup> Changing that does not require deconstruction of a type that should threaten the stability of the regime, because it is still based on the basic principles of this regime: the source country primarily taxes business income and the residence country gets the residual taxing right, reciprocity is generally kept as the fundamental rule, although in some cases countries could agree to divert from strict reciprocity if the communication line between the treaty parties would be kept open. Preferably, it would be made better, requiring a more effective exchange of information, for instance.

There are some additional challenges to this model proposal. One obvious challenge is the interference of tax havens. Their impact, however, is not different than under the current regime, although in a world without dividend withholding taxes countries may need to be more careful in curb-

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128. See, e.g., Kees van Raad, *Commentary Approaches to Internationally Integrated Taxation of Distributed Corporate Income*, 47 TAX L. REV. 613, 619 (1992).

129. Brauner, *supra* note 124, at 325.

130. See, e.g., Ault, *supra* note 15, at 569-70.

ing tax haven based tax evasion. A more concerning challenge may be that some typical capital importing countries hang on to source taxation as a primary source of revenue. The analysis of the desirability of this approach is beyond the scope of this article. Nonetheless, such insistence should not present a prohibitive challenge to the proposed solution model since in most of these countries it should not be necessary for jump-starting such an attempt, and, anyway, their needs could be met in a separate arrangement. They will, however, face increased pressure to open their economies due to competition over capital from countries that will subscribe to the new regime (and reduce or eliminate their dividend withholding taxes).

Despite all of the above, countries did not choose to take this path, but rather chose to replace imputation with an integration system that is not perfect, yet easier to implement in this world. This concern raises the question of incentives, or how (and if) this proposal could materialize.

B. *Reviving Imputation through Enhanced Coordination is Probably Desirable*

Advocating a solution model that opposes the direction of the actual behavior of countries requires one to carry a heavy burden in an attempt to prove its desirability. Moreover, in our case, leading experts consider the practical benefits of integration in general and imputation in particular rather minor.<sup>131</sup> Doubters argue that in most cases the biases created by the classical system are mitigated by other provisions of the Internal Revenue Code that provide self-help options to corporations, and that corporations who choose not to take advantage of these opportunities do not require legal protection. The debt/equity bias goes the argument is not even solved by integration – only mitigated at best. Finally, economic analysis did not reach consensus regarding some key aspects of taxation of corporate profits – most importantly the real incidence of the corporate tax and whether the tax on dividends affects stock prices,<sup>132</sup> and therefore some of the theoretical benefits of integration remain doubtful.

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131. See, e.g., Avi-Yonah, *supra* note 6.

132. This is the famous old v. new view of dividend taxation. See, e.g., Alan Auerbach, *Taxation and Corporate Financial Policy*, in 3 HANDBOOK OF PUB.

The two first hurdles are, of course, related, since the doubts about the benefits of integration in the international setting led to the policy reversals. Note, however, that even if this was the rational choice in the current international environment, it does not mean that the efficiency benefits of integration should be ignored. The fact that they are mitigated in many cases, such as those described above, does not mean that they are not significant enough to justify a reform such as the one suggested in this article.

Regarding the debt/equity bias, the argument is that this bias is not unique to the corporate tax regime, but rather a problem of the income tax as such.<sup>133</sup> This is true, yet integration mitigates the bias, and therefore seems superior to a classical system from this perspective. Others proposed to keep the classical system as “a global means of tax harmonization,” with the slight adjustment of double-taxing interest income (disallowing the interest expense deduction) to equate its treatment with dividend income.<sup>134</sup> This proposal does seem to present a politically more likely reform than the one proposed in this article, apart from its theoretical undesirability; moreover, it requires international cooperation of a similar degree – a requirement that casts further doubt about its superiority.

The two unresolved theoretical economic debates do cast doubt on the benefits of integration. This should not, however, discourage an otherwise desirable attempt to enhance international cooperation on tax matters. Further, once an international tax organization is formed, for instance, this doubt should not discourage the major economies from considering the suggestions of this article, since it is hard to imagine that any outcome of these debates will result in the classical system being more efficient, and since there are no normative justifi-

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ECON. (Alan Auerbach and Martin Feldstein, eds., 2003). These views are traditionally associated with: Martin Feldstein, *Corporate Taxation and Dividend Behavior*, 37 REV. ECON. STUDIES 57 (1970) (discussing the old view); Alan Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q. J. ECON. 433 (1979); and David F. Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981) (discussing the new view).

133. See Avi-Yonah, *supra* note 6, at 1601 n.17 (referring to Alvin C. Warren Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993)).

134. Kari & Ylä-Liedenpohja, *supra* note 40.



cations for the classical system except for alleged lower administrative costs.

C. *The Importance of Reviving Imputation through Enhanced Coordination*

Dividend yields have been declining in the last decades and are currently low worldwide.<sup>135</sup> Moreover, the vast economic literature analyzing dividend policy in general and the effect of dividend taxation on corporate decisions continues to evolve with no clear consensus. Recent studies indicate, however, that even if taxes have some effect on the decision to distribute dividends it is only minor,<sup>136</sup> and may be significant only in the case of a small number of corporations.<sup>137</sup> This reality does cast doubt on the practical desirability of diverting efforts and resources to the reform suggested in this article.

In conclusion, the suggested reform is both feasible and desirable if countries choose to adopt it in concert. Its biggest hurdle is that there is probably no imputation country that is economically strong enough to begin the process of international extension of imputation through enhanced cooperation, even if all remaining imputation countries combined forces. Absent an international organization's effort it does not seem to be realistic. The OECD or any of its larger economies do not have sufficient interest in jumpstarting the process and an international tax organization is, alas, still in the works. In addition, the magnitude of the gains from such an effort is doubtful, and therefore, it is hard to say if such an effort is worthwhile for now.

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135. See, e.g., RAJ CHETTY & EMMANUEL SAEZ, DIVIDEND TAXES AND CORPORATE BEHAVIOUR: EVIDENCE FROM THE 2003 DIVIDEND TAX CUT (Centre for Econ. Pol'y Res., Discussion Paper No. 4722, 2004), available at <http://www.cepr.org/pubs/new-dps/dplist.asp?dpno=4722> (noting the exception of a slight increase in the post-JGTRRA U.S.).

136. See, e.g., ALON BRAV ET AL., PAYOUT POLICY IN THE 21ST CENTURY (Nat'l Bureau of Econ. Res., Working Paper, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=358582](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=358582).

137. Even then, the effect was accounted for only when a significant and abrupt tax rate reduction was enacted. See, e.g., CHETTY & SAEZ, *supra* note 135.