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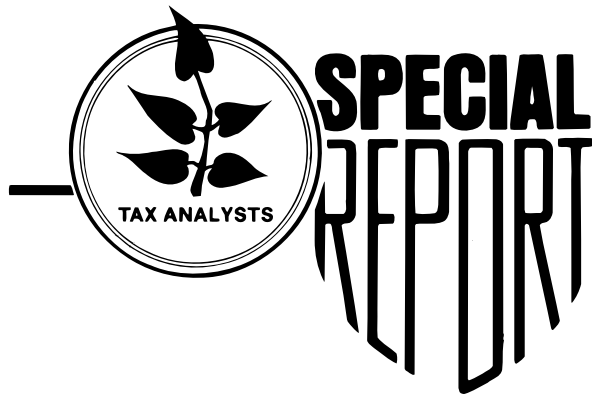
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## BACK TO THE 1930s? THE SHAKY CASE FOR EXEMPTING DIVIDENDS

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and Director of the International Tax LLM Program at the University of Michigan. This article is based in part on the author's U.S. Branch Report for Subject I of the 2003 Annual Congress of the International Fiscal Association, to be held next year in Sydney, Australia (forthcoming in *Cahiers de droit fiscal international*, 2003). He would like to thank Emil Sunley for his helpful comments on that earlier version, and Steve Bank, Michael Barr, David Bradford, Michael Graetz, and David Hasen for comments on this version. Special thanks are due to Yoram Keinan for his meticulous work on the EU regimes (see Appendix). All errors are the author's.

In this report, Prof. Avi-Yonah critiques the proposal to exempt dividends, either as a way to revive the economy or the stock market or as a way of achieving corporate-shareholder tax integration. Any efficiency gains from such integration may be more than offset by efficiency losses when the international aspects of the proposal are considered.

In recent weeks, there has been a renewed push for an old idea from the first Bush administration: Enact an exemption for dividends. The details are unclear, except for the potential significant revenue loss (some \$485 billion over 10 years).<sup>1</sup> The rationale for exempting dividends now is to boost the economy or at least revive the sagging stock market. Neither of these reasons is persuasive as an argument for a major change of our corporate tax structure. In general, as recent studies of last year's tax rebate have shown, it is very hard to boost the economy with tax cuts.<sup>2</sup> In addition, most taxable dividends are paid to high-income individuals who are likely to save, not spend the added funds.<sup>3</sup>

As for the stock market, it is unclear that increasing the price of stocks is a legitimate ground for government intervention (Alan Greenspan, for one, does not seem to think so). But even if it were, economists disagree about whether the tax on dividends has any impact on the price of shares. A high percentage of corporate equity is held through pension plans and by other tax-exempt institutions that do not pay the tax on dividends. Many corporations, like Microsoft or Intel, do not pay dividends. Thus, it is doubtful that cutting the tax on dividends will have a significant impact on the stock market. And even if it did, current holders of the stock, wealthy individuals who bought the stock at a discounted price anticipating that they would be taxed on future dividends, would get an unjustified windfall.

However, there is a more serious case for exempting dividends, which is that exemption is a form of corporate/shareholder integration, similar to what the U.S. had

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<sup>1</sup>*The Wall Street Journal*, Nov. 11, 2002, p. A1.

<sup>2</sup>See Matthew D. Shapiro and Joel Slemrod, "Consumer Response to Tax Rebates," NBER Working Paper 8672 (Dec. 2001); Matthew D. Shapiro and Joel Slemrod, "Did the 2001 Tax Rebate Stimulate Spending? Evidence From Taxpayer Surveys," NBER Working Paper 9308 (Nov. 2002).

<sup>3</sup>It is interesting that one of the reasons given for cutting back on intergration in Europe (see Appendix) is to discourage corporations from distributing earnings and encouraging them to invest instead. Since one of the problems with the current U.S. economy is underinvestment by corporations, this argument has some relevance here.

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up to 1936.<sup>4</sup> A significant body of academic literature supports integration, and the Treasury proposed the dividend exemption form of integration in 1992.<sup>5</sup> In addition, most of our major trading partners (it is said) have some form of integration.<sup>6</sup>

**The rationale for exempting dividends now is to boost the economy or at least revive the sagging stock market. Neither of these reasons is persuasive as an argument for a major change of our corporate tax structure.**

Or do they? The recent trend, in fact, has been to move away from integration. Integration has been cut back severely in Japan, Germany, and the U.K., and is being reconsidered in Italy and France.<sup>7</sup> Other countries (for example, Singapore) have also recently restricted the scope of integration. Thus, it may still be true that most of our trading partners practice integration (as they have since the 1970s), but perhaps not for long.

What is the reason for this reversal? In a word, it is globalization — or more specifically here, the increasing levels of cross-border equity investments. Integra-

tion has generally not been applied to foreign shareholders (except sometimes in treaties, and except for a brief failed attempt by the Australians in the 1990s).<sup>8</sup> As more and more investors are foreign, integration looks much less appealing to each country. In Europe, there is the added complication that the European Court of Justice is forcing countries to grant integration to investors from other European countries if they grant it to domestic shareholders, which is the major reason for the German and U.K. moves to change from full imputation to partial dividend exemption (rather than extend it to foreign investors).<sup>9</sup>

Thus, this seems to be a good time to re-examine the case for corporate tax integration (via dividend exemption or other means). On a closer look, it turns out that in a globalizing world, this case is much shakier than is commonly thought. In what follows, I will first explain the traditional case for integration and its limitations. I will then examine the drawbacks of integration from an international perspective. Finally, I will make some alternative suggestions about what should be done if we do or do not adopt integration.

### I. The Traditional Case for Integration

Historically, there have been three reasons advanced for countries to adopt corporate/shareholder integration, to overcome biases in the classical system:<sup>10</sup>

1. Under the classical system, there is a bias to conduct business in noncorporate forms, since they are not subject to double taxation (although this is mitigated if the individual rate exceeds the corporate rate, since in corporate form the individual tax can be deferred).
2. Under the classical system, there is a bias to avoid dividend distributions and instead retain earnings, thus avoiding the double tax (this bias is exacerbated when the individual rate exceeds the corporate rate);
3. Under the classical system, there is a bias in favor of capitalizing corporations with debt (producing deductible interest) rather than equity (producing nondeductible dividends).

None of these reasons is completely convincing in the U.S. context, which may be a reason why the U.S. has maintained the classical system since 1936 (and indeed strengthened it in 1986 with the repeal of the *General Utilities* doctrine, which enabled corporations to avoid corporate tax on a distribution of appreciated assets). First, the alleged bias against the corporate form is mitigated by the excess of the individual rate

<sup>4</sup>For an excellent historical review of how dividend exemption was adopted and then abolished see Steven A. Bank, "Corporate Managers, Agency Costs and the Rise of Double Taxation," 44 *William & Mary L. Rev.* 167 (2002). For the reason we have not reinstated the exemption, see Jennifer Arlen and Deborah M. Weiss, "A Political Theory of Corporate Taxation," 105 *Yale L. J.* 325 (1995). In both cases, the blame is put on corporate managers who do not want pressure to pay dividends.

<sup>5</sup>See generally Michael J. Graetz and Alvin C. Warren Jr., *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998); Charles E. McLure Jr., *Must Corporate Income Be Taxed Twice* (Brookings Institution, 1979); "Colloquium on Corporate Integration," 47 *Tax L. Rev.* 427 (1992). For a rare dissent, see Jeffrey L. Kwall, "The Uncertain Case Against the Double Taxation of Corporate Income," 68 *N.C. L. Rev.* 613 (1990).

<sup>6</sup>For a review of the principal systems, see Hugh J. Ault, *Comparative Income Taxation: A Structural Analysis* (Kluwer, 1997), 285-289; Peter A. Harris, *Corporate/Shareholder Income Taxation* (IBFD, 1996).

<sup>7</sup>For Germany, the U.K., and France, see Appendix; for Italy, see Anneliese Egger and Stefano Pellegrini, "Ambitious Reform Bill to Restructure Italy's Corporate Tax Regime," *Tax Notes Int'l*, Oct. 28, 2002, p. 316. In general, of OECD countries, Australia, Canada, Finland, Italy, New Zealand, and Norway currently have full integration; France, Germany, Portugal, Spain, Sweden, and the U.K. have partial integration; Belgium, Denmark, Ireland, Luxembourg, Netherlands, and the U.S. have a classical system. See Howell Zee, "Taxing Capital in a Globalized World," *Tax Notes Int'l*, June 28, 2002, p. 1185; Rainer Niemann, Mark Bachmann, and Deborah Knirsch, "Lessons From the Ruding II Report," *Tax Notes Int'l*, June 25, 2002, p. 1545. This is nowhere near the unanimity of the adoption of VAT, for example (which has now been adopted by all OECD members except the U.S.).

<sup>8</sup>See Hugh J. Ault, "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices," 47 *Tax L. Rev.* 565 (1992); Harris, note 6 *supra*. The international tax regime allocates the right to tax active income to the source country and passive income (including dividends) to the residence country — hence, no integration unless one or the other gives up its right to tax (e.g., by exempting dividends paid by foreign corporations). See generally, Reuven S. Avi-Yonah, "The Structure of International Taxation," 74 *Tex. L. Rev.* 1301 (1996).

<sup>9</sup>For the details, see Appendix.

<sup>10</sup>See Graetz and Warren, note 5 *supra*.

over the corporate rate (although that excess is much lower now than it was before 1986, and is scheduled to disappear) and by the absence of strong provisions to prevent retentions in the domestic context.<sup>11</sup> In addition, under current rules, the classical system applies primarily to large, publicly traded corporations, while small, closely held businesses are able to avoid the double tax even if they are in corporate form for nontax purposes. It is doubtful if there is sufficient substitutability between the two forms of business for the double tax to create much deadweight loss from the bias toward noncorporate form.<sup>12</sup> The double tax is a price large businesses have to pay for access to the public equity markets and the liquidity that accompanies that access. Finally, to the extent that the corporate tax can be shifted to consumers or to labor, the bias disappears, and even the Treasury's 1991 integration study has suggested that considerable shifting can take place.<sup>13</sup> (The bias reappears again if noncorporate businesses can likewise shift the individual tax burden, but it seems plausible that the shifting potential of large multinationals is larger than that of small, closely held businesses.)

Second, the bias in favor of retentions is mitigated by the ability of corporations to redeem shares from shareholders at the favorable capital gains rate, and by the fact that numerous shareholders are tax exempt or corporate (and thus do not pay a full tax on dividends).<sup>14</sup> Indeed, even U.S. corporations that used to pay dividends have now generally moved to structured redemption programs addressed to their taxable individual shareholders.<sup>15</sup> Other corporations (especially high-tech ones) retain all their earnings, but it is not clear that this is primarily tax motivated (corporations used to pay dividends under the same rules in

the past). Finally, there is an unresolved debate among economists whether the dividend tax is capitalized into the price of the shares. If it is, then the retention bias applies only to new equity, but new equity is unlikely to pay dividends for nontax reasons.<sup>16</sup>

Third, the bias in favor of debt and against equity is a general problem of the income tax that should not be addressed only in the corporate tax area.<sup>17</sup> Moreover, to address it completely it is necessary to make dividends not exempt, but rather deductible, a form of integration that is never adopted (in part because it would automatically extend integration to foreign and tax-exempt shareholders). If integration takes the normal forms of imputation or dividend exemption, there is still a difference in treatment between interest and dividends that can be manipulated.<sup>18</sup>

## II. The International Case Against Integration

Even if one accepts the validity of all the alleged biases generated by the classical system set out above, all of them need to be offset by the countervailing biases created by integration in the international context.<sup>19</sup> Two situations need to be considered: when the source country is integrationist and the residence country classical, and when the source country is classical and the residence country integrationist. In the following, I assume the current U.S. (classical) regime; if dividend exemption were adopted here, one would need to switch the examples to treat the U.S. as the integrationist country.

### A. U.S. as Residence Country

If a U.S.-resident portfolio investor invests in shares of a company of an integrationist country, the resulting bias depends on the form taken by integration. If the source country grants integration in the form of dividend exemption, the U.S. investor would not benefit since the U.S. would tax him on the dividend without allowing a foreign tax credit for underlying corporate taxes. A domestic investor in the source country would be subject only to the corporate tax, while the U.S.

<sup>11</sup>The accumulated earnings tax and the personal holding company tax are both weak.

<sup>12</sup>Most estimates of the deadweight loss (DWL) from this bias are quite low — see, e.g., Austan Goolsbee, "The Impact and Inefficiency of the Corporate Income Tax: Evidence From State Organizational Form Data," NBER Working Paper 9141 (September 2002) (an increase in the corporate tax rate by 10 percent reduces the corporate share of firms by 5-10 percent and the corporate share of sales and employment by 2-6 percent). Goolsbee concludes that "[t]he impact of tax rates is an order of magnitude larger than previous estimates . . . and suggests a larger DWL from corporate taxation, but is still relatively modest." As Goolsbee says, previous studies found much lower DWLs.

<sup>13</sup>Graetz and Warren, note 5 *supra*.

<sup>14</sup>In addition, this bias is reduced when (as now) the corporate rate is not significantly lower than the individual rate.

<sup>15</sup>Of course, this can be used as evidence that the lack of integration leads to a distorted choice of the form of distribution. Query, however, whether anybody but the IRS cares about the dividend/redemption distinction. In addition, U.S. corporations used to pay more dividends under the classical regime, and some are reverting to it now because of the signaling effect (showing that profits are for real). Thus, the choice between dividends and redemptions seems to be driven by nontax factors at least as much as by the tax factor. It would be interesting to compare current U.S. practice to other countries that have integration.

<sup>16</sup>The burden would still fall on the shareholders when they sell their shares, but this is mitigated by deferral until sale and by the capital gains preference.

<sup>17</sup>See Alvin C. Warren Jr., "Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.* 460 (1993).

<sup>18</sup>For example, if interest is taxed but dividends are not, you can have clientele effects (tax-exempts will hold bonds and taxable shareholders stock), as well as invest in stock and use derivatives to turn this economically into an investment in bonds (see Warren, note 17 *supra*). Neither of these problems arise if both interest and dividends are deductible or (as under the Treasury's CBIT model, see Graetz and Warren, note 5 *supra*) nondeductible, but neither of these seems to be a practical option politically.

<sup>19</sup>Admittedly, any welfare gain from adopting integration is likely to be experienced mostly by U.S. residents, while the welfare losses arising from integration internationally are likely in the short run to be experienced by foreigners. But from a worldwide efficiency perspective, the two should be netted against each other. In addition, in the long run, worldwide welfare losses are likely to affect the U.S. as well.

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investor would be subject to the corporate tax, any U.S. withholding tax on dividends, and the residual U.S. tax.

If the source country grants integration by way of imputation credits, the key issue is whether those credits are extended to foreign investors (by treaty or otherwise). If (as is typical) the credits are not extended to foreigners, a domestic investor would be subject to tax only at his or her individual rate, while the U.S. investor would be subject to tax at the corporate level, any withholding tax on dividends, and the residual U.S. tax. Whether the combination of these taxes exceeds the source-country tax on domestic investors depends on how high the source-country rates are (it is conceivable, for example, that a combined tax on the U.S. investor of 60 percent would be matched by the single-level source-country tax on a domestic investor).

***Even if one accepts the validity of all the alleged biases generated by the classical system set out in this report, all of them need to be offset by the countervailing biases created by integration in the international context.***

If the imputation credits are extended to U.S. investors, a different bias arises. In that case, both domestic source country and U.S. investors in a foreign corporation would be taxed the same by the source country, but the cost of imputation credits to U.S. investors would be borne by the source country, while any tax on the dividend would be collected by the U.S. From a U.S. perspective, moreover, there would be a bias in favor of investing in source-country corporations and against investing in U.S. corporations, since only dividends from the former would carry the imputation credits. Such a bias would not be eliminated by the U.S. taxing the dividends in full, since the investor would still receive an imputation credit check from the source country not available for her U.S. investment.

#### B. U.S. as Source Country

If the foreign residence country grants integration by way of dividend exemption, presumably the exemption would apply to dividends from U.S. as well as from domestic corporations.<sup>20</sup> In that case, a bias is created in favor of foreign investors in U.S. companies, since they would be exempt from tax on the dividend (unless a U.S. withholding tax applies, but those taxes are generally reduced by treaty or avoided by other devices). By contrast, a U.S. domestic investor would be taxable on the dividends in full.

If the foreign country grants integration by way of imputation credits, there will be no credits available for a foreign investor who invests directly in a U.S. company. In that case, there will be a bias in favor of the foreigner investing in her own country's domestic

<sup>20</sup>This is true for many dividend-exemption countries but not for others.

corporations. This bias may be partially eliminated if credit is given for U.S. taxes to a domestic portfolio investor in a domestic company with U.S.-source income. But, similar to the case of a dividend exemption, that would create a bias in favor of foreign investors in such companies over U.S. investors in a domestic U.S. corporation.

### III. Conclusion and Recommendation

In general, *there seems to be no reason to assume that the biases created by integration from an international perspective are less important than the biases created by the classical system from a domestic perspective.* In fact, the former may be gaining in importance as cross-border investment grows, while (as discussed above) there are reasons to doubt the importance of the latter. This is the reason why many countries (for example, Japan, Germany, and the U.K.) have recently been restricting integration. If the whole world reverted to the classical system, the international biases would be eliminated.<sup>21</sup>

Nevertheless, in the foreseeable future, some countries will continue to grant integration while others are likely to maintain a classical system. In that situation, it is necessary to make a choice between the international biases described above, which is similar to the choice between capital import neutrality (treating all investors in the source country alike) and capital export neutrality (treating all investment opportunities to a resident investor alike). Since most of the empirical evidence continues to suggest that the elasticity of the demand for capital is greater than the elasticity of the supply of capital, most economists would support a continued preference for capital export neutrality (neutrality in the allocation of investments) over capital import neutrality (neutrality in the allocation of savings).

If one prefers capital export neutrality, this suggests that integrationist source countries should not extend integration benefits to foreign investors (since that would violate CEN while maintaining CIN). This is consistent with current practice. When the integrationist country is the residence country, integration benefits should be extended to investments in classical source countries. This can be done by granting integration credits for taxes paid to the source country, either through a domestic corporation (which is common) or even through a foreign corporation (less common but possible — it is equivalent to granting the indirect foreign tax credit to portfolio U.S. investors, which would raise many difficult administrative issues). A simpler solution, however, is to exempt dividends from both domestic and foreign corporations.

<sup>21</sup>The biases may also be eliminated if all countries adopted integration in similar ways. However, under current imputation systems, domestic investment in local companies is generally favored and inbound and outbound investment discouraged (although ordering rules for distributions may mitigate this bias). This situation may persist even if all countries adopted integration. In addition, the current trend seems to be toward abandoning integration rather than adopting it.

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This would still leave a possible bias in the form of a dividend withholding tax imposed by the source country (plus a branch profits tax if the investment is through a foreign corporation), but in the case of the U.S., portfolio investors can usually avoid the dividend withholding tax.

Thus, if the U.S. were to adopt integration, I would recommend dividend exemption as the chosen method, as long as dividends from both domestic and foreign corporations are exempt. This would preserve CEN as far as the U.S. is concerned, but there will still be a bias in favor of investing in domestic corporations to the extent foreign source countries levy a withholding tax on dividends. In addition, foreign investors in U.S. corporations would be disadvantaged compared to

U.S. investors, either because of U.S. withholding taxes on dividends (which the U.S. can and should abolish) or because their country of residence taxes dividends (which the U.S. can do nothing about).

However, the best solution from a U.S. perspective to the above biases is to maintain the current classical system, as the case against it is shaky.<sup>22</sup> A temporary recession and stock market downturn is no reason to abandon our long-standing method of taxing corporations and shareholders.

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<sup>22</sup>In that case, we should consider abolishing the withholding tax on dividends (and the branch profits tax) so as to do our part to reduce the bias against investors from integrationist countries.