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Section 902 Is Too Generous

George Mundstock
University of Miami School of Law, gmundstock@law.miami.edu

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GEORGE MUNDSTOCK*

I. Introduction

Current U.S. tax law contains various provisions that reduce the multiple taxation of income that occurs when a corporation pays a dividend to a corporate shareholder out of income that already has borne corporate tax. In an earlier article, I noted that when the income and corporations have no foreign connection, special treatment for intercorporate dividends, rather than relieving multiple taxation, can provide unjustifiable tax windfalls.[1] This article appraises the special treatment provided by § 902 for dividends paid by foreign corporations to U.S. corporate shareholders.[2] Under this provision, a shareholder is allowed a credit against the U.S. tax on the dividend for foreign corporate taxes imposed on the income underlying the dividend, so that qualifying dividends are subject to reduced or no U.S. tax.[3] Here, as in the domestic context, special treatment of intercorporate dividends seems unjustified. While this treatment might be appropriate in an ideal tax system, the relief provision presents real problems in the current imperfect system.

In Section II of this article, I consider various U.S. international tax policies, particularly the policy against double international taxation. These policies suggest that U.S. tax law should treat intercorporate dividends paid by foreign corporations in a manner similar to the way dividends paid by domestic corporations are treated. In many instances, current law treats foreign dividends more generously. Thus, in order to harmonize the domestic and foreign rules, § 902 should be cut back. Foreign withholding taxes and tax treaties do not change this analysis.

Section II assumes that the current U.S. rules for the taxation of domestic intercorporate dividends are sound. Section III, however,

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* Professor of Law, University of Miami School of Law. The author would like to thank Alan Auerbach, Thomas Barthold, Mary Coombs and participants in a workshop at Boston University School of Law for their help with this article.

[1] George Mundstock, Taxation of Intercorporate Dividends Under an Unintegrated Regime, 44 Tax L. Rev. 1 (1989). The limitations on my earlier work, id. at 1 ns. 2, 3, 2 n.5, other than the limitation to purely domestic dividends, apply here as well.

[2] Throughout this article, a reference to § 902 includes a reference to its companion provision, § 78, unless the context suggests otherwise.

[3] IRC § 902.

attempts to develop the right rules for taxing intercorporate dividends. The general problem presented by intercorporate dividends is the possibility of multiple corporate taxation of the same economic activity. My earlier article presented a nonstandard approach to this problem.[4] Section III applies this approach to § 902. This analysis addresses the complexities presented by international capital flows and trade as well as multiple taxing jurisdictions. Nevertheless, this article reaches the same basic conclusions as the earlier article: The economic effects of the current international system for taxing corporations cause the tax imposed on operating corporations to be borne by a variety of persons. There is no reason to believe that special treatment for intercorporate dividends received, such as § 902, benefits these persons. Thus, § 902 provides a tax windfall to its beneficiaries. The final section briefly summarizes the conclusions.

II. International Taxation

The predecessor to § 902 was enacted in the Revenue Act of 1918, which provided the first general foreign tax credit. This deemed-paid credit was contained in the section that provided the first authority for consolidated corporate returns, however, and not in the general foreign tax credit section.[5] Thus, from its adoption, § 902 has reflected two sets of concerns: the proper taxation of international investment and multiple corporate taxation.[6] This Section evaluates the credit as

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[4] Mundstock, note 1, at 25-39.

[5] Pub. L. No. 65-254, §§ 238, 240, 40 Stat. 1080-82 (1918). See generally Mundstock, note 1, at 4-18 (discussing the history of consolidated returns and their relationship to the taxation of intercorporate dividends). This article does not address the complex issues surrounding dividends from controlled foreign corporations imputed under § 951.

[6] The American Law Institute recently noted:

> The U.S. tax system, although a "two tier" system in which tax is imposed both at the corporate level and again at the shareholder level when corporate earnings are distributed, assures that only a single corporate-level tax is paid. Thus when one U.S. corporation receives a dividend from another, it is allowed [full or partial exclusion of the dividend from income under § 243]. This measure cannot be applied with similar effect in the international context. When a corporation receives a dividend from a foreign corporation, the earnings have not yet borne a U.S. corporate-level tax; nor is there any assurance of the level of foreign corporate tax paid. Accordingly, the dividend is included in the recipient corporation's income to assure at a minimum the payment of a single corporate-level tax at the U.S. rate. But then, just as if the income had been directly received by the U.S. corporation, the corporation is permitted to offset against its U.S. corporate tax liability its foreign corporate-level tax imposed on the earnings. The result is the imposition of only a single corporate-level tax (at the higher of the U.S. or the foreign rate) and the avoidance of international double taxation at the same time.

ALI, Federal Income Tax Project, International Aspects of United States Income Taxation: Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons 377-78 (1987) (footnotes omitted).

a part of the U.S. international tax regime without questioning the current U.S. rules for taxing domestic intercorporate dividends.

U.S. international tax policies suggest that § 902 is too generous. The justification articulated most frequently by tax policy experts for the current U.S. regime for taxing foreign income of U.S. persons is "capital export neutrality": Income taxes should not affect the location of business investment.[7] From the capital export neutrality perspective, dividends from foreign corporations should be treated similarly to dividends from U.S. corporations. To achieve this harmonization, § 902 must conform to the narrower tax exclusion for domestic intercorporate dividends. Moreover, competing U.S. international tax policies provide little support for the current broad credit. Foreign withholding taxes and tax treaties complicate the analysis, but have little impact on the conclusions.

A. *The Basic Deemed-Paid Credit*

Current U.S. law allows domestic persons to elect to credit their foreign taxes against their U.S. tax otherwise due rather than deduct the foreign taxes against taxable income.[8] Taxpayers usually elect the credit. A credit generally is more valuable than a deduction of the same amount, because a credit reduces tax dollar for dollar, while the tax savings from a deduction is a smaller amount determined by multiplying the deduction by the tax rate.[9] The amount of foreign tax allowed as a credit for a year is limited to the U.S. tax on foreign income for that year, with further limitations in the case of taxes attributable to certain types of income.[10] Foreign taxes not allowed as a credit for a given year because of these limitations can be carried back for two years and forward for five years and are creditable in the year to which carried if the relevant limitation for that year exceeds the amount of creditable foreign taxes for that year.[11]

Section 902 provides that, when a foreign corporation pays a dividend to a qualifying shareholder corporation, basically a U.S. domestic corporation that owns 10% or more of the voting stock of the payor corporation,[12] the U.S. shareholder corporation is treated as

[7] Staff of Joint Comm. on Tax'n, 102d Cong., 1st Sess., Factors Affecting the International Competitiveness of the United States 243 (Comm. Print 1991) [hereinafter JCT Competitiveness Report]; Treasury Dep't, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 383 (1985).

[8] IRC §§ 275(a)(4)(A), 901(a).

[9] A deduction might be more valuable than a credit, however, if the actually usable credit is significantly restricted in amount. See Section II.C.

[10] IRC § 904.

[11] IRC § 904(c).

[12] IRC § 902(a), (c).

paying any foreign taxes of the foreign payor corporation that are attributable to the income underlying the dividend.[13] Complicated rules determine the amount of foreign taxes attributable to the dividend.[14] For a 10% or greater ownership interest acquired after 1986, the shareholder corporation is allowed to claim a foreign tax credit only for taxes attributable to dividends paid out of income earned while the shareholder held such interest.[15] Furthermore, § 78 provides that, in determining taxable income, the actual dividend received is increased ("grossed up") by these taxes deemed paid by the shareholder, thereby treating the shareholder exactly as if it received the income underlying the dividend prior to the imposition of the foreign corporate tax and paid the tax itself. Thus, income paid as a dividend to a qualifying U.S. corporate shareholder is treated much as if earned directly by the U.S. shareholder.[16] Section 902 is particularly important, as foreign corporations are not allowed to join in the filing of U.S. consolidated income tax returns.[17]

B. *Capital Export Neutrality*

In order to analyze § 902, it is necessary to understand the regime in which it operates. The United States taxes the worldwide income of U.S. persons (domestic corporations, U.S. citizens, individual U.S. residents, and domestic trusts and estates).[18] Thus, foreign source income[19] of U.S. persons can bear both U.S. and foreign tax. The foreign tax credit mitigates double international taxation.

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13 IRC § 902(a).

14 These complexities suggest current law is problematic. See Section III.

15 IRC §§ 901, 902(c)(3).

16 There are numerous important technical problems in implementing §§ 902 and 78. See generally Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income ¶¶ 23.1-23.19 (1990); Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ B4.09 (1992); 1 Elisabeth A. Owens & Gerald T. Ball, The Indirect Credit 37-194 (1975). One particularly interesting technical problem is how to determine the amount of the corporate tax underlying a dividend in a split-rate regime. See Section II.G. Such problems are only tangentially related to this article, however, and are not considered in detail.

17 IRC §§ 1501, 1504(a)(1), 1504(b)(3). Special rules apply to dividends paid by foreign corporations out of U.S. income. IRC § 245. Section 245 is basically a domestic rule to which the analysis in Mundstock, note 1, applies.

Section 960 works similarly to § 902 for deemed dividends under subpart F. See Section II.D. This article's analysis applies to the subpart F regime, but does not consider this regime in detail.

18 IRC §§ 1, 11, 871, 881, 7701(a)(30).

19 This article does not address the problems associated with determining the geographic source of income. Similarly, this article does not reflect the impact of the rules for allocating interest deductions between U.S. and foreign income. Reg. § 1.861-2, -3. These simplifications do not undermine the article's conclusions.

Congress never has articulated a refined policy analysis for this regime beyond expressing vague concerns that the United States should tax all income of U.S. persons, but without double taxation of foreign income.[20] The theoretical policy ideal that most closely approximates current law is capital export neutrality.[21]

A country's tax system achieves capital export neutrality when the system causes the worldwide network of income taxes to have no effect on the location of the business activity of domestic persons.[22] This is achieved by taxing the worldwide income of domestic persons and allowing them a foreign tax credit.[23] If foreign income were not taxed, there would be an incentive to do business in low-tax foreign countries. With foreign income taxed, merely allowing a deduction for foreign taxes also would interfere with capital export neutrality. An example illustrates this point:

> *Example 1*: Assume that both the United States and the foreign country impose tax at a 35% rate.[24] A foreign branch of a U.S. corporation earns the equivalent of $100. That $100 generates a foreign tax equivalent to $35.[25]

[20] See, e.g., S. Rep. No. 313, 99th Cong., 2d Sess. 293-307, reprinted in 1986-3 C.B. (Vol. 3) 293-307 (1986). This article does not support the basic U.S. regime for the taxation of foreign income of U.S. persons, but merely appraises § 902 in the context of that regime. The article evaluates § 902 under the "theory of the second best." This theory holds that government action which makes the most economic sense in an optimal world might not be the best action in a world in which other government actions have changed economic behavior. The best government action in this second-best world takes into account the impact of these other imperfect government actions. See generally R.G. Lipsey & Kelvin Lancaster, The General Theory of the Second Best, 24 Rev. Econ. Stud. 11 (1956).

[21] See note 7.

[22] JCT Competitiveness Report, note 7, at 243; C. Fred Bergsten, Thomas Horst & Theodore H. Moran, American Multinationals and American Interests 180 (1978); Richard E. Caves, Multinational Enterprise and Economic Analysis 227-29 (1982); Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 1, 36 (Assaf Razin & Joel Slemrod eds., 1990); Daniel J. Frisch, The Economics of International Tax Policy: Some Old and New Approaches, 47 Tax Notes 581, 582-83 (Apr. 30, 1990).

[23] See note 7. Capital export neutrality also would be achieved if foreign countries did not tax U.S. owned businesses operating within their borders and the United States taxed all income of U.S. taxpayers. Id. This unrealistic scenario is not considered in this article.

[24] Foreign definitions of taxable income often differ materially from the U.S. definition. Consequently, the effective foreign tax rate on foreign income determined in accordance with the U.S. definition of taxable income may differ significantly from its stated rate. This is quite important for purposes of evaluating the effects of the entire U.S. regime. See, e.g., James R. Hines, Jr., Taxation and U.S. Multinational Investment, in 2 Tax Policy and the Economy 33, 54-59 (Lawrence H. Summers ed., 1988). It has little impact on the instant analysis of § 902, as this discussion does not depend on any relationship between the foreign and U.S. rates or on the invariability of the foreign rate.

[25] This article does not consider the complexities of foreign currency conversion.

If the foreign tax were merely deductible, the U.S. taxable income would be $65, generating a tax of $22.75, leaving the corporation $42.25 after paying the two taxes. The same activity conducted domestically would generate a $65 after-tax return, because it would bear only the $35 U.S. tax. Thus, exporting capital would be discouraged.

The general foreign tax credit solves the problem. Rather than deducting the foreign tax, the business is allowed a credit for the tax.[26] In *Example 1*, the U.S. income is $100, generating a U.S. tax of $35, but the credit for the $35 foreign tax eliminates any U.S. tax liability, so that the corporation is left with $65 after worldwide income taxes, just as if the income had been earned domestically. Foreign taxes are not an extra burden on foreign activities, if they are creditable dollar for dollar. With crediting, the United States gives up tax revenue in the interest of capital export neutrality. Many other nations allow a similar credit or other tax benefit for investment in the United States[27] so that the United States does not have a complete net revenue loss from pursuing capital export neutrality.

Under these circumstances, it seems appropriate to analyze § 902 in light of capital export neutrality. In many cases, the provision achieves this policy. Consider the following example:

> *Example 2*: Assume that the foreign business in *Example 1* is conducted by a wholly owned foreign subsidiary. The $100 of foreign income bears $35 of foreign tax.[28] The remaining $65 is paid as a dividend to the U.S. parent corporation.

Sections 78 and 902 treat the parent as paying the $35 of foreign tax and receiving a total dividend of $100 ($65 actual dividend plus the $35 of gross up for the taxes it is treated as paying). The foreign tax credit of $35 exactly offsets the U.S. tax of $35 on the $100 dividend, so that the only tax borne by the foreign income is the $35 foreign tax. If the activity had been conducted by a U.S. subsidiary, the subsidiary would have borne $35 of tax and the dividend would have been tax-free to the parent.[29] Here, § 902 treats U.S. and foreign investment similarly so as to achieve capital export neutrality.[30]

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26 See text accompanying notes 8-11.

27 Charles H. Gustafson & Richard C. Pugh, Cases & Materials, Taxation of International Transactions 1991-1993, at 179 (1991).

28 For ease of explication, this article assumes that foreign corporations earn all of their income in the countries in which they are located.

29 IRC § 243(a)(3), (b)(1).

30 James Hines has reported an important empirical discovery: U.S. parent corporations pay a higher percentage of foreign earnings as dividends to the parent corporation's shareholders than are paid out of U.S. earnings. James R. Hines, Jr., Dividends and Profits:

Things are more complex, however, once one moves away from this simple example. As *Example 2* shows, § 902 has effects similar to exempting from tax intercorporate dividends from 10% or more owned foreign corporations. Domestic intercorporate dividends are treated less favorably, however. Exemption is available only for dividends paid by corporations that are 80% or more owned by the payee.[31] If less than 20% is owned, 30% of the dividend is taxable; if the ownership is less than 80% but at least 20%, 20% of the dividend is taxable.[32] Thus, in many instances, § 902 is more generous to foreign dividends than § 243 is to comparable U.S. dividends. Assume in *Example 2* that the domestic corporation owns only 79% of the foreign corporation, but still receives a $65 dividend. Because of § 902, the results are the same as above, no net U.S. tax is owed and the shareholder is left with $65. Where, however, the payor corporation is domestic, the dividend generates a $4.55 U.S. tax (35% tax on 20% of $65), leaving only $60.45. Thus, in this instance, current law treats the foreign dividend more generously than the domestic dividend,[33] a violation of capital export neutrality that loses U.S. and worldwide revenue.

History sheds some light on current law's more favorable treatment of foreign inbound dividends. When the deemed-paid credit was enacted by the Revenue Act of 1918, all domestic intercorporate dividends were completely tax-exempt.[34] Since then, the domestic rules have been tightened,[35] but the international rules failed to keep pace with domestic developments.

In this light, I propose that § 902 at least should be cut back to conform to the current restricted income exclusion for domestic intercorporate dividends. The amount of creditable deemed-paid taxes (but not the income gross up) would be reduced by an amount determined by applying the U.S. tax rate[36] to the amount of grossed up dividends that would be taxed if the payor were a domestic corporation. In *Ex-*

Some Unsubtle Foreign Influences 30 (National Bureau of Economic Research Working Paper No. 3730, 1991). No explanation exists for these findings. Id. at 30-32. The data suggest that traditional analyses of capital export neutrality reflected in this article are problematic. Nevertheless, until alternative analyses are constructed, traditional analyses provide the best methods available for applying capital export neutrality principles.

[31] IRC § 243(a)(3), (b)(1).

[32] IRC § 243(a)(1), (c).

[33] See Michael J. McIntyre, The International Income Tax Rules of the United States § 4-31 (1992).

[34] Pub. L. No. 65-254, § 240, 40 Stat. 1081-82 (1918).

[35] See Mundstock, note 1, at 9-17.

[36] This is equivalent to the taxpayer's marginal tax rate on the grossed up dividends. Were the dividends large enough to place the taxpayer into a higher tax bracket for some portion of them, an average marginal rate would be used. This would happen only rarely because the current U.S. corporate rates become flat quite quickly.

ample 2, $13 of the dividend would be taxable if the foreign corporation were instead domestic. Applying the U.S. rate of 35%, the tax would be $4.55. Thus, only $30.45 of the foreign tax would be creditable, leaving $4.55 of U.S. tax on the intercorporate dividend received and a total worldwide tax of $39.55, both the same as in the domestic context.

Under this proposal, less precise, but acceptable results are achieved when the foreign rate differs from the U.S. rate. First, consider the situation when the foreign tax rate is lower: In *Example 2*, assume that the foreign rate is 20%, while the U.S. rate is 35%. The $100 of foreign income bears $20 of foreign tax. An $80 dividend is distributed. The $100 of grossed up U.S. taxable income generates $35 of U.S. tax prior to the foreign tax credit. Under current law, the shareholder owes a net $15 of U.S. tax, leaving it with $65. Under the proposal, the $20 of creditable taxes would be reduced by $4.55,[37] leaving a net U.S. tax liability of $19.55. The shareholder ends up with $60.45 after worldwide taxes, the same result as when the payor corporation is domestic. Capital export neutrality is achieved.

Second, consider the situation when the foreign tax rate is higher: In *Example 2*, assume that the foreign rate is 50%, while the U.S. rate remains at 35%. The $100 of foreign income bears $50 of foreign tax and a $50 dividend is distributed. Under current law, the shareholder ends up with $50 cash and a $15 credit carryover. Under the proposal, the $50 of creditable taxes would be cut down by $4.55 (35% U.S. tax on 20% of $65), leaving a credit of $45.45. Thus, the shareholder would owe no net U.S. tax, and would have a $10.45 excess credit (usable as a carryover or against other foreign income for the current year) and $50 cash. If the payor corporation had been domestic, the shareholder would have been left with $60.45 cash. A $10.45 credit carryover plus $50 cash (the proposal's treatment with a foreign payor) is not necessarily as valuable as $60.45 of cash (current law's treatment with a domestic payor). Nevertheless, the proposal treats the domestic and foreign investment more similarly than does current law; any difference arises from the limitation on the amount of foreign tax credit, not from the proposal, as discussed in the next section of this article.

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[37] Problems are presented if the foreign rate is so low that the the reduction in creditable taxes exceeds the total foreign taxes. For example, if there are no foreign taxes, dividends received on a foreign portfolio holding bear only the U.S. tax, while dividends from a U.S. holding bear 1.3 U.S. taxes (the tax on the operating company plus the tax on 30% of dividends received). This can be fixed by imposing a U.S. tax when there are no foreign taxes to reduce under the proposal.

Current law's relief for dividends from less than 80% owned domestic corporations applies to any dividends,[38] while § 902 generally is limited to dividends out of income earned while the shareholder held its stock.[39] Capital export neutrality requires similar treatment in the two contexts. If the domestic rule is a given, there is no principled way to decide whether the domestic or foreign rule should be the common rule.[40]

Section 902 does not apply to dividends from less than 10% owned corporations.[41] These dividends are treated more harshly than comparable domestic dividends, only 30% of which are taxable.[42] This violates capital export neutrality. The current 10% ownership rule in § 902 was enacted in 1951 out of an "administrative" concern, presumably that small shareholders might have difficulty calculating the credit and securing access to the required information.[43] For the same reason, it might be appropriate to allow the deemed-paid credit under the proposal only to 10% or more shareholders, notwithstanding capital export neutrality concerns. The administrative concern, however, does not seem very convincing 40 years later. Today's automation and harmonization of international securities markets probably means that most shareholders can determine the credit and acquire any required information readily.

C. *Limitations on the Amount of Credit*

Current U.S. law deviates from capital export neutrality in a number of ways. One arises because the foreign tax credit is limited to the U.S tax on foreign income.[44] This causes foreign investment to bear more tax than domestic investment where the foreign rate exceeds the U.S. rate.[45] An example illustrates the problem:

> *Example 3*: A U.S. corporation's foreign branch has the equivalent of $100 of income. There are no other relevant foreign items. The U.S. rate is 35%, while the foreign rate is

[38] IRC § 243(a)(1).

[39] IRC § 902(c)(3).

[40] Adopting the foreign rule in the domestic context would limit the problem of "dividend stripping" from domestic corporations without the complexities of § 1059. See Mundstock, note 1, at 13-15, 44-47. Section III considers the right rule.

[41] IRC § 902(a).

[42] IRC § 243(a)(1).

[43] See 1 Owens & Ball, note 16, at 45.

[44] IRC § 904(a).

[45] A similar problem arises under § 904's credit limit when U.S. losses offset foreign income.

50%. A $50 foreign tax is generated. U.S. taxable income of $100 generates $35 of U.S. tax.

Because of the limit on the credit, only $35 of the foreign tax is creditable currently, leaving the taxpayer with no U.S. tax liability, $50 in cash and a $15 foreign tax credit carryover. If the branch had been situated in the United States, the only tax would have been a $35 U.S tax, leaving the taxpayer $65 cash. Thus, because of the overall limitation on the foreign tax credit, the foreign investment might bear more tax than a comparable U.S. investment, violating capital export neutrality.

Amendments to § 904(d) in 1986 gave more bite to the limitation on the amount of foreign tax credit.[46] Under prior law, the foreign taxes deemed paid under § 902 as well as most other kinds of foreign income taxes generally were creditable against any U.S. tax generated by any foreign income. This created tax averaging within the limitation that was perceived to be inappropriate.[47] For example, if a taxpayer were subject to U.S. tax at 35% and had the equivalent of $100 of income in each of two foreign countries, one that imposed tax at 50% and the other at 20%, all of the taxpayer's foreign taxes were creditable, since the total foreign tax ($70) did not exceed the U.S. tax on the total foreign income (35% of $200), even though one of the foreign tax rates exceeded the U.S. rate. In other words, the foreign tax credit limitation operated only to the extent that the average foreign rate exceeded the U.S. rate, regardless of whether particular foreign rates exceeded the U.S. rate. This created problems. For example, a corporation with high-taxed foreign income bore a zero net U.S. current tax on income from a new investment in a low-tax country when the resulting increase in the overall limitation on the credit (resulting from the low-taxed foreign income) generated a large current credit (for large amounts of otherwise currently uncreditable high rate foreign taxes) that exceeded the low foreign taxes on the new investment. This violated capital export neutrality. To restrict such averaging opportunities, the overall limitation on the amount of foreign tax credit was subdivided into "baskets" for various kinds of income, so that only foreign taxes paid on income in a basket could be averaged against each other.[48] One basket provides that the taxes

[46] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1201, 100 Stat. 2085, 2520-28.

[47] S. Rep. No. 313, note 20, at 302-05, reprinted in 1986-3 C.B. (vol. 3) 302-05; H.R. Rep. No. 426, 99th Cong., 1st Sess. 333-35, reprinted in 1986-3 C.B. (vol. 2) 333-35.

[48] IRC § 904(d). See S. Rep. No. 313, note 20, at 302-27, reprinted in 1986-3 C.B. (vol. 3) at 302-27; H.R. Rep. No. 426, note 47, at 333-53, reprinted in 1986-3 C.B. (vol. 2) at 333-53. This article takes no position on the soundness of the basket approach. Data suggest the approach causes U.S. persons to invest less in high-tax foreign countries and more in

deemed paid with regard to dividends from a noncontrolled foreign corporation (basically, 50% or less owned) to which § 902 applies can only be credited against the tax generated by dividends from that corporation.[49] Additionally, § 904(d) looks through a dividend from a controlled foreign corporation so that the appropriate portion of the dividend is included within a basket where the dividend is paid out of a type of income which would have been included in a basket if that income had been earned directly.[50]

The apparent basic policy underlying the overall and basket limitations is that, to the extent the foreign rate exceeds the U.S. rate, a credit is not needed to avoid international double taxation, because the United States does not impose so high a tax.[51] Any credit merely would subsidize high foreign taxes.[52] If capital export neutrality is violated, it is the high-tax foreign country's fault.

This section's analysis is not compromised by this variation from capital export neutrality. The high-rate foreign tax version of *Example 2* in the preceding section of this article shows how this section's proposal, like current law as applied to branches, gives no immediate credit for the portion of a high rate foreign tax in excess of the associated U.S. tax.[53] Thus, the proposal advances capital export neutrality while operating consistently with the current limitations on the amount of foreign tax credit. The proposal does no more than eliminate double international taxation.

The baskets do not deal with the problems considered in this section. Averaging can be viewed as providing an additional benefit to considerable foreign investment, whether effected directly through a branch or through a foreign corporation. The baskets reduce the gen-

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low-tax jurisdictions. Joel Slemrod, The Impact of the Tax Reform Act of 1986 on Foreign Direct Investment To and From the United States, in Do Taxes Matter? 168, 176, 192-93 (Joel Slemrod ed., 1990). Notably, however, although averaging within the overall limitation violates perfect capital export neutrality by encouraging investments in low-tax foreign jurisdictions by U.S. persons whose foreign taxes exceed the amount creditable, it advances capital export neutrality in other situations. Without averaging, the limitation on the credit discourages investment in high-tax foreign countries. When high-taxed income can be averaged against low-taxed income, the incentive for marginal investments in low-tax countries is eliminated by increasing the disincentive for marginal investments in high-tax countries. It is not clear whether this is a sound trade-off. Thus, there is no ready way to look at the basket problem. It certainly presents issues beyond the § 902 context.

[49] IRC § 904(d)(1)(E).

[50] IRC § 904(d)(3).

[51] S. Rep. No. 313, note 20, at 295, reprinted in 1986-3 C.B. (vol. 3) at 295; H.R. Rep. No. 426, note 47, at 333, reprinted in 1986-3 C.B. (vol. 2) at 333.

[52] Ault & Bradford, note 22, at 38.

[53] The proposal differs from current law in that it gives a smaller credit carryover. This is more consistent with the current U.S. rules applicable to the taxation of domestic intercorporate dividends.

eral effects of the problem. They do not deal specifically with the problem created by § 902. Consider the following example:

> *Example 4*: Assume that the high and low tax foreign operations in *Example 2* were conducted through two foreign corporations. The U.S. corporate shareholder would be entitled to an 80% exclusion on dividends received from either corporation (which are less than 50% owned) if they were domestic. The corporation in the 20% tax rate jurisdiction could pay an $80 dividend, while the other could pay a $50 dividend. Under these circumstances, applying the overall foreign tax credit limitation and § 902, no U.S. tax would be owed, as in the branch case. The baskets would reduce the U.S. credit with regard to the dividend from the corporation in the 50% tax rate jurisdiction to $35, generating a $15 U.S. tax (and a $15 U.S. foreign tax credit carryover).

The baskets do not address the § 902 problem, however. If the $100 earned in each of the two foreign countries had been earned through a similar investment in a U.S. company, the total corporate tax would have been $40.55. In the two cases where the investment is through foreign corporations, the worldwide tax in the first instance was only $35 ($20 foreign and $15 U.S. tax) and, in the second instance, it was $50 (the $50 foreign tax), but with a $15 U.S. foreign tax credit carryover. Foreign investment is treated more generously than the analogous U.S. investment. The proposal addresses the § 902 problem by raising the tax in the first instance to $40.55, and in the second to $50, but with only a $10.45 carryover.

D. *Deferral of U.S. Tax*

The discussion thus far has glossed over one key feature of current law: It generally respects the corporate entity. This presents a problem in achieving capital export neutrality. Foreign income of foreign corporations is taxed to U.S. shareholders only when paid as dividends.[54] As a consequence, U.S. tax can be deferred indefinitely. This deferral is particularly troublesome where the deferred income is invested in a country with a low foreign tax, such as a foreign tax haven, so that there is a low tax cost to the deferral. Domestic investment cannot achieve similar tax savings. Thus, deferral can benefit foreign investment and undercut capital export neutrality.[55] This

[54] But see IRC §§ 951-964.

[55] Two very thoughtful analyses of deferral are David G. Hartman, Tax Policy and Foreign Direct Investment, 26 J. Pub. Econ. 107 (1985); James R. Hines, Jr. & R. Glenn Hub-

deferral is quite troubling. While Congress intended the variation from capital export neutrality attributable to the limitations on the amount of the foreign tax credit, the variation attributable to deferral might be an unwanted consequence of the entity approach to taxing corporations.[56] Additionally, the credit limit increases U.S. tax revenues, while deferral reduces revenues. Subpart F polices transactions perceived to present the most possibility of deferral abuse. It taxes shareholders of controlled foreign corporations currently on certain kinds of income earned by the controlled corporations, primarily tax-haven and passive income.[57]

Elisabeth Owens and Gerald Ball argue that the deferral problem suggests that further limits on § 902 might be appropriate: Standing by itself, § 902 treats a foreign subsidiary like a foreign branch. The provision must be evaluated as part of the overall regime for taxing foreign investment, however. Deferral gives an advantage to foreign investment. Cutting back § 902 benefits for deferred income would offset these benefits from deferral, although imperfectly. Thus, conclude Owens and Ball, the deemed-paid credit for lower-than-U.S. foreign taxes should be limited to fairly recent taxes.[58] This article, however, accepts the basic structure of current law, including deferral.[59] Thus, this section's proposal does not reflect the Owens and Ball analysis. The proposal does go part way toward addressing their concerns by reducing the number of situations in which dividend income benefits from both deferral and § 902. Section III goes even further.

E. *Other International Policies*

In U.S. tax policy discussions, numerous alternative policies compete with capital export neutrality.[60] The principal examples are "capital import neutrality," which generally supports lower taxes on

bard, Coming Home to America: Dividend Repatriations by U.S. Multinationals (National Bureau of Economic Research Working Paper No. 2931, 1989).

56 Those who prefer capital import neutrality, discussed in Section II.E., to capital export neutrality, as a way to approach foreign investment by U.S. persons sometimes support deferral, as it pushes the U.S. regime closer to capital import neutrality.

57 IRC §§ 951-964. This article takes no position on the policy of subpart F.

58 2 Owens & Ball, note 16, at 330-32.

59 The elimination of deferral presents issues well beyond the scope of this article, such as the desirability of U.S. corporate tax integration for foreign corporations. Integration is discussed briefly at the text accompanying and following note 104.

60 See generally JCT Competitiveness Report, note 7, at 236-48; Bergsten et al., note 22, at 180; David F. Bradford, Untangling the Income Tax 195-97 (1986); Caves, note 22, at ch. 8; Ault & Bradford, note 22, at 29-42; Frisch, note 22, at 581-91; Joel Slemrod, Competitive Advantage and the Optimal Tax Treatment of the Foreign-Source Income of Multinationals: The Case of the United States and Japan, 9 Am. J. Tax Pol'y 113, 116-27 (1991).

foreign investments than does capital export neutrality, and U.S. "national neutrality," which generally supports higher taxes.[61] These policies do not support § 902 in its current form. Moreover, attempting to advance these policies only with § 902 without making other, major changes in the U.S. international tax regime would have pernicious results without advancing any policy. Once again, this article is agnostic on the policies, but simply evaluates § 902 in their light. A reader familiar with the analysis of why it is misguided to try to advance in a single provision a policy inconsistent with the pattern of current law should skip the potentially tedious discussion in this section.

Capital import neutrality looks to equalize the income tax burden on all uses of capital invested in a given country. In contrast, capital export neutrality seeks to equalize the taxes on all uses of capital originating from a given country. Capital import neutrality is achieved when all business activity in a country bears the same tax rate.[62]

The current U.S. regime, which taxes the worldwide income of U.S. persons while allowing a foreign tax credit, violates capital import neutrality. This can be seen in an example:

> *Example 5*: Assume that the U.S. income tax rate is 35%, while the foreign rate is 20%. The taxpayer earns the equivalent of $100 through a foreign branch and has no other relevant foreign items. It bears $20 of foreign tax. The U.S. tax is $35, but the U.S. liability is only $15 ($35 - $20) because of the general foreign tax credit, so that the taxpayer's total worldwide tax liability is $35. A local firm in the foreign country would have been subject to only $20 of tax on the same income, however. The U.S. corporation bears $15 of extra tax, which violates capital import neutrality.

The deferral of U.S. tax through the use of foreign subsidiaries discussed in the preceding section reduces the present value of U.S. taxes on foreign income so as to move the U.S. tax system toward capital import neutrality (but only with regard to U.S. investment in low-tax foreign countries). In order to effect complete capital import neutrality, however, the United States would have to go to a territorial system where the U.S. taxes only U.S. income. Then, in *Example 5*, the U.S. taxpayer's foreign branch would be subject only to the foreign

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[61] Id.

[62] Oswald H. Brownlee, Taxing the Income from U.S. Corporation Investments Abroad 20-22 (1979).

tax, and, thus, would be taxed identically to the foreign taxpayer.[63] Section 902 would serve no purpose in this type of capital import neutrality regime, as there would be no U.S. tax on foreign income against which to claim the credit.

When imbedded in current law, § 902 cannot advance capital import neutrality accurately. Under current law, income earned by a foreign corporation, paid out as dividends to a U.S. corporate shareholder, generates the same amount of corporate tax to the payee as would be imposed if the dividend were paid to a domestic corporation in the foreign country only if (1) the U.S. rate less the foreign corporate rate (the net U.S. tax) equals (2) the effective foreign rate on domestic intercorporate dividends.[64] This result, which would achieve capital import neutrality, seems extraordinarily unlikely. Nevertheless, § 902 does reduce U.S. tax on some foreign income, thus moving the U.S. tax system imperfectly toward territoriality. This might not be a good thing, however, from the perspective of capital import neutrality. If the foreign country does not provide equally generous relief for intercorporate dividends, § 902 could violate capital import neutrality by causing U.S. capital to bear lower taxes than domestic capital in the foreign country.

Another policy that competes with capital export neutrality is U.S. national neutrality. Under U.S. national neutrality, the U.S. income tax system should not affect the location of U.S.-owned businesses. Businesses should make business decisions just as if the U.S. did not impose an income tax. U.S. national neutrality only requires that the U.S. system have no impact on behavior, with no accommodation for the effects of foreign taxes.[65] In contrast, capital export neutrality requires the worldwide network of income taxes to have no effect on behavior. It utilizes the foreign tax credit to avoid the economic distortions that otherwise would result from foreign taxes.

Neither the foreign tax credit nor the territorial system achieves U.S. national neutrality. Consider the following:

> *Example 6*: Assume that both the U.S. and foreign rates are 35%. A U.S. taxpayer earns the equivalent of $100 from a foreign branch. Its return after paying the foreign tax is $65.

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[63] A territorial system, however, violates capital export neutrality. Consider the U.S. taxpayer in the example: If it operates in the United States, it is subject to a 35% tax, while if it operates in the foreign country, it pays only a 20% tax. The tax system encourages capital exporting.

[64] Matters are even more complicated when the § 904 limitation is taken into account. The discussion in the text also ignores taxes on the corporations' shareholders, which further complicate the analysis.

[65] See note 7.

> Thus, an "equivalent" U.S. operation, from the point of view of U.S. national neutrality, would have to earn only $65 prior to U.S. tax, leaving it $42.25 after taxes.

Under a foreign tax credit regime, the foreign operation would pay $35 of foreign tax, have $100 of U.S. taxable income, and be allowed a $35 U.S credit, leaving it $65 after taxes. The foreign operation would be taxed more favorably—in violation of U.S. national neutrality. Under a territorial regime, the foreign operation would bear no U.S. tax, while the domestic operation would, so that again the foreign operation would be treated favorably.

The only way to achieve U.S. national neutrality is to tax foreign income, but only allow a deduction for foreign taxes. Then, in the example, in both the U.S. and foreign cases, the U.S. taxable income would be $65, so that both would have the same $42.25 of after-tax return, and the U.S. tax system, in isolation, would not affect behavior. Sections 78 and 902 would serve no function in such a system, since merely taxing any foreign dividend received achieves U.S. national neutrality by effectively allowing a deduction for foreign taxes due to the taxable dividend necessarily being net of any underlying foreign tax.[66] Section 902 moves the system away from U.S. national neutrality, since a credit generally gives more U.S. tax benefits than are consistent with national neutrality.

F. Foreign Withholding Taxes

Many countries, including the United States,[67] impose withholding taxes on dividends paid to foreigners by domestic corporations of the taxing country.[68] If the foreigners otherwise are not subject to tax in the taxing country, so that there is no tax to credit the withholding tax against, the withholding tax becomes a final tax. U.S. tax law allows U.S. persons that are subject to such taxes by foreign countries to claim these foreign taxes as a credit under the general foreign tax credit.[69] These taxes are relevant here because they frequently are imposed on dividends that generate § 902 credits.

Foreign withholding taxes are nicely handled by the general foreign tax credit, and, thus, have little impact on the conclusions in this section. As shown below, current law does provide credits for foreign

[66] The foreign tax on the underlying income actually might not be paid until after the dividend is paid, but nevertheless, the dividend income economically has borne the foreign tax. Cf. IRC § 905 (foreign tax credit allowed for accrued, but not yet paid, foreign taxes, including § 902 deemed-paid taxes).

[67] IRC §§ 871, 881, 1441, 1442.

[68] Gustafson & Pugh, note 27, at 207.

[69] IRC § 903.

withholding taxes that can be viewed as violating capital export neutrality. A better analysis, however, is that any trouble with these credits are attributable to the current defects in § 902. Thus, any problems with foreign withholding taxes would be nearly eliminated by the proposal, so that these withholding taxes require no special attention. Consider an example:

> *Example 7*: A foreign country imposes a 35% corporate tax and a 20% withholding tax on dividends. The U.S. corporate tax rate is 35%. A domestic corporation in the foreign country earns the equivalent of $100, paying the equivalent of $35 in foreign taxes. The net $65 is paid as a dividend to a U.S. corporate shareholder that qualifies for § 902 (and would qualify under § 243 for 80% exclusion if the dividend were from a domestic corporation).

This dividend triggers the foreign withholding tax for the equivalent of $13. Under current law, the U.S. shareholder has $100 of U.S. income, generating $35 of U.S. tax. This tax is eliminated completely by the $48 foreign tax credit ($13 from the withholding tax plus $35 from § 902), with $13 of creditable taxes not allowed currently as a credit. Thus, the U.S. shareholder keeps the $52 net dividend plus a $13 credit carryover. If the foreign corporation had been domestic, the same $65 dividend would have generated $13 of taxable income and $4.55 of U.S. tax, leaving the U.S. shareholder with $60.45. Under these circumstances, current law treats the two investments differently, which violates capital export neutrality.

The proposal provides more acceptable results, as can be seen in *Example 7*. Under the proposal, only § 902's deemed-paid credit would be cut back. Since the withholding taxes are direct taxes, they would remain creditable under the general foreign tax credit. The amount of creditable foreign corporate tax, however, would be reduced under the proposal. Because it is assumed that 20% of comparable domestic dividends would be taxable, foreign corporate taxes would be cut back by an amount equal to the U.S. tax on 20% of the dividend or $4.55. Thus, only $30.45 of the foreign corporate tax would be creditable. The net U.S. tax would be zero, nevertheless, once credit for the foreign withholding taxes is reflected, with $8.45 of currently unusable credit ($35 – $30.45 – $13 = –$8.45), leaving the taxpayer with $52 cash plus a $8.45 credit carryover. If the corporation had been domestic, the $65 dividend would have generated $4.55 of tax, leaving $60.45. The cash ($52) plus the credit carryover ($8.45) is not as valuable as $60.45 of cash. This result is acceptable, however, since the variation from capital export neutrality is attributable to the limitations on the amount of foreign tax credit.

To generalize, the current U.S. modified capital export neutrality regime accepts the foreign tax burden as if it were fixed and then accommodates the U.S. tax burden to it. Consequently, variations in the foreign burden, including variations attributable to foreign withholding taxes, have little impact on the basic analysis.[70]

G. Tax Treaties and Foreign Corporate Integration

The United States is party to a number of bilateral international income tax treaties that reduce double taxation by the parties to the treaties, provide dispute resolution mechanisms and implement cooperation in tax administration.[71] These treaties contain little that is directly relevant to the analysis of § 902 because they generally have no effect on U.S. taxation of U.S. persons.[72] They do affect the foreign taxation of U.S. persons in one relevant way: These treaties generally provide for reduced foreign withholding tax on foreign dividends paid to U.S. shareholders.[73] In this case, the treaties reduce the total foreign taxes on intercorporate dividends. Here, as in the preceding subsection, however, the rate of withholding tax has little bearing on the analysis.

Some foreign tax systems contain a "gross-up-and-credit" mechanism.[74] Under these systems, when domestic shareholders receive dividends from domestic corporations, the shareholders are allowed to claim a credit for a portion of the corporate tax that was borne by the income underlying the dividends (with the appropriate increase in the amount of taxable dividend, that is, the gross up).[75] A gross-up-and-

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70 This is true only with regard to foreign investments of U.S. persons, the exclusive concern of this article. As to U.S. investments by foreign persons, current law does not pursue capital export neutrality (which would be difficult anyway, since capital export neutrality is a policy of home countries, not investor countries), and the foreign rates present real issues. This is particularly poignant lately, in light of recent foreign withholding tax reductions. See Catherine Hubbard, Practitioner Comments Sought for Possible Revamp of Model Treaty, 56 Tax Notes 403-04 (July 27, 1992).

71 See, e.g., Treasury Dep't, Model Income Tax Convention, June 16, 1981, Tax Treaties (CCH) ¶ 211 [hereinafter U.S. Model Treaty], withdrawn by News Release NB-1900 (July 17, 1992); see also OECD Model Income Tax Convention, July 23, 1992, Tax Treaties (CCH) ¶ 201 [hereinafter OECD Model Treaty].

72 See, e.g., U.S. Model Treaty, note 71, art. 1, ¶ 3.

73 See, e.g., id., art. 10; OECD Model Treaty, note 71, art. 10.

74 See generally Charles E. McLure, Jr., Must Corporate Income Be Taxed Twice? 50-91 (1979). The discussion in the text glosses over mechanical differences in the foreign regimes.

75 For convenience, the grossed up credit is a fixed percentage of the actual dividends. If the payor corporation has not paid enough tax to support its shareholders' credits, the corporation pays the appropriate additional tax.

credit mechanism reflects a concern for the double taxation of corporate income: that corporate income is taxed to the earning corporation and, again, to the shareholders. These systems partially integrate the corporate tax into the shareholder tax so as to reduce or eliminate double corporate taxation.[76]

Treaties with France,[77] Germany[78] and the United Kingdom[79] take account of these countries' gross-up-and-credit mechanisms.[80] The French and U.K. treaties provide U.S. shareholders partial refunds of foreign corporate tax underlying their dividends[81], so that U.S. shareholders are treated more like French and U.K. shareholders.[82] For U.S. income tax purposes, and for French and U.K. withholding tax purposes, these refunds are treated as a further dividend from the payor corporation.[83] In effect, qualifying dividends received by U.S. shareholders are treated as if the underlying income had been subject to a reduced French or U.K. corporate tax. While mechanically different, the German Treaty has the same basic, but smaller effect.[84]

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[76] Concerns regarding the multiple taxation of corporate earnings are explored further in Section III.

[77] Income Tax Convention, July 28, 1967, U.S.-Fr., Tax Treaties (CCH) ¶ 3003 [hereinafter French Treaty].

[78] Income Tax Convention, Aug. 29, 1989, U.S.-F.R.G., Tax Treaties (CCH) ¶ 3249 [hereinafter German Treaty].

[79] Income Tax Convention, Dec. 31, 1975, U.S.-U.K., Tax Treaties (CCH) ¶ 10,903 [hereinafter U.K. Treaty].

[80] For example, the U.K Treaty has rules for allocating any extra U.K. tax on dividends imposed to support U.K. shareholder credits back to the years in which the underlying income was earned in order to determine the U.K. tax attributable to dividends for purposes of § 902. Treasury Dep't, Technical Explanation of the Income Tax Convention, U.S.-U.K., art. XXIII, Tax Treaties (CCH) ¶ 10,941. Since this article's analysis does not focus on such attribution, this feature of the U.K. Treaty has little impact on the instant analysis.

Canada, Australia and Italy have gross-up-and-credit mechanisms, but this tax relief is not reflected in the treaties with the United States. Income Tax Convention, Aug. 16, 1984, U.S.-Can., art. 10, Tax Treaties (CCH) ¶ 1903; Income Tax Convention, Aug. 6, 1982, U.S.-Austl., art. 10, Tax Treaties (CCH) ¶ 503; Income Tax Convention, Apr. 17, 1984, U.S.-Italy, art. 23, Tax Treaties (CCH) ¶ 4803.

[81] In some instances, particularly with § 902 shareholders, the refunds are smaller than the credits given to domestic shareholders, or zero.

[82] French Treaty, note 77, art. 9; U.K. Treaty, note 79, art. 10. The French Treaty gives no credit to U.S. corporate shareholders that own 10% or more of the payor's voting stock, while the U.K. Treaty provides a smaller credit to such shareholders. See also Tax Convention, Dec. 31, 1975, U.S.-U.K., S. Exec. Rep. No. 18, 95th Cong., 2d Sess. 22 (1978); Tax Convention with Japan and Tax Protocol with France, Mar. 8, 1971, S. Exec. Rep. No. 12, 92d Cong., 1st Sess. 4 app. at 5-6 (1971) (Statement of Edwin S. Cohen, Assistant Secretary of the Treasury).

[83] French Treaty, note 77, art. 9; U.K. Treaty, note 79, art. 10.

[84] German Treaty, note 78, art. 10; Tax Convention, Aug. 29, 1989, U.S.-F.R.G., S. Treaty Doc. No. 10, 101st Cong., 2d Sess. 19-23 (1990). The German Treaty reduces the difference in tax treatment between U.S. and German shareholders by reducing the German withholding tax on dividends from German corporations to U.S. shareholders that

In dealing with multiple corporate taxation, the German system provides, in addition to the gross-up-and-credit mechanism, a reduced rate of corporate tax on distributed earnings.[85]

The foreign integration systems and related treaty provisions have no effect on this section's analysis. This section reflects current law's approach: Dividends received should bear the same tax regardless of whether earned domestically or offshore. This approach incorporates both capital export neutrality[86] and the view that dividends bear taxes.[87] Thus, the only relevant feature of the taxation of dividends is how much tax they have borne. Whether other foreign income or other shareholders are taxed differently has no bearing.

H. Section 1248

In most cases where a shareholder that qualifies for § 902 sells the qualifying stock, § 1248 converts the appropriate portion of the amount realized for the stock into a deemed dividend of all income that would qualify for § 902 benefits if the corporation whose stock was sold had distributed all of its retained earnings as a dividend.[88] Thus, when the U.S. shareholder qualifies for § 902, fully taxable gain[89] is converted into a tax-preferred dividend.[90] Congress wanted

own less than 10% of the payor's voting stock (instead of allowing refunds, as in the French and U.K. Treaties) by five percentage points. Id. This reduction is considerably smaller than the parallel French and U.K. credits, however. U.S. law must treat the German dividend received transaction as if the payor corporation paid the large gross dividend that, after a full German withholding tax, would leave the U.S. shareholder with an amount equal to the net dividends actually received. Id. Ignoring the formal distinction between withholding and corporate taxes, however, this regime is equivalent to Germany's reducing its corporate tax (and not the withholding tax) on income paid out as dividends. Id. at 45.

[85] McLure, note 74, at 55-61.

[86] Even though France and the United Kingdom can be viewed as trying to achieve limited capital import neutrality as to U.S. investors, the U.S. modified capital export neutrality regime necessarily undermines this attempt. See David R. Tillinghast, Corporate-Shareholder Integration as an Obstacle to the International Flow of Equity Capital: A Proposal, 56 Tax Notes 1215, 1216 (Aug. 31, 1992). This same basic point was made in the discussion of withholding taxes in Section II.F. The differing treatment of U.S. and non-U.S. investors simply is irrelevant under capital export neutrality, since this approach compares investments, not investors. See id.

[87] This view is rejected in Section III.

[88] Section 1248 was aimed at the then common situation where the foreign tax was low, so that realizing retained earnings by selling stock converted ordinary income that carried only a small foreign tax credit into more tax-preferred capital gain. S. Rep. No. 1881, 87th Cong., 2d Sess. 107-08, reprinted in 1962-3 C.B. 813-15; H.R. Rep. No. 1447, 87th Cong., 2d Sess. 76-77, reprinted in 1962-3 C.B. 480-82. As to corporate shareholders, the capital gains preference no longer is beneficial, so that § 1248 no longer limits opportunities to reduce taxes through creating capital gains. IRC §§ 11, 1201. Under these circumstances, the text does not reflect the historical concern.

[89] Section 1248 only applies if the stock is sold at a gain. IRC § 1248(a). The apparent basis for this rule is that, if stock is sold at a loss, there must be no retained earnings

to treat such a sale, which puts cash in the U.S. shareholder's hands as a result of any retained earnings of the foreign corporation, the same as if those earnings actually had been paid to the U.S. shareholder.[91] An analysis of this policy is beyond the scope of this article. Assuming its validity, the proposal requires no change to § 1248 as the proposal simply would cut back § 902 benefits for § 1248 deemed dividends. It should be noted, however, that capital export neutrality would require similar relief in the domestic context.

III. Multiple Corporate Taxation

The analysis thus far has accepted the traditional analysis of the taxation of intercorporate dividends. Under this analysis, it is inappropriate for the same income to be taxed more than once. In particular, it is wrong to tax dividends paid to a corporation when those dividends already have borne a corporate tax to the payor corporation. Thus, under the traditional analysis, tax relief for payee corporations is appropriate.

In my earlier article,[92] I questioned the conclusion of the traditional analysis that relief for intercorporate dividends received solves the multiple corporate taxation problem. I concluded that, in most cases, such relief does not benefit those who bore the corporate tax on the payor corporation, so that the benefits to the dividend payee effect a windfall rather than reduce multiple taxation.[93] Thus, the benefits for domestic intercorporate dividends should be cut back considerably. If so, the analysis in Section II suggests that capital export neutrality requires a parallel narrowing of § 902. Rather than repeat analysis of the domestic issue here, however, the ensuing discussion applies the basic approach of the earlier work directly to § 902 and focuses on the components of the earlier analysis most important in the international context. The analysis reflects capital export neutrality and takes into account open international markets.

attributable to the time the selling shareholder owned its shares. See H.R. Rep. No. 1447, note 88, at 76-77, reprinted in 1962-3 C.B. at 480-82. Of course, if a corporation experiences a large unrealized loss on its assets, its stock can decline in value even if the corporation has retained operating earnings in the period in which the assets lose value. In this case, on the sale of the stock for a loss, the retained earnings still could be treated as a dividend with an offsetting increase in the loss. This article does not consider problems presented by losses, however, so that this quirk in current law is not considered further.

[90] Section 1248 can affect a taxpayer adversely when it triggers a small credit and any capital gain would have been sheltered by an otherwise unusable capital loss. See IRC §§ 1211(a), 1212(a).

[91] S. Rep. No. 1881, note 88, at 107-08, reprinted in 1962-3 C.B. at 813-15; H.R. Rep. No. 1447, note 88, at 76-77, reprinted in 1962-3 C.B. at 480-82.

[92] Mundstock, note 1, at 25-39.

[93] Id.

A. *Incidence at the Market*

Economic activity should not bear multiple levels of corporate tax, whether U.S. or foreign. The Code deals with multiple levels of corporate tax by giving tax relief—with an exclusion for domestic dividends[94] and a deemed-paid credit for foreign dividends—to corporate shareholders when they receive intercorporate dividends.[95] This regime gives relief to dividend-payee corporations, and not to the dividend-payor corporations that incurred the original corporate tax; and it gives relief when the income is paid out as dividends and not as earned. The theory underlying this regime is that the problem is *income* bearing multiple taxes, and that relief to the payee when the income would otherwise bear another layer of corporate tax reduces the multiple taxation of *income*. Unfortunately, this reification of "income" into a taxpayer obscures the true economics. Things do not bear tax; people bear tax. Special treatment for intercorporate dividends received makes sense as a way to reduce multiple corporate taxation only if the preference benefits those who bore the underlying corporate tax. Thus, it is important to understand who bears the corporate tax.

The incidence of the corporate tax, even looking at only one closed economy, is one of the most difficult questions in economics; once multiple open economies and multiple taxing authorities and the consequences of currency exchange are taken into account, the question becomes nearly unanswerable and certainly unanswered. Traditionally, many viewed the tax as borne by investors (through lower returns on their investments). More recently, many believe that the tax is borne by consumers (through higher prices) or wage earners (through lower wages), particularly once international capital flows between open economies are taken into account. The tax probably is borne by a variety of economic players.[96]

B. *Shooting at a Moving Target*

In light of the complex and uncertain incidence of a corporate tax in the international arena, the futility of special tax treatment for inter-

[94] IRC § 243(a).

[95] IRC § 902(a).

[96] Richard Goode, Government Finance in Developing Countries 80-84, 113-16 (1984), and Mundstock, note 1, at 18-39, summarize most of the literature. Some more recent work is Richard Goode, Forward Shifting of the Corporate Tax in the Presence of Competing Imports: A Reply, 44 Pub. Fin. 327 (1989); Roger H. Gordon, Can Capital Income Taxes Survive in Open Economies? (National Bureau of Economic Research Working Paper No. 3416, 1990); Suresh Narayanan, Forward-Shifting of the Corporate Tax in the Presence of Competing Imports: A Note, 44 Pub. Fin. 320 (1989); Hans-Werner Sinn, Share Repurchases, the "New" View, and the Cost of Capital, 36 Econ. Letters 187 (1991).

corporate dividends received is apparent. This Subsection looks at tax benefits for dividends received from stock purchased on the market and Section III.D. considers stock acquired from the issuing corporation.

Tax benefits for intercorporate dividends probably do not benefit the persons who bore the underlying tax on the operating payor corporation. For example, it would be a surprising coincidence if a deemed-paid credit to Chrysler with regard to dividends it receives on its Mitsubishi stock benefits the persons who bore the tax, perhaps years before the dividend payment, on the income underlying those dividends. As Chrysler bears a lower tax on Mitsubishi dividends than a similarly situated U.S. individual investor, Chrysler receives a windfall after-tax return.

By focusing on whether § 902 creates windfalls, one can see the economic analysis underlying this example. A tax windfall arises when a taxpayer receives an after-tax return on an investment that is higher than the after-tax return that the taxpayer generally receives on its investments. Thus, a tax preference for income from a given investment does not result in a net windfall to the extent the pretax return on the investment is appropriately less because of the tax preference. For example, current law allows a tax exemption for interest on a variety of state and local obligations,[97] yet that exemption is not viewed as a complete windfall, since the yields on those bonds are lower (prices are higher) as a consequence of the tax exemption.[98] The after-tax

[97] IRC § 103.

[98] Windfalls still arise to the extent some receive more preference than others in the market: Assume that there are two taxpayers, one in the 25% bracket and one in the 50% bracket. Taxable interest rates are a 10% annual yield. Investors are indifferent between the nontax characteristics of taxable and tax-exempt obligations. In order to sell a tax-exempt obligation to the 50% bracket taxpayer, a borrower need pay only a 5% annual yield, as 5% is the after-tax yield to a 50% bracket taxpayer on a fully taxable obligation. To attract the 25% bracket taxpayer, the borrower must pay a 7.5% annual yield in order to match the after-tax yield on a taxable obligation. A 50% bracket taxpayer who buys this 7.5% tax-exempt obligation earns a yield two and one-half percentage points higher than it could earn on a taxable obligation. The 50% bracket taxpayer enjoys a relative preference, a windfall. To generalize, a taxpayer whose relative tax preference is greater than those of the investors who set the market price receives a tax windfall from its extra tax preference.

The analysis in the preceding paragraph is oversimple in one important regard. The investors might not be indifferent between the two types of obligations, as assumed. Diversification concerns might make the 25% bracket investor want tax-exempt obligations more than taxable, so that it would accept a yield on a tax-exempt obligation of less than 7.5%, even though that would cause the tax-exempt obligation to have a lower after-tax return than a taxable obligation. If so, the net economic windfall to the 50% bracket taxpayer is not a full two and one-half percentage points of yield. The tax windfall is partially offset by the nontax cost of acquiring the tax-favored asset (buying an asset that it values less than the market). Nevertheless, there is still a meaningful windfall. This limitation on the basic windfall analysis seems forced in this simple example, but is quite real when one looks at complex markets containing investment products, such as stock, futures, equities returns on tax-exempt obligations roughly approximate the after-tax returns on alternate investments. Matters are different, however, with a preference for intercorporate dividends received. After all, in most markets individuals buy the same stock as corporations[99] at the same price, and individuals do not receive a relative tax preference. Under these circumstances, the market price of stock must be sufficiently low so that stock is an attractive investment for investors who do not receive a relative tax benefit. The price of stock does not adjust for the preference for intercorporate dividends received, unlike the price of state and local obligations.[100] Thus, corporate shareholders receiving a tax-reduced or tax-exempt return on corporate stock get a relatively higher after-tax return on stock than on alternative investments, a tax windfall. Of course, if, for nontax reasons, a corporate shareholder finds stock a less attractive investment than alternative investments, the net economic windfall from owning stock is less than this tax benefit.[101]

Turning around this analysis of who benefits from a preference for intercorporate dividends received, one can see why the preference does not reduce multiple corporate taxation. The preference would make sense if it benefitted those who bore the underlying corporate tax. This could happen if the market passed the preference benefits from payee corporate shareholders to others. Comparing stock with tax-exempt obligations again illustrates how this could occur. The lower yields on (higher prices for) tax-exempt obligations pass much of the benefit of the holders' tax exemption back to the borrower or other beneficiaries who are able to borrow at low interest rates as a consequence of the exemption. If § 902-like benefits applied to all corporate dividends, a similar transfer of the benefits of the preference would be possible. Then, if the underlying tax is borne by consumers or wage earners and the preference appropriately raised the price of stock, the higher stock prices would make it easier for corporations to raise capital, lowering their cost of capital so as to offset the

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and options, with wildly different nontax characteristics. This is discussed further in note 101.

[99] For an example of a market where this does not happen, the U.S. market in preferred stock, see Mundstock, note 1, at 54-60.

[100] Foreigners do not buy the low-yielding tax-exempt U.S. state and local obligations, since any benefits in their home country for U.S.-sourced interest apply to higher-yielding U.S. taxable instruments.

[101] Noncorporate investors with a smaller relative tax preference on stock than corporations have, might want corporate stock more than alternative investments to achieve some diversification goal. If so, the price of corporate stock will be relatively high resulting in a lower return. Under these circumstances, the corporations do not find stock particularly desirable, and the windfall to corporations from holding corporate stock is reduced. This concern is discussed in an analogous context at note 98.

increased cost of capital from the corporate tax, which presumably would cause corporate management to reverse, at least in part, any increase in prices or decrease in wages that was caused by the increase in the cost of capital attributable to the corporate tax. The preference benefits would pass to consumers or wage earners. If the underlying corporate tax is borne by shareholders (or all investors) through lower stock values (or lower returns on all investments, as alternate investments need offer less to compete with stock on an after-tax basis) and the preference appropriately raised the price of stock (or increased the return on all investments, as nonstock investments provide competitive returns with stock), the preference would offset the underlying corporate tax and reduce multiple corporate taxation. Unfortunately, in the instant case, a preference that is limited to intercorporate dividends received is not sufficiently broad to affect the market price, so that the preference cannot flow through to the persons who should benefit. The preference shoots at a rapidly moving target and misses.

It is important to focus on what drives this section's analysis. As long as the international stock markets operate so that the relatively tax-preferred investor can buy stock at the same price as others, the market prevents a tax preference for intercorporate dividends received from eliminating multiple corporate taxation.[102] Under these circumstances, reflecting open international markets reinforces the analysis of the taxation of intercorporate dividends presented in my earlier article.[103] Of course, a foreign market might operate differently. For example, a foreign government could require U.S. corporations to buy a stock at a higher price than other investors, which price offsets the corporations' U.S. tax benefit. This section's analysis should apply to most markets, however.

The presence of low- or no-tax persons (U.S. or foreign) in the market that bear as little tax on dividends as do U.S. corporations that benefit from the special rules for intercorporate dividends received does not change this analysis. What is important is that U.S. corporations get a relative tax benefit with regard to stock that is not available to others in the market, not that others might bear similarly low tax

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[102] There is another, relatively unlikely, situation where a tax preference for intercorporate dividends does not result in after-tax windfalls: If the market operates so that corporate pretax returns on fully taxable, nonstock investments are greater than the pretax return on stock by the value of the preference for intercorporate dividends, the preference merely equalizes the treatment of stock and nonstock investments. As long as individuals and partnerships can buy the same assets as corporations, this should not happen, however. Individuals would arbitrage between the stock and nonstock markets so as to reduce the different pretax returns.

[103] Mundstock, note 1.

burdens. Consider the most extreme case: the market price for stock of a foreign corporation set by foreigners that pay no tax, including withholding taxes. The foreigner buys the stock when its risk-adjusted after-tax return is preferable—or at least equal—to returns on comparable investments, such as debt instruments. For the foreigner, the after-tax return equals the pretax return. It shops among investments by looking at pretax returns. Thus, the market price for the corporate stock should give pretax returns comparable to the pretax returns on alternate investments. The foreigner gets the same after-tax return on the stock as on alternate investments. It does not get a tax windfall. Now, look at how a taxable U.S. corporation fares in this market. Most of the corporation's potential investments bear a full tax. Corporate stock, however, is relatively tax-preferred. Thus, corporate stock generates a much better than average, windfall, after-tax return *to it.* To generalize, when a taxpayer receives a *relative* tax preference with regard to corporate stock, as long as the market price is set by investors who are not allowed comparable (U.S. or foreign) *relative* tax benefits, the preference creates windfalls.

This section's analysis is consistent with the general concern for multiple corporate taxation and the concern for corporate tax integration. For some time, many have been troubled by a regime, like current U.S. law, where corporate income is taxed at least twice, once to the earning corporation, and again to the shareholders when realized through dividends or gain on their stock.[104] Those concerned wonder whether a system where the corporate tax is integrated into the individual tax so that corporate income is taxed only once might be preferable to the current unintegrated system. This article is agnostic on the desirability of such integration. The point here is that, while reduced tax on intercorporate dividends might make sense in an integrated system, an unintegrated regime probably has economic effects that prevent the tax preference from reaching its intended beneficiaries. For example, if double corporate taxation generally were dealt with by allowing all shareholders (corporate or individual) a gross up and credit for all (U.S. and foreign) corporate tax on the income underlying dividends received (similarly to the European systems discussed in Section II.G.), all dividends would be tax-preferred (compared to, say, interest), so that the market could respond with higher stock prices. In contrast, the current U.S. rules give special treatment only to U.S. corporate shareholders, so that these rules cannot so affect the market price (as long as other kinds of investors set this price), and, therefore, can effect only windfalls to the specially

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104 Most recently, and prominently, see Treasury Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992).

treated U.S. corporate shareholders.[105] This is true even if all foreign regimes provide similar benefits to corporate shareholders, as, even under these circumstances, the benefitted shareholders do not set the market price.

In short, under this analysis, § 902 should not apply to purchased stock. This reform, however, should be part of a larger reform of the taxation of intercorporate dividends. Simply repealing §§ 78 and 902, so that inbound foreign dividends are taxed more harshly than domestic, would violate capital export neutrality.

C. *Current Law's Limitations*

Section 902's limitation on dividends qualifying for the deemed-paid credit, in many cases, to dividends out of income earned while the payee was a shareholder, does not mitigate the basic problem with § 902. Limiting the credit in this fashion so as to target corporate multiple taxation makes sense if, as to dividends paid out of income earned while a shareholder held its shares, the shareholder bears both (1) the taxes on the dividends received and (2) the corporate taxes on the underlying income. Matters are not this simple, however. The market takes expected taxes into account. Again, consider tax-exempt obligations. Their price is higher (giving lower yields) because the market takes expected future tax benefits into account. Similarly, if the market expected future extra tax burdens, there would be a lower current price reflecting future tax burdens. This market repricing for expected future tax effects protects shareholders from bearing all taxes associated with dividends paid out of income earned while the shares were held. The price of stock reflects that net after-tax dividends are expected to be smaller because of future corporate and dividend taxes. Corporate shareholders enjoy this "low" price. Consequently, because the market takes expected taxes into account, even if corporate shareholders seem to bear all taxes associated with dividends received, the shareholders do not bear all of the taxes, since, in effect, they were compensated for the extra taxes in advance through a lower share price. In short, the circumstances under which the § 902 limitation to dividends out of income earned while the payee held its qualifying interest would be sound, simply cannot occur.

The various § 904 limitations on the amount of the foreign tax credit do not address the defects in current § 902. In the case of dividends paid by a corporation not controlled by the payee shareholder, current law still allows a current credit for all foreign taxes up to the

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[105] Mundstock, note 1, at 36-39.

current U.S. tax on the dividend.[106] Any credit presents windfall potential. In the case of dividends paid by a controlled corporation, the results are far more complicated. It is possible that some portion of the foreign tax deemed paid by operation of § 902 will be subject to a limitation that prevents any portion of the tax from being creditable, even taking into account carrybacks and carryforwards. Nevertheless, most such dividends probably result in at least some credit at some time.[107] Again, windfalls seem likely.

D. *Similarities with Branches*

Thus far, the discussion in this Section has focused on U.S. shareholders that purchased their stock in the market. Where, however, stock is acquired from the issuing corporation, the prior analysis does not apply. Moreover, a consideration of this case motivates an important insight into the intuition that subsidiaries should be taxed like branches.

Where a shareholder buys stock from the issuing corporation, it is far more likely that tax benefits to that shareholder with respect to that stock actually reduce multiple corporate taxation. To see this, it is helpful to think about who bears the multiple corporate tax. If any shareholders bear the extra tax, the old shareholders in place when the corporation issues new stock are the most likely candidates. The shareholders who buy newly issued stock are able to demand low prices reflecting any extra tax they bear, much like shareholders who buy on the market.[108] This low price dilutes the value of the old shares. The old shareholders might be willing to accept this dilution if no cheaper source of capital is available (and the investment opportunity is attractive even taking the dilution into account). Under these circumstances, special benefits for the new shareholders can address multiple taxation.[109] If the new shareholders are allowed a benefit like § 902, they will pay more for newly issued stock. This higher price reduces the old shareholders' dilution and its consequences. Multiple corporate taxation is reduced.[110]

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106 IRC §§ 904(a), 903, 901.

107 Of course, part of the deemed-paid credit mechanism is the grossed up dividend under § 78. As a consequence of the § 904(d) credit limitations, it is possible for the extra tax resulting from § 78 to exceed any benefit from § 902. This case seems sufficiently unusual that it is not considered further.

108 See text accompanying note 99.

109 This analysis also applies to stock newly issued to individuals.

110 Mundstock, note 1, at 40-42, 67 n.269, sets out the basic argument in the domestic context. The approach used in my earlier work is applied to foreign subsidiaries, with no change in the conclusions, in Hartman, note 55, at 120; Hans-Werner Sinn, Taxation and

Now, it is possible to identify the economic insight underlying the common comparison of a branch with a subsidiary. If the subsidiary were formed by the parent corporation, relief for intercorporate dividends makes sense. A branch and a parent-formed subsidiary are similar. If the subsidiary were purchased in a market that contained investors who do not receive a comparable preference, however, such relief effects windfalls, as the market price probably reflected a discount for multiple taxation. A branch and such a purchased subsidiary are not similar. The key is not a vague resemblance between a subsidiary and a branch, but a more precise tax similarity between a formed subsidiary and a branch (or between a share of a formed corporate joint venture and a partnership).[111]

In light of this analysis, § 902 could be made available to corporate shareholders who bought their stock as part of an issue sold solely to corporations (that are allowed the U.S. or parallel foreign benefits). A tax preference is appropriate here,[112] but not in the general case, because here it comes into play early enough in the life of the relevant corporate capital (stock issued) that it is likely to do some good—by increasing the prices at which shares are sold at issuance. A tax benefit that applies after stock is issued might be too late and cause windfalls.

The proposal's limitation on tax benefits to stock issued in a transaction in which all buyers receive similar benefits is needed to prevent windfalls. If any stock is issued to an investor that does not receive a relative tax benefit, the share price in the stock issue might not be marked up fully to reflect the U.S. tax benefit. Under these circumstances, the credit would effect windfalls for the U.S. corporate shareholders. To prevent this, the deemed-paid credit should be allowed only if all investors buying stock in a given issue are corporations whose home countries provide parallel relief (that is appropriately limited so as to preclude windfalls). The best way to implement this at first might be to allow benefits only with respect to stock sold in an issue placed exclusively with U.S. corporations, and then subsequently to expand benefits by treaty.

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the Birth of Foreign Subsidiaries 29-30 (National Bureau of Economic Research Working Paper No. 3519, 1990).

[111] Id. It should be noted that the same critique of the branch-like notion applies to distinctions drawn in the tax treaties (discussed in Section II.G.) between dividends paid on portfolio stock and dividends received by shareholders with larger than portfolio interests in the payors for purposes of (1) the amount of withholding tax and (2) the application of any rules accommodating foreign countries' partial integration mechanisms.

[112] This article does not address the issue of whether the United States should finance the elimination of a foreign corporate tax, as this article accepts the approach of current § 902, which results in the United States so doing. An examination of whether this makes any sense is beyond the scope of this article. See generally McLure, note 74, at 185-214.

A deemed-paid credit rather than, say, a simpler exclusion for dividends on qualified stock is used here to reduce multiple corporate taxation. The more complicated mechanism is needed for the same reasons that apparently it is used under current law: to prevent excess U.S. tax benefits for dividends paid out of low-taxed foreign income.[113] If such dividends were excludable from income, a foreign subsidiary would bear less worldwide tax than a foreign branch, which is unacceptable.

One nice feature of the deemed-paid credit relief under this section's proposal, as compared to current law, is that it is simply a crude offset for various tax effects, not a misguided attempt at a precise reduction in multiple corporate taxation. Thus, it is not as important here, as it is under current law, to figure out the exact income distributed as dividends and the taxes attributable to that income. Similarly, it would not be necessary to limit the relief to dividends out of income earned while the shareholder held its interest. The actual tax benefit merely must approximate the benefit expected when the shares were bought. Under these circumstances, it might be appropriate to provide rules that are simpler than the current rules. Additionally, it might be reasonable to limit benefits for less-than-10%-owned shares for administrative reasons.[114] The deemed-paid credit benefits for foreign stock, however, should approximate the benefits for domestic stock.

A further question is what to do when a shareholder previously allowed this special deemed-paid credit sells its stock. If the stock sold at a normal price and the sale had the normal tax consequences, the seller would owe a tax on any gain with no credit benefits; if the seller had held on to the stock, it would have continued to enjoy benefits. Additionally, the buyer would not get the same benefits the seller would have received, pushing the price down. In other words, a stock sale presents two intertwined problems: (1) a tax on gain and (2) the loss of future tax benefits undermining share values. Anticipating these problems where stock is sold, potential stock purchasers at issue would demand a lower price at that time to give them a cushion against these possible untoward future consequences. Thus, failure to address these problems would undermine the deemed-paid credit's reduction of multiple corporate taxation.

An easy solution to the tax-on-sale problem would be to exempt from taxation any sale of stock that qualifies for the deemed-paid credit under this section's proposal.[115] Exemption, however, might be

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[113] See note 6.

[114] See Section II.C.

[115] The economic issues here are considered in Mundstock, note 1, at 31 n.172.

too generous. Not only gain attributable to the retained earnings of the issuing corporation, but also gain attributable to unrealized gain on the issuing corporation's assets, would escape tax. This section's analysis has little to say about when this gain should be taxed.[116] Tax exemption would treat a sale of stock more generously than a sale of a branch, however. Thus, the easy solution is not obviously desirable.

Another solution would tax these stock sales, but apply § 1248 (without the limitation to earnings attributable to the period of stock ownership). The deemed-paid credit triggered by the § 1248 deemed dividend would apply with respect to the retained earnings of the corporation whose stock is sold on the day of sale.[117] Thus, an amount of the shareholder's gain equal to its share of the investee corporation's retained earnings would be tax-preferred. Ignoring differences in the U.S. and foreign rates and problems presented by the limitation on the foreign tax credit, this § 1248 approach approximates taxing only gain attributable to appreciation in the issuing corporation's assets, with no associated credit.[118]

Both the no-tax and the tax-and-§ 1248 regimes contemplated in the preceding paragraphs address only the tax-on-sale problem. The problem resulting from a loss of future benefits deflating stock prices also must be faced. To do this, the deemed-paid credit could apply to U.S. corporate shareholders that buy from a qualifying U.S. corporate shareholder (with appropriate expansion to other corporate shareholders by treaty). Then, the corporation selling stock will be able to get a high price because of the buyer's tax benefits. This high price prevents the buyer from receiving a tax windfall.[119] (In this case, the relevant market is taxpayers who receive similar relative preferences, so that the stock price will be sufficiently high that a windfall does not arise.) More importantly, the promise of this high price on a future sale should prevent a potential purchaser of newly issued stock from demanding a low price on issue that effects multiple corporate taxation. As always, the domestic rules should work similarly. There is a

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116 This section's analysis also has little to say about how this gain should be taxed; that is, whether credit should be allowed for (estimated) foreign taxes that will be incurred when the issuing corporation realizes the gain (through sale or reduced depreciation).

117 At this point, it is assumed basically that the selling shareholder has owned the sold stock from the birth of the issuer, so that there is no question with regard to earnings retained prior to stock ownership.

118 Mundstock, note 1, at 62, proposed a simpler basis adjustment to achieve the same result in the domestic context. Section 1248's approach is used here for the same reason that a deemed-paid credit rather than exemption is used for actual dividends. See text accompanying notes 89-91.

Issues presented by losses are beyond the scope of this article. See Reg. § 1.1502-20 (draconian rules to deal with losses on sales of stock in consolidated groups); note 89.

119 Mundstock, note 1, at 62.

problem, however. Only certain buyers would qualify for the tax benefit, so that this approach would not deal fully with the sale problem and could interfere with stock sale decisions in a troublesome manner. Unfortunately, allowing benefits to noncorporate buyers from qualifying shareholders, the only other apparent approach, seems unworkable. Under such a regime, individual shareholders would be allowed benefits on certain stock purchased from some corporations and not on any other stock. The recordkeeping, compliance and enforcement problems associated with keeping track of individuals' shares depending upon from whom the shares were purchased could be substantial.

Allowing buyers the same benefits as their sellers presents a problem under the § 1248 approach: underlying income receiving a double benefit. The basic economics are best understood by comparing § 1248 treatment in a sale to the treatment that would have resulted if the stock had not been sold, but rather the issuing corporation had actually paid the § 1248 deemed dividend and the payee shareholder had reinvested the dividend in the payor corporation. In the actual dividend case, the reinvestment can be pulled out tax-free at some point. Under the proposal, when the buyer gets the parallel distribution, it gets § 902 benefits that might be more (or less) generous than exemption (depending upon the foreign rate and how the credit limitations affect the payee). To address this problem, the proposal could provide rules that treat the buyer in a manner more similar to treatment of the ongoing shareholder that made a reinvestment (by providing that distributions of the deemed reinvestment are merely tax-free). In the sale situation, however, because of the tax on any gain beyond that attributable to retained earnings, the double benefit should not drive too many transactions. Thus, the problem might not justify the complexity of the anti-abuse rule.

E. *Withholding, Treaties, Integration and § 1248*

The foreign withholding taxes[120] have little impact on the analysis in this section. Withholding taxes on dividends are an additional tax that arises solely as a result of the cross-border ownership of stock. Consequently, these taxes probably are not reflected in the price of purchased stock. Allowing the foreign tax credit for these taxes, thus, is not likely to effect windfalls. Moreover, such credit (subject to the normal limitations) is required by current law's limited capital export neutrality. Treaties[121] also generally have no impact on this section's conclusions.

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[120] See Section II.F.

[121] See Section II.G.

In a liquid and large worldwide open economy, withholding taxes on dividends paid to foreigners that are not allowed as a tax deduction or credit on the foreign payee shareholder's home country tax return probably are borne by that payee. If the stock price were discounted to reflect these taxes, shareholders in the payor corporation's home country, whose dividends received were not subject to the withholding tax, would receive an above-market after-tax return. If so, investors in this country would quickly buy up all stock owned by persons subject to the withholding tax (who would be willing to sell, as the stock does not provide them above-market returns). This would bid the price up to a market price that would not reflect the withholding tax. At this price, shareholders would bear the withholding tax.

Under these circumstances and assumptions, a foreign tax credit would be needed to effect capital export neutrality. A U.S. investment by a U.S. investor does not bear a withholding tax. In order to treat an investment by a U.S. corporate investor in a country that imposes a withholding tax similarly, the effects of the foreign withholding tax must be taken into account. Crediting, rather than deducting, is required to achieve capital export neutrality for withholding taxes for the same reasons that crediting is required for foreign income taxes. The policies underlying current law's limitations on the amount of credit also support applying the current limitations to credits of these foreign withholding taxes.

U.S. income tax treaties generally have no impact on U.S. income taxation of intercorporate dividends (other than on the amount of creditable withholding taxes). The provisions in the treaties with France, Germany and the U.K. dealing with these countries' gross-up-and-credit mechanisms do present a few problems under this section's analysis, however. The treaties provide partial refunds of foreign corporate taxes underlying dividends received by some U.S. shareholders (or the equivalent, in the case of Germany).[122] As to purchased stock, if the price is set by taxpayers that receive credits or refunds of French, German or U.K. tax, which seems likely, the price will be relatively high to reflect that benefit. Under these circumstances, if a U.S. investor buys such stock and does not receive parallel benefits, it bears excess taxes (through a high price) in violation of capital export neutrality. Thus, similar treatment for U.S. shareholders is required to achieve capital export neutrality.[123] To the extent the treaties do not provide benefits to U.S. shareholders that are equivalent to the

[122] French Treaty, note 77, art. 9; U.K. Treaty, note 79; German Treaty, note 78, art. 10.

[123] Section II did not address non-U.S. shareholders, since there the only issue was whether reified income incurs the same tax regardless of whether earned domestically or off shore. Here, however, the concern is whether the domestic or offshore investment bears comparable effective tax burdens.

credits allowed to the foreign domestic shareholders, U.S. deemed-paid credits can make up the shortfall.[124] This supports credits with regard to purchased French, German and U.K. stock even though this section concludes that such credits generally are inappropriate. The German split-rate system[125] applies without regard to the identity of the dividend payee, and, thus, does not change this analysis.

As to incorporator stock, no change in the proposal's operation is required. The deemed-paid credit compensates for the lack of full French, German and U.K. refunds (or the equivalent). As to Germany, the split-rate system merely makes this compensation less likely, with no other effect on this section's analysis.

Section III.D concluded that § 1248 could apply to sales of stock allowed the deemed-paid credit under this section's proposal. Since § 902 would not apply to other stock sales by corporate shareholders, there would be no reason to apply § 1248 to these sales. This would conform the foreign and domestic rules.

III. Conclusion

What is now § 902 was enacted as part of a tax system that generally exempted intercorporate dividends from taxation. Benefits for domestic intercorporate dividends have been cut back considerably since then. At the very least, § 902 should be conformed to the rules for domestic intercorporate dividends. Moreover, the current domestic rules are overly generous and result in tax windfalls. The domestic rules should be limited so as to apply only when windfalls are not likely. Domestic intercorporate dividends should be tax-exempt only when the shareholder is a corporation that is an original shareholder (or any successor). Under this regime, § 902 should apply similarly. Of course, if Congress should change the basic approach to taxing foreign income of U.S. persons (modified capital export neutrality), conforming changes in § 902 would be required.

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124 This would mean that the United States would finance the elimination of foreign corporate multiple taxation before solving the parallel domestic problem, however. See note 112.

125 See notes 84-85 and accompanying text.