

A Recommendation for Integration  
of  
The Individual and Corporate  
Tax Systems



Department of the Treasury  
December 1992

December 11, 1992

The Honorable Dan Rostenkowski  
Chairman  
Committee on Ways and Means  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed is a description of our recommended approach to integrating the corporate and individual income tax systems. This material is a follow-up to the *Report of the Treasury on Integration of the Individual and Corporate Income Tax Systems—Taxing Business Income Once* (released in January 1992, hereafter the *Treasury Integration Report*). The Treasury Integration Report identified the distortions caused by our current system for taxing corporate profits and the substantial benefits to the economy that would result from integration, and described four alternative integration prototypes. At that time, we committed to recommending a specific integration system in late 1992.

1. **Recommended prototype.** Although each of the prototypes described in the *Treasury Integration Report* has merit, we are recommending a system similar to the *dividend exclusion prototype* for the following reasons:

- Relative to the shareholder allocation and imputation credit prototypes of relieving the double taxation of corporate equity income, the dividend exclusion approach is the most straightforward and easily administered.
- While there are strong arguments that some version of the Comprehensive Business Income Tax (CBIT) prototype may be preferable from a long-term policy and administrative perspective, the dividend exclusion approach can be implemented much more rapidly, with far less potential for disruption of financial markets and many fewer transition issues.
- The dividend exclusion approach is preferable to the shareholder allocation and imputation credit prototypes because it is consistent with our policy view that, over the long-term, it may be

desirable to move the tax system in the direction of a schedular tax on enterprise activity (e.g., the CBIT prototype or some version of a business cash flow tax or business transfer tax).

The dividend exclusion model we recommend is simple and will generally tax corporate income once. A corporation will compute its taxable income and pay tax as under current law. Any distribution out of the corporation's income that remains after paying tax and after making certain limited adjustments to taxable income (adjusted taxable income or ATI) is treated as a dividend and is excludable from gross income when received by shareholders. Distributions in excess of ATI are treated as a return of capital to the shareholders (or capital gain to the extent the distribution is in excess of basis).

ATI is defined as corporate taxable income reduced by U.S. federal income taxes and creditable foreign taxes paid or accrued and increased by excludable dividends received and by items that are permanently excluded from income (e.g., tax-exempt interest and percentage depletion in excess of basis). Because distributions in excess of ATI will be treated as a return of capital, no distributions are ever treated as taxable dividends. Thus, under the proposal, earnings and profits (E&P) accounts will no longer be relevant for determining the character of distributions from U.S. corporations. Similarly, the dividends received deduction will no longer be necessary because dividends will be excludable.

While the capital gains tax on the sale of stock will be retained, the proposal allows corporations to adopt Dividend Reinvestment Plans (DRIPs). Through the DRIP, a corporation will deem that a cash dividend was paid to its shareholders out of its ATI and immediately reinvested by the shareholders. The shareholders will pay no tax on the deemed dividend (because dividends are excludable), but will increase their bases in their shares by the amount of the deemed dividend. The effect will be to reduce the capital gains (or increase the capital losses) realized when shareholders sell their stock by an amount equal to the corporation's retained previously-taxed earnings.

**2. Modifications to Treasury Integration Report Version of Dividend Exclusion Prototype.** The principal differences between our current recommendation and the prototype described in the *Treasury Integration Report* are: (a) we treat all distributions in excess of ATI as returns of capital (even if the corporation has E&P); (b) we extend integration to foreign source income (by "flowing-through" creditable foreign taxes); and (c) we recommend an immediate effective date (with limited, elective transition relief for corporate shareholders). We have made these modifications for the following five reasons:

- (1) They are more consistent with our stated policy goals.
- (2) They create fewer character of income and timing distortions, result in a system that is more easily administered, and permit other significant simplifying changes in the tax law.
- (3) We believe that any objection to existing tax law preferences should be addressed directly, rather than through continued reliance on an E&P-based measure of dividends.
- (4) We believe that revenue concerns are more properly addressed in a policy-neutral manner (e.g., by scaling back underlying preferences; raising revenue elsewhere in the system; or, if necessary, by scaling back the dividend exclusion).
- (5) While extending the benefits of integration to creditable foreign taxes is clearly justified on policy grounds, it also is based on the assumption that reciprocal treatment will be provided by our major trading partners. This recommendation should be reconsidered, and alternatives should be explored, in the absence of reciprocity.

**3. Interaction with Other Tax Policy Issues.** In developing our recommendations, it has become increasingly clear that an integration regime should not be developed in isolation (or under the assumption that other structures in the tax law will remain unchanged). Rather, the design of an integration system should be considered in the context of--and be addressed in a manner consistent with--long-term policy goals relating to the compelling case for international reform, the AMT and corporate preferences, the accumulation and investment of capital by tax-exempt entities (including non-U.S. and taxpayers and companies with substantial net operating losses), and the overriding need for tax simplification and the reduction of taxpayer burden.

**4. Setting priorities.** We recognize that other fiscal and tax policy issues may be given higher priority in the near term, that many of the specific technical issues arising under any integration proposal are yet to be resolved, and that any specific legislation would require off-setting tax law changes to deal with revenue and distributional concerns.

Nonetheless, we remain convinced that integration should be a high-priority, tax policy objective. Current tax law distortions--which encourage debt financing by the corporate

sector, penalize businesses conducted in corporate form, discourage dividend distributions, and leave us out of step with our primary international trading partners--impose very real costs on the economy. We believe that these costs are likely to increase in the years ahead and that the case for some form of corporate integration will be all the more compelling.

I urge you to give the recommendation careful consideration in your deliberations on reform of the U.S. tax system. I am sending similar letters to Senator Lloyd Bentsen, Chairman of the Senate Committee on Finance; Senator Bob Packwood; Representative Bill Archer; and Representative Charles Rangel, Chairman of the Subcommittee on Select Revenue Measures.

Sincerely,



Nicholas F. Brady

Enclosure

# **A Recommendation for Integration of the Individual and Corporate Tax Systems**

## **CURRENT LAW**

Two levels of income tax are generally imposed on earnings from investments in corporate equity. First, tax is imposed on the corporation's taxable income. Second, if the corporation distributes earnings to shareholders, the earnings are taxed at the shareholder level, either as ordinary income in the case of dividend distributions, or as capital gain in the case of non-dividend distributions in excess of the shareholders' stock bases. Retained earnings are taxed at the shareholder level through the capital gains tax on stock sales.

By contrast, the income on debt investments in corporations is taxed only once because interest expense is generally deductible by the corporation and includable in income by the creditor. In addition, the income on equity investments in unincorporated businesses (such as proprietorships and partnerships), qualifying small business corporations (i.e., S corporations), and certain types of investment corporations (such as regulated investment companies) is generally taxed only once, at the investor level. Distributions from those types of businesses are generally tax-free to the extent they represent earnings that were previously taxed to the investors or are treated as a return of capital to the extent of any excess over previously taxed earnings.

## **REASONS FOR CHANGE**

The disparities between the taxation of income from corporate equity investments and income from other types of investments cause three serious inefficiencies:

- A tax disincentive to incorporate, which causes many businesses to forego the non-tax benefits of operating a business in the corporate form, and a penalty on businesses that must operate in corporate form.
- A tax-motivated preference to use debt rather than equity capital, which encourages corporations to operate with higher debt-equity ratios than they otherwise would choose for non-tax reasons.
- A tax-motivated preference to retain rather than distribute corporate earnings to shareholders.

As discussed in Chapter 13 of the *Report of the Treasury on Integration of the Individual and Corporate Tax Systems — Taxing Business Income Once* (January 1992) (the *Treasury Integration Report*), these biases reduce corporate investment, encourage artificially high debt-equity ratios, and discourage dividend payments, all of which lead to significant inefficiencies and competitive disadvantages to the U.S. economy. An integrated tax system, in which

corporate earnings generally are taxed only once, will reduce these distortions and thus provide significant economic benefits. It also will bring our tax system more in line with those of our major trading partners, many of whom have adopted some form of integration of their individual and corporate tax systems.

## RECOMMENDATION

### Overview

We recommend a corporate/shareholder tax integration scheme that will generally tax corporate income once. Under our recommendation, a corporation computes its taxable income and pays tax as under current law. Any distribution out of the corporation's income that remains after paying tax and after making certain limited adjustments (adjusted taxable income or ATI) is treated as a dividend and is excludable from gross income when received by shareholders. Distributions in excess of ATI are treated as returns of capital to the shareholders (or as capital gain to the extent the distribution exceeds their basis).

ATI is defined as corporate taxable income reduced by U.S. federal income taxes and creditable foreign taxes paid or accrued and increased by excludable dividends received and by items that are permanently excluded from income (e.g., tax-exempt interest and percentage depletion in excess of basis). Because distributions in excess of ATI will be treated as returns of capital, no distributions are ever treated as taxable dividends. Thus, under our recommended approach, earnings and profits (E&P) accounts will no longer be relevant for determining the character of distributions from U.S. corporations. Similarly, the dividends received deduction will no longer be necessary because dividends will be excludable.

The capital gains tax on the sale of stock will be retained. Standing alone, the combination of a dividend exclusion regime and a capital gains tax on stock sales would create artificial incentives to distribute previously taxed income (because dividends would be excludable but increases in stock value that represent retained earnings would be taxed to the selling shareholders) and would comparatively disadvantage corporations that retain earnings for further investment by raising their cost of capital. To minimize this distortion, corporations will be allowed to adopt Dividend Reinvestment Plans (DRIPs). Through the DRIP, a corporation will deem that a cash dividend was paid to its shareholders out of its ATI and immediately reinvested by the shareholders. The shareholders will pay no tax on the deemed dividend (because dividends are excludable), but will increase their bases in their shares by the amount of the deemed dividend. The effect will be to reduce the capital gains (or increase the capital losses) realized when shareholders sell their stock by an amount equal to the corporation's retained previously-taxed earnings. DRIP dividends may be declared at any time during the year.

The ATI system will be fully effective for each corporation in its first taxable year beginning after the date of enactment. A special rule will allow corporations to continue to claim the dividends received deduction for five years.

## Discussion

Our major goal in devising a system of integration is to reduce the distortions caused by the current two-level tax system while avoiding a system that was difficult to administer or overly complex. While the ATI system does not eliminate all the distortions under current law, we believe it significantly reduces many of them. The ATI approach treats corporations more like other forms of business and thus reduces the tax disincentive to incorporate. It treats equity more favorably than does current law, reducing the disparity between debt and equity. Finally, it reduces the tax incentive to retain earnings, because dividend distributions will be excludable by shareholders.

In addition, the ATI system is both administrable and understandable. By drawing heavily from existing rules, the ATI system reduces the need to implement new sets of rules where existing law is well established. The recommended changes to current law should simplify the corporate tax system (e.g., ATI is easier to compute than E&P, the concept it largely replaces). All distributions are either dividends (and therefore excludable) or returns of capital, simplifying shareholder level treatment as well. The DRIP provisions add some complexity because the DRIP allows upward adjustments of shareholder basis, but the DRIP rules are necessary to avoid creating tax incentives to distribute income. Finally, a number of existing tax rules will be repealed as unnecessary, further simplifying the tax laws. Thus, we believe that the ATI system reduces current law distortions within the context of an administrable system.

Although each of the prototypes described in the *Treasury Integration Report* has its merits, the system we recommend is similar to the dividend exclusion prototype described in Chapter 2 of the *Treasury Integration Report*. Relative to the shareholder allocation and imputation credit prototypes, the dividend exclusion system is the most easily administered approach to relieving the double taxation of equity earnings. While there are strong arguments that the Comprehensive Business Income Tax (CBIT) prototype may be preferable from a long-term policy (and administrative) perspective, the dividend exclusion approach can be implemented much more rapidly, with far less potential for disruption of financial markets and many fewer transition issues. In addition, the dividend exclusion system is preferable to the shareholder allocation and imputation credit prototypes because it is consistent with our policy view that, over the long term, it may be desirable to move the tax system in the direction of a schedular tax on enterprise activity (e.g., the CBIT approach or some version of a business transfer tax).

There are two principal differences between the system we now recommend and the dividend exclusion system described in the *Treasury Integration Report*. First, our recommended system treats all distributions in excess of previously taxed income as returns of capital (even if the corporation has E&P). Second, our recommended system extends integration to foreign source income by flowing through creditable foreign taxes although this extension of integration benefits to foreign taxes is predicated on the assumption that our major trading partners will, over time, provide reciprocal treatment.



The dividend exclusion system in the *Treasury Integration Report* would have treated distributions in excess of previously taxed income (up to the amount of available E&P) as taxable dividends. Two basic considerations were implicit in that decision. First, to the extent that E&P is viewed as reflecting economic income, the *Treasury Integration Report* reasoned that the distribution of that income from corporate solution should trigger a tax at the investor level if a domestic corporate level tax had not already been imposed. Second, the *Treasury Integration Report* gave significant weight to the revenue cost of repealing the E&P-based measure of dividends.

Although these concerns remain valid, we are now placing greater emphasis on simplicity and economic efficiency, and therefore have concluded that the E&P-based measure of dividends should be eliminated and replaced with the ATI approach. Compared to the E&P approach, the ATI system (i) more closely parallels a schedular tax on enterprise activity, (ii) reduces tax-based distortions among different forms of business enterprise, and (iii) reduces artificial incentives to retain earnings. In addition, the ATI approach creates fewer character and timing distortions, is more easily administered, and permits other significant simplifying changes in the tax law. We also believe that any objection to existing tax preferences should be addressed directly, rather than through reliance on E&P. Finally, we recommend addressing revenue concerns in a policy-neutral manner (e.g., by scaling back the underlying preferences, raising revenue elsewhere in the system, or, if necessary, by allowing only a partial exclusion of dividends), rather than by retaining the E&P regime.<sup>1</sup>

Thus, we recommend a dividend exclusion system based on ATI rather than E&P.<sup>2</sup> Under this system, preference income will receive one of two possible treatments depending on whether the preference is a timing preference or a permanent exclusion. Corporate distributions attributable to a timing preference, such as accelerated depreciation, will reduce shareholder basis. If the shareholder holds the stock until the timing preference reverses, basis can be restored through a DRIP dividend when the corporation recognizes the deferred income. If the shareholder sells the stock before the timing preference reverses, the preference will be recaptured through a capital gains tax on the stock sale, approximating the result that would have

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<sup>1</sup> A partial dividend exclusion system would treat distributions out of ATI as part excludable and part returns of capital to shareholders. If the revenue cost of such a partial dividend exclusion system is still too high, an alternative partial exclusion would treat distributions out of ATI as partially excludable and partially taxable to shareholders. If the revenue cost needs to be reduced even further, we would recommend an E&P-based system modeled after the dividend exclusion prototype in the *Treasury Integration Report*.

<sup>2</sup> We also considered a regime that retained the E&P measure of dividends, but provided that all distributions from E&P would be excluded from income at the shareholder level. We rejected this alternative for some of the same reasons that we decided not to retain E&P as a measure of taxable dividend distributions (e.g., retention of the same tax base for all purposes; minimization of timing and character distortions; and ease of administration). Moreover, we were concerned that the E&P approach would further exacerbate the distinctions between inside and outside basis. The basis reduction approach we have adopted is admittedly rough justice, and will result in distortions in a number of real-world cases. While an exclusion based on E&P would mitigate some of these concerns, it would create other more troublesome distortions (e.g., a significant shifting in the nominal incidence of taxation on disposition of shares following distributions from E&P in excess of ATI).

followed if the corporation had sold a portion of the asset that created the preference. When the corporation eventually pays the deferred tax, the new shareholders will receive an offsetting basis adjustment. Distributions attributable to permanent exclusions will not reduce shareholder basis, because reducing basis would result in a recapture of preferences that were meant to be permanent. Thus, these preferences are made excludable by including them in ATI.

The *Treasury Integration Report* also recommended against extending the benefit of integration to creditable foreign taxes. While we are continuing to study this issue as part of our International Tax Study, we believe that passing through foreign tax credits is consistent with the fundamental goals of integration. It also furthers the goal of capital export neutrality, because equivalent integration treatment applies to corporations earning foreign source income and corporations earning U.S. source income. We therefore recommend extending integration to creditable foreign taxes, provided that our major trading partners grant reciprocal treatment. At present, other countries with integrated tax systems generally do not pass through foreign tax credits.<sup>3</sup> If this continues to be the case, we will reconsider our recommendation.<sup>4</sup> An alternative would be to pass through foreign tax credits by treaty in cases where the treaty partner grants reciprocal benefits, although this could entail a significant level of complexity. The ATI system can be modified so that it does not extend integration to foreign taxes by providing for either a basis adjustment or shareholder-level income inclusion upon the distribution of income sheltered by foreign tax credits.

## TECHNICAL EXPLANATION

### **Recommendation 1:** Retention of Current Law

- (a) Corporations will continue to calculate their income under current law rules and will pay tax according to the existing graduated rate schedule. Credits, including foreign tax credits, will offset corporate tax as under current law.
- (b) Distributions in excess of basis will continue to be taxed as gains from the sale or exchange of property. The distinction under section 302 between redemptions that are treated as section 301 distributions (i.e., generally as dividends) and redemptions that are treated as in exchange for stock (i.e., generally as capital transactions) will remain. The rules governing corporate transactions, such as acquisitive and divisive reorganizations, liquidations, and taxable acquisitions will

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<sup>3</sup> The Ruding Committee, however, has recommended that countries within the European Community with integrated tax systems extend integration benefits to foreign taxes levied by other members of the European Community. See Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* (1992).

<sup>4</sup> Excluding the pass-through of creditable foreign taxes from our integration recommendation could also be justified on revenue grounds. On balance, however, we recommend addressing revenue concerns in other ways.

generally be the same as under current law. Corporations will continue to be eligible to file consolidated returns as under current law, although the consolidated return regulations will be amended to conform to the integrated corporate tax.

**Discussion:** The desire to retain current law was a major reason for choosing a dividend exclusion system. Retaining current law significantly simplifies the transition to integration by relying on established principles and rules. To the extent current law is modified, the changes generally result in simplification or repeal of existing rules and a reduction in taxpayer burdens. Recommendation 1 summarizes the major components of corporate tax law that are retained.

### **Recommendation 2: Definition of Adjusted Taxable Income**

- (a) **In General:** Each year, corporations will compute their addition to ATI. The addition to ATI is equal to taxable income (calculated after the application of any loss carryforward), reduced by (i) the regular U.S. federal income tax liability before the application of any minimum tax credits and (ii) creditable foreign taxes paid, deemed paid or accrued during the taxable year, and increased by (i) excludable dividends received and (ii) items that are permanently excluded from income. Permanent exclusions include tax-exempt interest under section 103 and percentage depletion in excess of basis.
- (b) **Special Rule for the Alternative Minimum Tax:** Corporations paying alternative minimum tax (AMT) increase ATI by the amount of their AMT liability, grossed-up by a factor of 66/34, and decrease ATI by an amount equal to 20 percent of the amount by which they increased ATI for permanent exclusions, grossed-up by a factor of 66/34. In addition, corporations must decrease ATI by minimum tax credits used during the taxable year, grossed-up by a factor of 66/34.

**Discussion:** By starting with taxable income, ATI does not initially include any preference income. ATI is then adjusted downward by U.S. federal income taxes paid after the application of credits other than the minimum tax credit. Creditable foreign taxes reduce the amount of after-tax income available for distribution, so ATI is reduced by all creditable foreign taxes, including foreign taxes in excess of the amount that can be used to reduce U.S. tax liability for the taxable year. ATI is then adjusted upward by certain permanent exclusions. In general, the practical effect of this definition is that preference income other than income sheltered by credits and by permanent exclusions will not be included in ATI. By including permanent exclusions and credits in ATI, Recommendation 2 allows shareholders to exclude distributions attributable to those items without a reduction in basis. This treatment is appropriate because basis reduction for permanent preferences would make the preferences temporary.<sup>5</sup>

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<sup>5</sup> We realize that ATI may not accurately reflect all of the current rules that govern income and basis (e.g., sections 108 and 167(e)(3)). Nevertheless, to keep the system simple, we did not adjust ATI for these items. If significant distortions result, the ATI rules can be amended.

The calculation of ATI begins with taxable income (which cannot be less than zero) and adds permanent exclusions. Thus, if the corporation has an overall loss for the year but has permanently excluded earnings, the corporation may still distribute excludable dividends during the year. For example, a corporation with a loss of \$100 and tax-exempt interest of \$10 has \$10 of ATI and can distribute \$10 of excludable dividends. The net operating loss of \$100 can be carried forward against other years' taxable income.

As previously announced, we are studying the effects of the corporate AMT. While our study is not complete, it is clear that the AMT creates economic distortions, and that substantial reform or outright repeal of the AMT may be warranted. The AMT also complicates the calculation of ATI because the AMT operates on a separate, parallel tax base (alternative minimum taxable income). We considered using alternative minimum taxable income for determining ATI for AMT taxpayers, but this would add complexity, allow AMT taxpayers to pass through timing preferences without a basis reduction, and cause discontinuities whereby a modest change in items of income or deduction could cause an extraordinary fluctuation in ATI. We also considered ignoring the AMT and the minimum tax credit for purposes of computing ATI, both for reasons of simplicity and on the theory that the AMT is essentially a prepayment of regular tax. We rejected this approach because some taxpayers are subject to the AMT for many years. For these taxpayers, the AMT becomes their corporate-level tax regime. Ignoring AMT paid would inappropriately deny these taxpayers the benefits of integration.

We opted for an approach whereby AMT paid is grossed-up and added to ATI.<sup>6</sup> The amount of permanent exclusions added to ATI is reduced for corporations that pay AMT, so that permanent exclusions are not double counted in computing ATI. The 66/34 gross-up factor insures that dividends will be paid only out of fully taxed income. The alternative was to gross up AMT at the AMT rate (i.e., by a factor of 80/20). An 80/20 gross-up, however, allows the corporation to distribute preference income without a shareholder basis reduction. For example, suppose a corporation has no regular taxable income and \$100 of alternative minimum taxable income due to timing preferences. The corporation pays no regular tax and \$20 of AMT. If the gross-up were 80/20, the corporation would generate \$80 of ATI and could pay \$80 of excludable dividends to its shareholders. The earnings would not be taxed at a 34 percent rate until the preferences reversed and the corporation were subject to the regular tax, regardless of whether the shareholders sold their stock. With a 66/34 gross-up, the \$20 of AMT will generate \$38.82 of ATI. If the corporation makes an \$80 distribution, the remaining \$41.18 will reduce the shareholders' bases. If the shareholders are taxable at a 34 percent rate, the difference between the 20 percent rate imposed through the AMT and the 34 percent rate of the regular tax will be recaptured if the shareholders sell their stock before the preferences reverse (34 percent

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<sup>6</sup> Minimum tax credits are grossed up and subtracted from ATI in the year they are applied to reduce regular tax liability. We considered not reducing ATI by minimum tax credits that were earned before the effective date of the integration system. This would require all corporations to maintain a pre-enactment minimum tax credit account and apply a stacking rule (e.g., FIFO) to determine when the pre-enactment credits were used and would result in significant complexity. Our recommendation of an immediate effective date necessarily creates detriments to some taxpayers and windfalls for other taxpayers, and we are not generally recommending any correction for those losses or gains.

of \$41.18 is \$14). This treatment is consistent with our general rule that distributions from earnings that have not been fully taxed reduce basis.

**Recommendation 3: Dividends**

- (a) Distributions will be classified as dividends to the extent they are paid (or deemed paid) out of current or accumulated ATI. E&P no longer controls the treatment of distributions from U.S. corporations and all distributions not out of ATI are treated as returns of capital. If distributions in a given year exceed available ATI, ATI will be allocated first by the priority of the classes of stock on which distributions were paid during the taxable year. For classes of equal priority, or for multiple distributions paid within a single class of stock, ATI will be allocated under a "first-in-time" rule.
- (b) Shareholders will exclude all dividends from gross income. As under current law, shareholders will not reduce their share bases when dividends are received.
- (c) Distributions in excess of ATI will not be classified as dividends, and will instead be treated as returns of capital.

**Discussion:** The highest priority, first-in-time allocation of ATI to distributions reduces potential uncertainty about the amount of a distribution that is treated as a dividend. Moreover, the allocation rule is consistent with non-tax rules governing priorities and claims, and as a practical matter allows preferred stock generally to continue paying non-taxable dividends.

The disadvantage of the highest priority, first-in-time rule is that it may allow a corporation to "stream" its dividends by creating multiple classes of stock, some of which receive dividends (and are held by taxable shareholders) and some of which receive non-dividend distributions (and are held by tax-exempt shareholders). While the same issue arises under current law, its practical significance would increase substantially under the integration regime we are recommending because the dividend base will be reduced (ATI will often be less than E&P on a year-to-year basis and, as noted below, the "nimble dividend rule" will be eliminated).

In theory, this concern could be addressed by allocating ATI pro rata among all distributions made during the taxable year. A pro rata approach would reduce the possibility of streaming in the case of routine distributions with respect to multiple classes of stock, but would create other problems. The amount of any given distribution that is a dividend would depend on the amount of distributions made later in the year. This would raise uncertainty and would make declaring DRIP dividends difficult, except where there is a sufficiently large amount of ATI. On balance, we chose to use a highest priority, first-in-time rule and to address streaming concerns with other rules (many of which are in place under existing law) and a general anti-abuse rule.

We chose to allow dividends out of estimated ATI for the current year. Any other rule would require dividends to be paid out of ATI one year in arrears, a requirement inconsistent with the goals of our recommended approach.

We did not adopt the nimble dividend rule of current law (which allows dividends out of current E&P notwithstanding a deficit of accumulated E&P). We recognize that eliminating the nimble dividend rule may mean that corporations with large net operating loss carryforwards will be unable to pay dividends until the losses are used up because taxable income, the starting point for ATI, is calculated after the application of loss carryforwards. Nevertheless, where the estimated current year's taxable income, after the application of any loss carryforwards, is zero, the corporation has not produced any taxable income for distribution as a dividend. Consequently, a distribution under those circumstances is more properly treated as a return of capital.

We considered imposing a surrogate tax in cases where a corporation informs shareholders that a dividend is excludable but later finds that it has insufficient ATI to support the dividend. The tax would have been refundable when the corporation produced ATI and would have offset ATI (when refunded) by a grossed-up amount. The effect would have been an interest charge on the reduced tax that shareholders would have paid if they had sold during the period between the erroneous dividend and the refund of the surrogate tax. We opted not to impose a surrogate tax because of the problems with determining the appropriate blended rate for the tax. Instead, the Commissioner will have the authority to impose a surrogate tax at the maximum shareholder tax rate (currently the 34 percent corporate tax rate) where ATI has not been reported in good faith (e.g., where ATI is not reported consistently with estimated tax payments).

Although the amount of a distribution that is considered a dividend is determined by a corporation's ATI, not its E&P, we do not recommend eliminating E&P for all purposes. In particular, E&P will be retained for various computations relating to foreign corporations. We are studying ways in which E&P computations under these other provisions can be simplified or eliminated.

#### **Recommendation 4: Treatment of Redemptions**

- (a) **In General:** The distinction between a redemption that qualifies as a payment in exchange for stock under section 302(b) and a redemption that is treated as a section 301 distribution will remain as under current law. Redemptions that qualify under section 302(b) will generally not reduce ATI even though such redemptions reduce a pro rata portion of E&P under current law.
- (b) **Significant Redemptions:** Section 302(b) redemptions of stock from significant shareholders, defined as those shareholders holding at least five percent of a corporation's equity (with attribution rules), will reduce ATI pro rata and give rise to a corresponding increase in the basis of the redeemed shares. In addition,

a corporation that redeems more than five percent of its stock (by vote or value) from any group of shareholders in section 302(b) redemptions will be subject to the same pro rata ATI reduction, basis increase rules. All redemptions that take place within a one-year period will be aggregated for purposes of this rule.

- (c) **Special Rule:** Corporations will be allowed to assume that there are no section 318 relationships (which might cause redemptions that would otherwise qualify under section 302(b) not to qualify) among small shareholders (defined as those that hold less than one percent of the corporate equity). In addition, corporations will be allowed to assume that small shareholders are not purchasing stock at the time of a redemption in a manner that could cause a redemption to fail to qualify under section 302(b).
- (d) **Treatment of Shareholders:** Shareholders will treat redemptions that qualify under section 302(b) as a sale or exchange of their stock. Shareholders will receive a statement from the corporation if they are entitled to a basis increase in connection with such sale or exchange (whether by reason of the significant redemptions rule described above, or because the corporation has declared one or more DRIP dividends prior to the redemption).

**Discussion:** We chose generally to treat section 302(b) redemptions of stock like sales of stock and to retain the existing rules of section 302(b) for distinguishing a true redemption from a corporate distribution.<sup>7</sup> A selling shareholder in a widely-held corporation generally will not distinguish between selling shares to a third party and selling shares to the corporation. Given this fact and our preference for retaining current law, we believe that sales of stock to the corporation that qualify under section 302(b) should generally be treated the same as sales to third parties.

Nevertheless, some section 302(b) redemptions should be treated as a pro rata distribution of ATI plus a return of capital to the redeemed shareholders. This rule is needed to prevent corporations from streaming through a combination of redemptions of tax-exempt shareholders and dividend payments to taxable shareholders.<sup>8</sup> Thus, in redemptions of large shareholders and

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<sup>7</sup> We recognize that the rules of section 302 reflect a bias towards treating redemptions as dividend distributions, a result that has historically been unfavorable to individual shareholders, but favorable to corporate shareholders. Under our recommended system, all taxable shareholders will prefer dividend treatment, a result not contemplated by the drafters of section 302. Nevertheless, the section 302 rules generally should produce the correct result under our recommended system.

<sup>8</sup> For example, consider a corporation with two shareholders, one taxable and one tax-exempt, each contributing \$500 to the corporation. If the corporation earns \$100 of after-tax profits (and therefore has \$100 of ATI), it can redeem the tax-exempt shareholder for \$550. This will leave the taxable shareholder with \$500 of basis in a corporation with a value of \$550 and ATI of \$100. The corporation can pay a \$100 dividend and the taxable shareholder can sell its stock for a \$50 loss.

(continued...)

in large redemptions, a corporation's ATI is reduced and the selling shareholders' stock bases are correspondingly increased. For example, if a corporation redeems two percent of its stock from a five percent shareholder, the corporation will reduce its ATI by two percent and the shareholder will correspondingly reduce its amount realized. Similarly, a successful public self-tender for seven percent of a corporation's stock will reduce the corporation's ATI by seven percent and the shareholders will correspondingly reduce their amounts realized.

This treatment of significant redemptions may appear to be more favorable than the treatment of small redemptions of small shareholders. A corporation can equalize the treatment of redemptions, however, by declaring a DRIP dividend before purchasing its own stock. Moreover, because ATI is not reduced in small redemptions of small shareholders, ATI is retained in the corporation to support excludable dividends to all other shareholders.

We recommend special rules allowing a corporation to assume that there are no section 318 relationships among small shareholders because of the new corporate level distinction between redemptions that qualify under section 302(b) and those that do not (i.e., the former generally will not reduce ATI while the latter will).

**Recommendation 5:** Sections 305 and 306

- (a) Section 305: Distributions of stock of the corporation to existing shareholders generally will not affect ATI. Nevertheless, the rules under section 305 for classifying certain stock distributions as distributions of property under section 301 will remain. To the extent that, under section 305, stock dividends are characterized as distributions to which section 301 applies, shareholders receiving stock will be treated accordingly and the corporation will make appropriate adjustments to ATI.
- (b) Section 306 will be repealed.

**Discussion:** We chose to retain section 305 to prevent streaming by paying excludable dividends on one class of stock (held by taxable investors) and stock distributions on another class (held by tax-exempt investors). In such a transaction, the distribution of stock would dilute the class receiving cash, creating a loss on that class when sold. The loss is theoretically offset by gain on the sale of the distributed stock, but if that stock is held by tax-exempts, the gain will never be taxed. Section 305 reduces this possibility by treating certain stock distributions as distributions of property under section 301.

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<sup>8</sup>(...continued)

The pro rata ATI reduction rule will not allow corporations to stream through the opposite transaction of redeeming taxable shareholders and reducing ATI in the redemption. In the above example, if the corporation redeems its taxable shareholder, ATI will be reduced by \$50 and the shareholder will recognize no gain or loss on the redemption. The tax-exempt shareholder will be left with \$500 of basis in a corporation with a value of \$550 and ATI of \$50.



Section 306 will be repealed because preferred stock bailouts will not offer the same benefits under the ATI system as when dividends were taxable as ordinary income.

**Recommendation 6: Adjustments to Tax and Refunds**

- (a) Adjustments to a corporation's taxable income for a prior year will be reflected as adjustments to the corporation's ATI in the current year. An increase in a prior year's taxable income, therefore, will increase the ATI (by an amount net of the increased taxes paid) in the year the adjustment is made and the additional tax is paid.
- (b) ATI may not be reduced below zero. To the extent that ATI would be reduced below zero by a downward adjustment to taxable income that would give rise to a refund, the refund will not be paid to the corporation. Instead, adjustments to the corporation's taxable income in excess of the amount necessary to reduce ATI to zero will be carried forward to reduce future taxable income.

**Discussion:** Adjustments to a corporation's tax liability for a prior year must be reflected in ATI in the year the adjustment is made because of the practical problems with recharacterizing distributions made in prior years. If, for example, when a corporation agreed in 1998 to report additional net taxable income for 1993, the corporation's ATI were increased for 1993, actual 1993 distributions that were reported as returns of capital to shareholders would become excludable dividends. The corporation's shareholders might have to amend their returns for 1993 (or for subsequent years prior to 1998, if they disposed of their shares during that period). The obvious problems with this approach led to the rule requiring ATI to be adjusted in the year the additional taxes are paid or refunded.

ATI cannot be reduced below zero by losses or downward adjustments to taxable income. Allowing ATI to be reduced below zero would be the equivalent of a loan from the Treasury to the shareholders who had received excludable dividends. The loan would be repaid by the corporation only if and when it had paid sufficient corporate taxes to increase its ATI to zero. If the corporation ceased doing business, the loan might never be repaid. We considered allowing corporations to receive tax refunds in excess of ATI at the cost of reducing current shareholders' stock bases. We rejected this approach because of problems where the stock has changed hands between the initial distribution of ATI and the subsequent refund of tax. We therefore recommend requiring corporations to use the net operating loss or downward adjustment to taxable income against future taxable income.

**Recommendation 7: Dividend Reinvestment Plans**

- (a) In General: If a corporation has an ATI account with a balance greater than zero, the corporation may declare a DRIP dividend. The corporation will be deemed to have paid a cash dividend and the shareholders will be deemed to have

received the cash and recontributed it to the corporation. Because a corporation may only declare DRIP dividends to the extent of ATI, DRIP dividends are always excludable by the shareholders. The only effects of a DRIP dividend are to increase the shareholders' share bases by the amount of the DRIP dividend and to reduce the corporation's ATI by an identical amount.

- (b) **Method of Declaring a DRIP Dividend:** Corporations will declare DRIP dividends in the same manner that they declare actual dividends, including the amount of any such DRIP dividend and the class or classes of stock on which the DRIP dividend will be deemed paid. Allocations of ATI to DRIP dividends are the same as allocations of ATI to cash dividends.

**Discussion:** We considered a number of ways to equalize the treatment of those corporations that choose to retain earnings and those that choose to distribute earnings. As noted in Chapter 8 of the *Treasury Integration Report*, reducing or eliminating the tax on capital gains when stock is sold introduces other problems into the system. We therefore chose to allow corporations to declare DRIP dividends. While the DRIP mechanism adds complexity to our recommendation, it is needed for two reasons. First, it prevents a tax law bias favoring the current payout of dividends. Second, it equalizes the treatment of widely- and closely-held corporations (because the latter could replicate the DRIP result using actual dividend, recontribution transactions).<sup>9</sup>

We chose to allow corporations the same flexibility in declaring DRIP dividends that they possess in declaring actual dividends. Although it may increase opportunities for streaming, this flexibility is consistent with the corporation's ability to determine its own dividend policy under current law, and is necessary to permit corporations to implement cost-efficient capital structures.

We considered requiring corporations to declare DRIP dividends with respect to otherwise undistributed ATI, at the latest, during the year following the year in which the ATI was generated (a mandatory DRIP). The practical effect of this rule would have been to limit ATI accumulations to not more than the amount produced in the last two years. A mandatory DRIP would prevent large accumulated ATI accounts in most cases, and thus would reduce corporations' interest in and opportunity for dividend stripping, streaming, "trafficking" in ATI, and other similar transactions.

We concluded that a mandatory DRIP would not eliminate the need for anti-abuse rules, and that it might interfere with the attempts of corporations in cyclical businesses to maintain level dividend payment policies. As a result of the mandatory DRIP, shareholders during upturns

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<sup>9</sup> Unlike DRIP dividends, which increase the basis of shares pro rata, actual cash dividends followed by a purchase of new shares concentrate basis in the recently-purchased shares. This is similar to the result under dividend reinvestment plans that some corporations have in place under current law. We considered allowing corporations to declare pro rata stock dividends instead of DRIP dividends, and thereby concentrate basis in the distributed shares. We rejected this approach because of mechanical complexities and because corporations can achieve similar results under section 305.

could receive both cash dividends and DRIP dividends resulting in basis increases, while shareholders during downturns could receive return of capital distributions.

A second concern about mandatory DRIPs relates to the broader issue of net operating losses (NOLs).<sup>10</sup> The practical effect of a mandatory DRIP, coupled with the rule limiting tax refunds attributable to adjustments and tax losses to available ATI, would be to eliminate the 3-year NOL carryback period. While the same result would follow if the corporation voluntarily declared sufficient actual or deemed dividends, there is a difference between voluntary and mandatory imposition of this regime.

On balance, we believe that the benefits of a mandatory DRIP (particularly in reducing the potential for streaming or other tax-motivated transactions) are outweighed by its detriments. We chose to address concerns about streaming and other tax-motivated transactions through a combination of existing law and a new general anti-abuse rule (see Recommendation 19).

#### **Recommendation 8: Corporate Transactions**

- (a) **Distributions of Appreciated Property:** Current law rules of section 311(b), requiring recognition of gain on corporate distributions of appreciated property, will continue to apply.
- (b) **Liquidations:** Liquidations will be taxed to the corporation as under current law. Upon a section 331 liquidation, the corporation may declare actual or DRIP dividends and thereby allocate its ATI among its classes of stock. Liquidations that qualify under section 332 will continue to be tax-free, with appropriate adjustments to ATI for minority shareholders.
- (c) **Taxable Acquisitions:** Taxable acquisitions will be treated as under current law and section 338(h)(10) will remain available. As a result, a stock acquisition will not affect the target corporation's ATI.
- (d) **Acquisitive Reorganizations:** Current law rules that treat a qualifying corporate reorganization as tax-free at the corporate level and at the shareholder level will remain available. Section 381, providing for the carryover of certain corporate attributes, will be extended to provide for the carryover of the target's ATI balance.
- (e) **Divisive Reorganizations:** Current law rules governing tax-free divisive reorganizations will remain, except that the device restriction of section 355 will be repealed. Under current law, E&P of the distributing corporation in a division

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<sup>10</sup> As discussed above, distributions from corporations with NOL carryforwards will generally represent returns of capital.

that qualifies as a reorganization under section 368(a)(1)(D) are divided between the distributing corporation and the controlled corporation based on the relative fair market values of their assets. Rules for the division of ATI will follow these rules.

**Discussion:** We chose to continue to impose a corporate level tax on distributions of appreciated property. The alternative was allowing a carryover or substituted basis for distributions of appreciated property, as under the partnership rules. Following the partnership rules would defer the tax and collect the tax at the shareholder rate. Collecting the tax at the corporate level rather than the shareholder level, however, is consistent with the policy of collecting a single level of tax at the corporate rate. While a comprehensive carryover basis regime governing the transfer of assets can be justified on policy grounds, it would be inappropriate (and unadministrable) to take a limited step in that direction solely in the context of corporate distributions to shareholders.

Liquidations are treated as under current law, except that the corporation may allocate all of its ATI to shareholders during the liquidation. The ability of corporations to allocate ATI upon a liquidation may present opportunities for streaming, but these opportunities should be no worse upon liquidation than for ongoing corporations. Moreover, the general anti-abuse rule will discourage tax-motivated allocations in liquidation.

Under a dividend exclusion system, existing section 338(a) is of minimal use because it imposes a tax on the buyer, not the seller. A rule modeled after section 338(h)(10) would be more effective, because the ATI produced by the deemed asset sale could be used immediately by the selling shareholders. We considered extending section 338(h)(10) to all targets (instead of just targets in consolidated groups) and all buyers (instead of just corporate buyers). For now, we recommend retaining the existing limits on section 338(h)(10) because of the complexity of extending section 338(h)(10) to all targets and all buyers. We are studying ways to broaden section 338(h)(10).

We recommend repealing the device restriction of section 355, because it is no longer necessary where dividends are not taxed. We retained the rest of section 355 because of the important distinction between divisive reorganizations and section 311 distributions.

#### **Recommendation 9: Consolidated Returns**

Affiliated groups of corporations will continue to be allowed to file consolidated returns. ATI, like E&P under current law, will be calculated separately for each member of a consolidated group. As under the current consolidated return regulations governing E&P, ATI will flow up to the common parent. Special rules will apply to ensure that ATI is not duplicated when a member leaves the consolidated group.

**Discussion:** We continue to believe that affiliated groups of corporations should be permitted to file consolidated returns to reduce any remaining distortions between operating as separate divisions and operating as separate corporations. We are continuing to study what adjustments to the consolidated return regulations would be necessary under the ATI system. This review is taking place in the context of our ongoing, broad-based reconsideration of the consolidated return regulations, as reflected in the recently proposed investment adjustment regulations, the forthcoming deferred intercompany transaction regulations, and our overall movement in the direction of a single entity approach for affiliated groups, as evidenced by the loss disallowance regulations.

**Recommendation 10: Pass-through Entities**

The current treatment of S corporations, partnerships, and other pass-through entities, such as regulated investment companies, real estate investment trusts and real estate mortgage investment conduits, will be retained.

**Discussion:** We recognize that retaining current law treatment of S corporations, partnerships, and other pass-through entities is somewhat inconsistent with our long-term policy preference for a schedular tax on enterprise activity and our goal of tax simplification. Nonetheless, we believe that these alternative regimes should be retained at present. As a practical matter, they are so deeply embedded in the system that any effort to require uniformity of business forms would be exceedingly disruptive and require elaborate transition rules. In addition, certain of the passive conduit regimes (RICs, REITs, and REMICs) are mechanical devices for permitting risk pooling and portfolio diversification. As such they should be retained as part of any system. Finally, to the extent partnerships are viewed as permitting parties to tailor their economic arrangements, with the tax consequences merely reflecting those arrangements, their continued availability (at least in certain circumstances) is warranted.

**Recommendation 11: Stock Sales**

Shareholders will be taxed on sales of their stock, as under current law.

**Discussion:** By increasing share basis, DRIP dividends prevent tax on that portion of the appreciation in stock value attributable to previously taxed income that the corporation has chosen to retain rather than distribute. The capital loss limitation will remain as under current law.<sup>11</sup>

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<sup>11</sup> Some commentators have suggested that a rule disallowing losses to the extent of basis attributable to DRIP dividends may be necessary to prevent certain abuses. We have rejected this approach in favor of the more general anti-abuse rule described below as Recommendation 19.

#### **Recommendation 12: Corporate Shareholders**

Corporate shareholders will no longer be entitled to a deduction for dividends received. Excludable dividends received by a corporation will increase the recipient corporation's ATI and will, therefore, remain excludable when distributed by the recipient corporation.

**Discussion:** We recommend eliminating the dividends received deduction, because it is no longer needed to reduce the multiple levels of corporate tax that can be imposed under current law. To the extent that earnings have been taxed to a corporation, there will be ATI to support dividends paid to corporate shareholders. The corporate shareholders will exclude the dividends from their income and will increase their own ATI by the amount of excludable dividends received. To the extent that the distribution is in excess of ATI, the corporate shareholders will reduce their bases, which is consistent with the general treatment of preferences under the ATI system.

#### **Recommendation 13: Shareholder AMT**

The alternative minimum tax will be retained, but excludable dividends are not an AMT adjustment or preference.

#### **Recommendation 14: Accumulated Earnings Tax**

The accumulated earnings tax will be repealed, because it is of diminished importance in a system that does not tax dividends.

#### **Recommendation 15: Personal Holding Companies**

The personal holding company rules will be retained.

**Discussion:** While in general corporate tax rates are higher than individual tax rates and, therefore, there is no tax benefit to incorporation, graduated rates remain available to corporations. To the extent that the graduated rates are lower than the individual rates applicable to a specific taxpayer, an integrated tax system still presents the opportunity to use the corporate form to shelter personal income. Indeed, repeal of what amounts to a toll charge on distributions of that income may exacerbate the problem. Thus, the personal holding company rules will be retained.<sup>12</sup>

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<sup>12</sup> Because the determination of whether a corporation is a personal holding company is based on the corporation's gross income, dividends received under our recommendation will not affect whether a corporation is considered a personal holding company.

**Recommendation 16:** Shareholder Level Debt

Section 246A will not be extended to cover excludable dividends and is therefore repealed, and section 265 will not be extended to the purchase of corporate stock. Section 163(d) will continue to apply to individual shareholders.

**Discussion:** The decision not to extend sections 246A and 265 is consistent with our decision not to recommend modifications to the rules governing debt, and our policy bias against rules that are complex and difficult to administer.

Section 163(d) limits individual interest deductions to net investment income. Because dividends are excludable, dividends will never result in investment income, so interest on debt used to purchase stock will be deductible only to the extent of other investment income. This is consistent with the purpose of section 163(d), to preclude the use of interest deductions to shelter personal expenses.

**Recommendation 17:** Limitations on Dividend Exclusion

Rules similar to those in section 246(c) will apply to all shareholders that receive dividends (including DRIP dividends). Section 1059 will be repealed.

**Discussion:** We recommend a section 246(c)-type rule to prevent dividend stripping. Without such a rule, tax-exempt shareholders could sell their stock to taxable shareholders immediately before a dividend is paid. The taxable shareholders would receive the excludable dividend and immediately sell the stock for a loss. This is the same problem faced under current law with the dividends received deduction, except that many more shareholders could take advantage of dividend stripping under the ATI system. If the shareholder does not meet the holding period requirements, the shareholder also will be denied an increase in basis if a DRIP dividend is declared. Section 246(c) must be extended to DRIP dividends to prevent tax arbitrage through the combination of a DRIP dividend (causing a basis step-up), an actual cash distribution in excess of ATI (reducing basis by the amount of the step-up), and a sale of the stock at a loss.

Retaining section 1059 would prevent payment of excludable dividends of pre-acquisition earnings followed by sale of the stock for a loss. We recommend repealing section 1059, however, because section 246(c), other elements of current law, and our general anti-abuse rule should adequately police this problem.

If the current rules prove inadequate to prevent dividend stripping in particular cases (e.g., where the selling shareholder is a foreign person seeking to avoid U.S. withholding tax or where the corporation is privately held) and those cases cause significant distortions, we will consider additional rules.

**Recommendation 18: Section 1014**

Section 1014 generally will continue to apply to stock held at death. Nevertheless, for decedents who owned at least five percent of the corporation's equity on the date of death, the amount of the section 1014 basis step-up is reduced (but not below zero) by the decedent's pro rata share of any increase in the corporation's undistributed ATI while the decedent owned the stock (as determined on the close of the taxable years that include the date of acquisition and the date of death).

**Discussion:** This recommendation prevents heirs from receiving the double benefit of a basis step up and excludable dividends, which would result in a capital loss (or reduced capital gain) when the heirs sell the stock. The capital loss would effectively offset corporate tax paid prior to death, which would be an unwarranted extension of section 1014. We considered prohibiting heirs from claiming capital losses on inherited stock for several years after the date of death, but that alternative would deny heirs any tax benefit for post-death economic losses. We also considered treating dividends received by heirs as returns of capital for several years after the date of death, but that alternative was similarly arbitrary. Our recommendation requires significant shareholders to ascertain the corporation's ATI in the year they acquired a five percent interest in the corporation and forces the estate to ascertain the corporation's ATI in the year of death, but it retains the benefit of section 1014. If the heirs desire a full basis step-up, the corporation can declare a DRIP.

**Recommendation 19: General Anti-abuse Rule**

If a corporation creates multiple classes of stock or engages in a transaction (or series of transactions), a principal purpose or effect of which is to allocate dividend distributions to taxable shareholders and parallel return of capital distributions to tax-exempt shareholders (including foreign shareholders and shareholders with substantial NOLs), the Commissioner may treat all such distributions as having been made pro rata out of the corporation's ATI and, to the extent such distributions exceed ATI, as returns of capital. The Commissioner may impose a surrogate tax at the maximum shareholder rate (currently 34 percent) on the corporation or its successors, or, in the absence of sufficient corporate assets, on significant shareholders as transferees.

**Discussion:** Neither the section 246(c)-type rules described above nor other specific rules may be sufficient to address the potential for tax-motivated transactions. Our general anti-abuse rule effectively codifies application of the step transaction and substance-over-form doctrines to streaming transactions and provides additional protection. By providing for collection at the corporate level of a surrogate tax at the maximum shareholder tax rate, the rule deters schemes that purport to generate a significant portion of their return by manipulating the integration rules. The surrogate tax applies to the incremental return of capital distribution that the Commissioner allocates to taxable shareholders.



Because corporations may seek to engage in tax-motivated transactions as part of a liquidation, the rule assigns transferee liability for the surrogate tax to successors and significant shareholders (i.e., those that hold at least five percent of the corporation's equity at the time of the abusive transaction), including tax-exempt shareholders.

**Recommendation 20:** "Trafficking" in ATI

Section 382-type rules will not apply to limit the use of ATI following an ownership change.

**Discussion:** To the extent that section 269 prevents tax-motivated acquisitions, it will continue to apply. Should ATI-motivated acquisitions become a problem, a section 382-type rule can be added at that time.

**Recommendation 21:** Foreign Shareholders

- (a) Integration benefits will not extend to foreign shareholders by statute. Thus, nonresident aliens and foreign corporations will continue to be subject to withholding tax on dividends. In addition, foreign corporations will continue to be subject to the branch profits tax. Integration benefits may, however, be granted to foreign shareholders by treaty.
- (b) DRIP dividends will generally have no tax consequences to foreign shareholders. A DRIP dividend will not increase the bases of foreign shareholders' stock, but will reduce the corporation's ATI.
- (c) Corporations will maintain an account of DRIP dividends paid (the deemed dividend account). Distributions in excess of ATI will be considered made out of this account. To the extent distributions are out of the deemed dividend account, they will be considered dividends for withholding tax purposes (regardless of whether the foreign shareholder receiving the distributions was a shareholder at the time the DRIP dividend was declared). Distributions to foreign shareholders out of the deemed dividend account will not reduce stock basis for foreign shareholders.
- (d) A distribution to a foreign shareholder will reduce corporate ATI. Distributions (to any shareholder) in excess of ATI will reduce the deemed dividend account.

**Discussion:** We would like to extend integration benefits to foreign shareholders on a reciprocal basis with other nations. Nevertheless, in contrast to our recommendation on foreign taxes, we recommend that integration treatment be provided to foreign shareholders only by treaty, for two principal reasons. First, unilaterally extending the benefits of integration to foreign shareholders

by statute may not achieve the intended purpose, because the tax policies of a shareholder's country of residence will ultimately determine the shareholder's total tax burden. Second, addressing the tax treatment of nonresidents through the treaty process is generally consistent with international norms concerning source-country taxing rights. Other countries, in certain cases, have extended integration benefits to nonresidents through bilateral income tax treaties. We are continuing to study foreign tax issues relating to integration as part of our International Tax Study.

Under the recommended system, DRIP dividends will not be treated as dividends to foreign shareholders, because it would be administratively difficult and arguably unfair to impose withholding tax where no cash or other property is actually distributed to shareholders. We considered but rejected other methods of addressing this problem. One alternative (modeled after the taxation of original issue discount accruing to foreign persons under section 871(a)(1)(C)) would be to permit a basis increase for stock held by foreign shareholders and to collect a deferred withholding tax at the time the foreign shareholder either sells his stock or receives distributions from the corporation. We rejected this alternative in part because of potential administrative difficulties in collecting withholding tax at the time of sale and because imposing that tax arguably would contravene the general U.S. policy of exempting foreign shareholders from tax on capital gains.

A foreign shareholder will be eligible for the benefits of DRIP dividends if the shareholder qualifies for integration benefits by treaty. Additional rules will be necessary to implement the general exclusion of foreign shareholders from DRIPs, such as rules governing basis adjustments in connection with the transfer of stock by a foreign person to a U.S. person in a nonrecognition exchange.

#### **Recommendation 22:** Compliance and Administration

- (a) Corporations will be required to keep ATI accounts and deemed dividend accounts and will report the balance of those accounts to the IRS annually on their income tax returns. All information necessary to keep the accounts should be available to corporations in the ordinary course of preparing their income tax returns. Corporations also will be required to include additional information on Forms 1099. Revised Forms 1099 will indicate the amounts by which actual or deemed distributions are excludable, reduce basis, or increase basis.
- (b) Shareholders will keep track of increases in basis as well as decreases in basis. Each shareholder will receive a revised Form 1099 to assist with this record-keeping burden.

**Discussion:** Minimizing recordkeeping was a significant goal in designing our integration system. Although shareholders will now have to track basis increases as well as basis reductions, this additional recordkeeping requirement should not be overly burdensome because it is

augmented by information reporting. Recordkeeping at the corporate level should not be significantly increased.

**Recommendation 23: Transition Rules**

- (a) In General: The ATI system will be effective for a corporation in its first taxable year beginning after the year of enactment.
- (b) Dividend Received Deduction: During their first five taxable years beginning after the date of enactment, corporations may elect to continue reporting their E&P to their shareholders. Corporate shareholders may elect, for each class of stock in a corporation that reports E&P, to treat all distributions out of E&P as taxable dividends and claim a dividends received deduction, as under current law. The ATI regime would continue to apply for all other purposes to electing corporations and their non-electing shareholders. Neither pre-enactment nor post-enactment E&P will affect the treatment of distributions by corporations that do not elect to report E&P.

**Discussion:** The *Treasury Integration Report* recommended a phase-in period for its prototypes. For several reasons, we are now recommending an immediate effective date. First, the substantial benefits that will flow from integration can be realized more quickly through an immediate effective date. We believe that these benefits outweigh the potential adverse impact of short-term disruptions in the market. Second, an immediate effective date minimizes distortions in taxpayer behavior that might otherwise occur during a five year transition period. Finally, we believe that an immediate effective date minimizes complexity and taxpayer burdens. Retention of taxable dividends during a phase-in period would require a complex set of interim rules, in effect requiring a complete and separate integration system during the phase-in. Based on these reasons, we believe that an immediate effective date is warranted.

We recognize that the value of certain stocks may be dependent on the dividends received deduction. We therefore recommend a special rule to phase out the dividends received deduction in a manner intended to reduce the volatility in the value of stock held by corporations.

**REVENUE COST**

	Fiscal Years					
	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1993-97</u>
Cost (billions of dollars)	17	31	33	34	35	150