(1) elimination (or significant reduction) of credit-producing investment incentives; (2) replacing generous accelerated depreciation methods with methods that more closely relates to the useful life of the depreciable assets; and (3) introducing limitations on interest deduction of debt financing, i.e., thin capitalization rules.

Most of these changes took place during the late 1980s, in the wake of the worldwide tax reform movement[152]; however, recent surveys indicate that many countries have been introducing similar reforms as late as the late 1990s and even well into the 2000s.[153] In other words, modern tax legislators continue to copycat old base-broadening trends, rather than implementing new (and maybe more creative) broadening instruments.

VI. CORPORATE/SHAREHOLDERS TAX INTEGRATION OF DISTRIBUTED PROFITS

A. Definition of integration and general issues

An area of corporate taxation in which trends of convergence have been identified by many commentators is in the extent by which the taxation of corporations and their individual shareholders are integrated.

Integration of the individual and corporate tax systems means that corporate income should be taxed only once, integrating individual income tax and corporate income tax in order to eliminate double taxation of corporate income and the connected economic distortions (most commonly referred distortion are the incentive to invest in noncorporate rather than corporate structures, the incentive to invest in debt rather than equity, and the incentive to retain corporate profits within corporations).

There is an overwhelming variety of practical and theoretical methods to integrate corporate/shareholder taxation and an almost equally overwhelming abundance of literature describing them.[154] For our purpose, it is not necessary to provide a detailed description of all methods but rather to understand that all of them operate in an easily described spectrum.

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[152] See, *e.g.*, Auerbach, Devereux &Simpson, *supra* note 144, at 5; Devereux, Griffith & Klemm, *supra* note 148, at 1302–03.

[153] *See, e.g.*, OECD Tax Policy Studies No. 9: Recent Tax Policy Trends and Reforms in OECD Countries, 31–126; 157–58 (2003).

[154] Some examples include OECD Report, *supra* note 130, at 85–90; Douglas A. Kahn & Jeffrey S. Lehman, Corporate Income Taxation, 5th ed., 28–36 (Foundation Press, 5th ed. 2005); Graeme Cooper & Richard K. Gordon, *Taxation of Enterprises and their Owners*, *in* Tax Law Design and Drafting, Vol. 1, ch. 19 (Victor Thuronyi ed., 1996). *Colloquium on Corporate Integration*, 47 Tax L. Rev. 427–723 (1992).

One end of the spectrum is marked by the Classical Method, under which full tax authority is exerted both on companies and their shareholders; namely, there is no integration. Under such a system, all corporate profits are taxed twice at full rates. The first instance of taxation is at the corporate level, on corporate profits, at corporate tax rates. The second collection of taxes is being done at the shareholder level, at individual tax rates (assuming shareholders are individuals), when the corporate profits are being distributed.

At the other end of the spectrum, this double taxation is completely eliminated. The most extreme way to eliminate double taxation is to treat corporations as conduits for all tax purposes, while all of their profits, losses and other tax attributes are allocated to their shareholders, as it is usually done in the case of partnerships and their partners. Such a radical system of corporate/shareholder taxation has never been adopted, as a general rule, in any country,[155] and hence, we shall embrace some more relaxed versions of integration as the other end of our spectrum.

These relaxed methods of integration are also dedicated to the elimination of the double tier taxation. Such systems appear in many forms. The most obvious one is the Full Imputation System. In cases of full imputation, corporate taxes are being levied, but in essence, they are nothing more than a partial withholding regime on shareholders' taxation. When corporate profits are being distributed, shareholders are taxed at their individual capacity but also receive full credit for their proportional share of the taxes already paid by the corporation. Another way to achieve a relief in double taxation is by Dividend Exclusion/Exemption. In such a system, the corporate taxes are levied, but shareholders' level taxation is eliminated by excluding distributed profits from the individual tax base.

An article by Yariv Brauner provides us with a full account on some recent trends of corporate/shareholder integration.[156] Exploring evidence from several jurisdictions,[157] Brauner concludes that "[d]uring the second half of the last century, many countries gradually replaced their so-called classical corporate tax regimes, under which corporate earnings were taxed twice . . . with an integrated regime (imputation), which taxed such earnings only once."[158] However, he also asserts that "[t]his clear and gradual trend has been abruptly reversed with the turn of the century."[159] This reversal of trends is also supported by a 2003 IFA

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[155] KAHN & LEHMAN, *Id.* at 36.

[156] Yariv Brauner, *Integration in and Integration World*, 2 N.Y.U. J. L. & BUS. 51 (2005).

[157] *Id.* at 68–76.

[158] *Id.* at 51.

[159] *Id.*

study arguing that a "significant move away from the imputation system" can be observed throughout the world.[160] Brauner argues that the primary reasons for which imputation has been abandoned are the difficulties to extend its benefits across borders.[161] If a country, in which a company is resident, grants credits to foreign shareholders for taxes paid by the resident company, the result is zero revenue for the source country (with respect to the part of the stake held by foreign shareholders). Of course, it is technically possible to maintain imputation as a strictly domestic policy (i.e., extend the credits only to local shareholders), as was being done during the 1990s,[162] but such policies create preferential treatment to domestic shareholders. These policies both scared investors away (to other countries which did extend the credits across borders)[163] and also contradicted international nondiscrimination rules.[164]

The theoretical scheme to maintain imputation at the international level requires the source country to give up any taxation of the foreign shareholders,[165] in fact, to move from a full imputation system to a dividend exemption system. This can be maintained in one of two ways: unilateral or coordinated. Under a unilateral approach, the source system would simply exempt shareholders (both foreign and domestic) from any taxation on dividend and compensate for the revenue loss by rising corporate tax rates. This is not a feasible solution in the prisoner-dilemma-like environment of global taxation. Such a tactic would probably divert FDI away to lower-rates jurisdictions.

Under a cooperative method, the source country will not raise corporate taxes but will share information with the residence country in order to assure that the residence country will only tax the difference between the corporate tax rate in the source country and the individual tax rate in the residence country. Thus, the source country is able to collect some revenue. It requires any country that is a partner to such a scheme to completely forego withholding on dividends and trust the other country to share complete and accurate information (in order for the former to be able to tax its own residents holding stakes in foreign corporations). Such a level of cooperation is not easy to achieve. With inadequate level of international cooperation and information sharing, countries had to find middle solutions to the problem as they moved

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[160] Richard Vann, *General Report*, *in* 88A Cahiers De Droit Fiscal—Trends in Company/Shareholders Taxation: Single or Double Taxation?, 21, 30 (2003).

[161] Bruner, *supra* note 156, at 7, 78–86.

[162] *Id.* at 84.

[163] *Id.* at 84–85.

[164] *Id.* at 82–83.

[165] *Id.* at 80–82.

away from the imputation method, while trying to maintain some of its merits.

If we adhere to a functional approach, it is arguable that even though a set of corporate tax reforms in the 2000s implemented different integration methods throughout the world, jurisdictions have all some remarkably similar ends. In almost all jurisdictions, imputation systems have "been replaced by the less accurate reduced dividend tax rate system, which, in a way, is a hybrid of dividend exclusion and the classical system."[166] By lowering tax rates on dividends (but still taxing them), countries were able to keep some virtues of imputation (since it is not eliminated completely); avoid being categorized as discriminatory toward foreign shareholders (by exerting the same "partial dividend taxation" to both foreign and domestic shareholders); maintain reasonable tax revenues; and at the same time, maintain their competitive standing in comparison to other jurisdictions.

Thus, even though the movement away from imputation has been executed in different directions, eventually, all roads have led to Rome. Placing this global movement on our previously noted spectrum, many countries have moved from the imputation end to a midlevel position between imputation systems and classical systems. One commentator specifically stated that "[T]here can be detected a general convergence of countries' company shareholder tax systems in an international setting. The convergence is towards dividend relief systems that are more neutral than imputation internationally yet retain some of the domestic benefits of imputation."[167]

B. Some specific integration methods adopted by countries

As we have seen, every country has to deal with the following basic tax issue: how (and to what extent) double dividend taxation caused by the overlapping of personal and corporate income taxes should be avoided. In other words, every country has to decide how to deal with integration.

Summarizing the discussion so far, four models can be identified as tax solutions to the above-mentioned tax problem:

1. the classical system (modified or unmodified);
2. the imputation system (full or partial);
3. the reduced taxation of distributed profits (split-rate method, dividend deduction method, zero rate method); and
4. the participation exemption.

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[166] *Id.* at 77–78. *See also* Vann, *supra* note 160, at 68–69.

[167] Vann, *supra* note 160, at 69.

According to the unmodified classical system, all distributions are taxed as any other items of income. In other words, this system provides no or little relief for personal income tax on dividends. Traditionally both the United States and Switzerland have adopted this method. The assumption of this model is that there is no real double taxation behind taxing distributions.

The modified classical system provides shareholders with relief of various kinds for personal income tax on dividends unconnected with corporate income tax paid on distributions. This is the system adopted by Italy for individuals.

According to the partial imputation system, partial credit is given for shareholder personal income tax liability in respect to corporate income tax paid on distributed dividends. This system is adopted by the United Kingdom and France.

A full imputation system grants partial credit to shareholder personal income tax liability in respect to corporate income tax paid on distributed dividends. In other words, tax-credit shareholders are provided full-tax credit on tax liability for the corporate tax attributable to the dividends they receive. This system has been adopted by Australia. It was also adopted by Italy before 2004.

The reduced taxation of distributed profits model can be split into three submodels: (1) the split-rate method, according to which a lower rate is applied to distributed profits than to retained profits; it was adopted by Germany before it moved to the participation exemption model; (2) the dividend deduction method, which provides a deduction of distributed income from the corporate income tax base; and (3) the zero rate method (or full integration), according to which distributed profits are exempt from corporate income tax.

The fourth model of solving the integration problem is the participation exemption model, under which dividends are not subject to tax for the receiving shareholders. Today, this model is the most common one in **Europe**, due to the fact that European tax law prescribed this method for cross-border EU distributions, and, therefore, many countries also adopted it domestically. For example, in **Italy**, under the current system, corporate shareholders can exclude 95 percent of the dividend from taxable income (partnership shareholders and sole proprietorship shareholders can exclude 60 percent of the dividend from taxable income). However, individual shareholders are subject to a reduced rate on dividends (and capital gains) of 12.5 percent. In other words, Italy adopts the participation exemption model for corporate and partnership shareholders, while it adopts the modified classical system for individuals. It is worth noting that Italy, before 2004, used to adopt a full imputation system, which granted a full integration. The current model provides only a partial integration.

In the **United States,** a dividend tax rate cut, adopted for individuals in 2003, provided a partial integration because it reduced the extent of

double taxation of corporate income. However, this system, which is currently under revision, can be criticized with many arguments:

- It does not reach a full integration.
- It creates distinctions among taxation of different forms of income.
- It could give rise, through corporate income tax avoidance (tax shelters and loopholes) and evasion to (quasi) double nontaxation, and only a small part of the benefits given by such tax avoidance activities are recaptured upon payment of dividends.
- It increases incentives for individuals to convert (through tax avoidance) ordinary income to capital gains.
- Price adjustments could grant unjustified (and undeserved) benefits to people who already owned stock before the reform.

As for corporate shareholders, the United States has adopted a dividend received deduction method, which can be considered an evolution of the participation exemption model. Generally, the United States has not adopted this method for dividends from foreign corporations.