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DOUBLE TAXATION - TREATMENT OF CORPORATE EARNINGS UNDER AMERICAN AND GERMAN LAW

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I. Introduction

This thesis is going to describe the different ways the United States and Germany deal with the problem of double taxation in the legal context of corporate distributions to its shareholders in form of dividends. Tax law is particularly one of the areas of laws that is subject to frequent and often substantial changes. This is true for the German as well as for the U.S. tax lawS.

The U.S. corporate tax law treated this matter quite differently over the last 133 years.[1] The main feature of the present U.S. corporate tax law with regard to the treatment of distributed dividends is the two tier tax structure, meaning that dividends are taxed on the corporate level as well as on the shareholder level. Such tax treatment has caused a lot of controversy among scholars. Most of them conclude that the present state of the U.S. law violates the basic tax policy principles of equity and efficiency and therefore should be reformed.

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[1] For an overview of the historical examples of the U.S. income and corporate tax *see* Scott A. Taylor, Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future, 10 VA. TAX REV. 237, 260-88 (1990). The Civil War income tax of 1864 taxed income of individuals and certain enumerated corporations. As far as these corporations distributed dividends, such dividends were exempt from the income tax at the shareholder level. The income tax law of 1894 imposed a flat tax of 2 % on individual income, also providing a general exemption of $ 4,000. Besides, all corporations were now subject to a 2 % of their income without the allowance of a general deduction. Dividends paid to individuals were exempt from their tax base. From 1913 on, corporate income was taxed on the corporate and the individual level. However, whereas corporations paid a flat tax rate on their earnings, individuals paid both a flat rate ‘normal’ tax and a progressive rate ‘additional’ tax on their income. Dividends were not included in the individual ‘normal’ tax, which led to the result that corporate income did not bear a substantially greater tax burden than non-corporate income. The Revenue Act of 1936 allowed corporations to deduct distributed dividends from their income. From 1939 on, the U.S. corporate tax law provided for the first time that distributed corporate income was subject to the corporate level tax as well as the shareholder level tax. To mitigate the double taxation effect, Congress provided in 1954 the individual shareholder with a 4 % credit for dividends received and that the first fifty dollars were allowed as a general exclusion. Congress repealed the credit in 1968 and, instead, increased the allowed deduction to one hundred dollars. The Tax Reform Act of 1986 significantly increased the corporate and income tax burden on distributed dividends.

The main feature of the German corporate tax law with regard to dividends is the *imputation procedure*, meaning that shareholders are allowed to use the corporate level tax as a credit against their individual income tax liability. This *imputation procedure* was implemented by the Corporate Tax Reform of 1977. Preceding the reform, for several years scholars discussed the pros and cons of the double taxation issue and the necessity of reforming the system. Ten years after the reform, scholars evaluated the change in law and commented on how far the tax reform succeeded in fulfilling its objectives.

Since some of the issues being discussed in the United States today in connection with the corporate tax law are similar if not identical to the issues discussed in Germany before the tax reform, the purpose of this thesis is to describe the impact and effects the tax reform had on the corporate tax law in Germany. After stating the results of the tax reform, the thesis determines whether or not the suggestions raised by the legal literature to improve the U.S. tax system with regard to the policy principles of equity and efficiency are likely to be successful.

The second chapter of the thesis introduces the reader to the tax principles of equity and efficiency, since these principles set the standards for the evaluation of the tax provisions. The third chapter describes in its first part the history and the present state of the U.S. tax law with regard to the distribution of dividends. The second part of the chapter explains the corresponding issues under the German tax law. The fourth chapter describes first the adverse and supporting criticism that is expressed in the ongoing discussion about double taxation in the United States. Afterwards, the thesis addresses whether the results of the German tax reform met its original objectives. Partly because of the experiences gained in connection with the German tax reform and partly because of convincing supporting criticism expressed in the discussion in the United States, the thesis is going to conclude the following:

First, a tax reform that exclusively repeals the two level taxation of distributed dividends is not going to substantially improve the tax system with regard to the equity and efficiency principles. Second, adverse criticism of double taxation focuses entirely on the legal aspects of the equity and the efficiency principles without taking the economic requirement into account that the tax system has to raise a certain amount of revenue. Thus the conclusion of the legal literature that the repeal of the double taxation is going to lead to a more equitable and efficient tax system is not based on a comprehensive consideration of all the circumstances and is therefore highly debatable.

II. Principles of Taxation in General

A. Why is There Taxation?

As one of the major issues of social and economic policy, taxation serves generally the purpose to enable the public sector to raise revenue[2] from the private sector (the tax payer)[3] which is needed to finance the governmental tasks. The modern state finances its expenditures by raising revenue through taxation. Thus taxation is the basis of a state's ability to execute its functions. These functions include the preservation of peace among its citizens as well as providing conditions which enable people to build an operating society. Part of the government's share in this process is "to pay public employees needed to provide social goods and services."[4] By claiming the responsibility for these functions, taxation became the centerpiece for a state's capacity to execute power.[5]

Moreover, taxation serves the additional purpose as an instrument to intently influence people's economic decisions. By implementing tax incentives, tax law can be used as a device to encourage the taxpayer to act in a specific way. By taxing certain transactions and by relieving from taxation other transactions, to a certain extent legislation

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[2] MICHAEL D. ROSE, JOHN C. CHOMMIE, FEDERAL INCOME TAXATION, at 1 (3rd ed. 1988); PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION, at 52, (1994).
[3] JOSEPH A. PECHMAN, FISCAL TAX POLICY, 5th ed. 1987, at. 5.
[4] RICHARD A. MUSGRAVE, PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE, 248 (4th ed., 1984).
[5] E.W. BOECKENFOERDE, *ENTSTEHUNG DES STAATES ALS VORGANG DER SAEKULARISIERUNG*, [Evolvement of a State as a Process of Secularization] *in STAAT, GESELLSCHAFT, FREIHEIT*, [State, Society, Freedom] 42 (1976).

discourages or respectively encourages the execution of business decisions.[6] This is the "inescapable regulatory effect"[7] that comes along with every tax.

These two purposes of the taxation illustrate its enormous importance.

Today, the state's justification to raise revenue in form of taxation is no longer in doubt.[8] The United States Constitution explicitly grants the power to tax to the federal government. Article 1, Section 8, clause 1 in connection with the 16th Amendment of the Constitution of the United States warrants the imposition of an income tax.

B. How Should Taxation be Executed?

A current tax system is always the temporary result of economic, political , and social influences. There is not a flawless tax system "constructed by a master architect in line with the optimal requirements for a 'good' tax structure."[9] Although federal tax law changes quite frequently, certain basic tax structures are not altered because they conform with generally accepted principles and norms.[10] These principles are laid out in two group of norms, the "fairness norms" (or "equity norms) and the "economic norms".[11] These norms differ in their effect: Fairness norms have an direct impact on people, whereas "economic norms" influence economic behavior, executed by real people or through an entity.[12]

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[6] JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION, 32 (9th ed.,1996).
[7] *Id.*, (the authors contend that "federal income tax is far from a neutral, revenue raising device; it has a profound impact on what people do.").
[8] This is not as self-evident as it might seem today. In the 18th century, the French philosopher and writer Jean Jaques Rousseau broadly criticizes the concept of taxation in general. He contends that in a country where individuals serve rather with their pocket book instead of rendering primarily personal services, the decline of such a country is inevitable. He concludes that the word "tax" is a slave word and that in a truly free country its citizens do everything themselves and nothing with money. *See JEAN JAQUES ROUSSEAU, VOM GESELLSCHAFTSVERTRAG, 1762* [The People's Contract], at 102 (reprinted 1977).
[9] MUSGRAVE & MUSGRAVE, *supra* note 4, at 224.
[10] JOSEPH M. DODGE, ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY at 17 (1995).
[11] *Id.* at 18.
[12] *Id.*

From an idealistic point of view, "fairness" or "equity norms" seek a "'correct' distribution of wealth or income among people in society".[13] On the other hand, "economic norms" aim towards economic efficiency, "which refers to aggregate maximization of wealth and income without regard to distribution of that income or wealth in society".[14] Other criteria to evaluate a tax system are e.g. the degree of complexity and the degree of enforcement difficulty. In this overview of tax policy, there is going to follow a closer look at the two major concepts, the "fairness norms" and the "economic norms".

1. Fairness Norms

There are no controversies about the contention that as a matter of fairness people in the same positions should be treated the same.[15] In the area of tax, this maxim is called the concept of *horizontal equity*: Persons in an alike position should bare the same tax burden.[16] Somewhat accordingly, the maxim of *vertical equity* asks for a different treatment of differently situated taxpayers. This different treatment can be achieved by simply applying a proportionate tax rate to the taxpayer's taxable income. By a matter of calculation, the higher a person's taxable income, the higher his tax liability will be. This leads eventually to the different treatment. A possibility to emphasize the effect of the different treatment is to apply a progressive tax to the taxpayer's taxable income.

The effectiveness of the two policy principles *horizontal* and *vertical* equity depends on one's determination of the tax base, i.e. what should be taxed.[17] A decision has to be made

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[13] *Id.*
[14] *Id.*
[15] JOSEPH M. DODGE, THE LOGIC OF TAX, at 88 (1989).
[16] JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY, at 804 (W.J. Ashley ed., London: Longmans, 1921) (Taxpayers are said to be treated equally if their tax payments involve an equal sacrifice of loss of welfare.); DODGE ET AL., *supra* note 10, at 18.
[17] DODGE ET AL., *supra* note 10, at 19.

to choose "the most appropriate criteria by which to apportion the aggregate federal tax burden among individuals."[18] The following criteria are most commonly suggested:

First there is the *equal sacrifice principle*.[19] People should be taxed in equal amounts since they benefit from the government equally. This might be true for general government services like providing personal security through police forces and assuring basic civil and political rights. On the other hand, people with more property naturally receive a greater portion of governmental services. Therefore the prerequisite of "equal benefit" does not exist.

Another criteria is the *benefit principle*, saying "that individuals should pay tax in proportion to the varying benefits they receive from government."[20] On first glance, the idea of taxing people in accordance to the advantages they take from governmental services sounds reasonable.[21] This is a special form of buying services from the government. However, there are governmental services for specific people (e.g. welfare services) who are definitely unable to pay. Other governmental services (e.g. public universities) are considered to create benefits not only to the recipient but at the same time to the public as well. In these situations, the *benefit principle* simply fails as a criteria for an ideal tax base.

After the *standard of living principle* people would be taxed "according to their standard of living, as evidenced by their level of personal consumption."[22] The weakness of this principle is that it takes only people's consumption into account, whereas it does not consider their savings.

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[18] *Id.* (the authors describe this process as an "inquiry into 'substantive tax equity'.")
[19] *Id.* at 20.
[20] *Id.* at 20; MUSGRAVE & MUSGRAVE, *supra* note 4.at 228.
[21] *Id.* at 20 (Tax payments are considered to be the *quid pro quo* for the governmental services).
[22] *Id.* at 21.

The most comprehensive concept is the *ability to pay principle.*[23] "Persons should sacrifice the funds required for government operations according to the economic resources - including both current income and accumulated wealth - under their control."[24]

2. Economic Norms

The general idea of a functioning capitalist system is that of a free market. Individuals pursue their economic goals in a business environment with as few regulations as possible. The desired result is economic efficiency, which leads to the most possible maximization of wealth and income.[25] The tax system with its burdensome regulations poses a threat to this system. Therefore, "the fundamental free-market economic norm relevant to tax systems and provisions is that of *neutrality*."[26] In theory, tax norms should as a consequence neither encourage nor discourage individual's economic activities.[27] Neutral taxes are those that have little or no effect on marketplace behavior.[28] An efficient tax does not influence the economic decision that taxpayers would make if there were no such tax provision.[29] However, in reality there are hardly no tax provisions that do not affect individual's decision-making.[30]

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[23] As Musgrave points out, the *ability to pay principle* predates the *benefit principle* since it goes back to the 16th century. Supporters of this principle include social philosopher Rousseau and economist John Stuart Mill, *see* MUSGRAVE & MUSGRAVE, *supra* note 4, at 232.

[24] DODGE ET AL., *supra* note 10, at 21; Adam Smith combined the *benefit* and the *ability to pay principle* in his first canon of taxation: "The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state", *see* ADAM SMITH, THE WEALTH OF NATIONS at 310, (E. Cannan ed., vol. 2, 1904).

[25] DODGE ET AL., *supra* note 10, at 22.

[26] *Id.*

[27] *Id.*

[28] C. MCLURE, MUST CORPORATIONS BE TAXED TWICE, 253 (1979).

[29] Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C.L.REV. 613, 615 (1990); MUSGRAVE AND MUSGRAVE, *supra* note 4, at 291-312.

[30] Taxes might have a disincentive effect, called the *substitution effect*, when persons prefer low-taxed activity to higher taxed activity in spite of economic disadvantages; On the other hand, there might be the incentive effect called *income effect*, causing persons to earn more income to reach a targeted after-tax goal, *see* DODGE ET AL., *supra* note 10, at 22.

Moreover, there are exceptions to this principle. The free market ideal does not always lead to the desired consequences.[31] Thus, tax law is used as a device to encourage or discourage activities or investments to achieve particular social and economic goals where the free market system is unlikely to succeed in achieving the goal of economic efficiency.[32]

3. Summary of the Above Discussed Tax Principles

Economists and social philosophers developed the idea of certain general principles which can be considered essential requirements of a "good" tax system.[33] The most important principles are the following:

1. The tax system should be equitable. Every taxpayer should carry an equal burden with regard to financing the cost of government.[34]

2. The implementation of taxes should have as little impact as possible on the taxpayer's economic decisions in otherwise efficient markets.[35]

3. Where the tax is mainly used as a regulatory device, e.g. by granting incentives through preferential treatment of certain expenditures, again this should cause as little as possible interference with the equity of the system.[36]

4. The tax system should set the set the prerequisites for "the use of fiscal policy for stabilization and growth objectives."[37]

5. The administration of the tax system should be "fair and non-arbitrary".[38]

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[31] One example for market failure is e.g. the formation of monopolies.
[32] McDaniel et al., *supra* note 2, at 53 (Tax provisions may encourage investment in particular economic activities or may encourage socially valuable activities like charitable contribution.)
[33] Cite Adam Smith and J.S. Mill
[34] Musgrave & Musgrave, *supra* note 4, at 225.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*

In other words, the desirable requirements of a "good tax structure" ask for an equitable, efficient and well administered tax system.[39]

[39] *Id*; McDANIEL ET AL., *supra* note 2, at 53.

III. Taxation of Retained and Distributed Corporate Dividends

A. Introduction to Corporate Tax in the U.S.

1. History and Constitutional Issues

The United States Constitution today contains the following principle provisions addressing the issue of taxation:

> *Article I, Section 8 Clause 1*: "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."
>
> *Article I, Section 9, Clause 4*: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census of Enumeration herein before directed to be taken."[40]
>
> *Amendment XVI*: The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Congress' first and successful attempt to raise revenue by taxing income, rather than relying on customs duties, was made during the Civil War to gather sufficient funds to finance the military expenditures.[41] This legislation which applied to both corporate and individual incomes turned out to be temporary.

In 1894, Congress tried to reestablish the income tax. It implemented the Income Tax Act of 1894, which again applied to corporate as well as individual income.[42] The Supreme Court declared the tax as unconstitutional.[43] According to its reasoning, the tax violated the Constitutional requirement that "direct" taxes on property be apportioned among the states according to population since a tax on individuals' incomes from real

[40] Now changed by the XVI. Amendment.
[41] Act of June 30, 1864, 13 Stat. 223 (1864).
[42] Income Tax Act of 1894, ch. 349, 28 Stat. 509 (1894).

estate and personal property was indistinguishable from a direct tax on the underlying property.[44] Furthermore it held that the corporate provisions of the statute were inseparable from the individual provisions and therefore also contradict the Constitution.[45]

In 1909, under consideration of the Supreme Court ruling in the Pollock case, Congress passed the Revenue Act of 1909, regulating only the corporate income.[46] It pointed out that corporations are neither taxed on their receipt of income from their property nor on the franchises of the corporation. The Supreme Court agreed with Congress, finding that the latest Revenue Act implemented not a direct tax but a constitutional excise or indirect tax on the privilege of doing business in a corporate capacity that was only measured by such income[47]:

> "[T]he tax is imposed not upon the franchises of the corporation, irrespective of their use in business, nor upon the property of the corporation, but upon the doing of corporate or insurance business, and with respect to the carrying on thereof, [...], that is, when imposed in this manner it is a tax upon the doing of business, with the advantage which inhere in the peculiarities of corporate or joint stock organizations of the character described."[48]

This Supreme Court ruling dealt only with the aspect of doing business in a corporate form, whereas is did not address the issue of passive income derived from property. The question how far such income would be protected from being corporate taxable income by the Supreme Court ruling in the Pollock case[49] did no longer arise since the implementation of the XVI. Amendment in 1913. From that moment on, the United States Constitution explicitly grants power to Congress to collect taxes on (corporate) incomes from whatever source derived.

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[43] Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).
[44] *Id.* At this point it needs to be emphasized that the Supreme decided this case before the XVI Amendment was implemented.
[45] Id.
[46] Revenue Act of 1909, ch. 6, 36 Stat. 11.
[47] DOUGLAS A. KAHN, JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION, 5 (4th ed. 1994); Jane G. Gravelle, The Corporate Income Tax: Economic Issues and Policy Options, 48 NAT'L TAX J. 267 (1995).
[48] Flint v. Stone Tracy Co., 220 US 107, 115-116 (1911).
[49] Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

2. Present State of the Corporate Tax and Income Tax on Dividends[50]

The United States tax system contains a two-tier tax structure for income of corporations and their shareholders' income. The income of corporations is subject to the corporate tax, since they are legal entities distinct from their owners.[51] In case of distributions by the corporation to the shareholder, the shareholder is subject to tax on these after-tax profits of the corporation.

A separate corporate tax is necessary to avoid substantially different tax treatment of businesses pursued as a sole proprietorships and businesses conducted in the form of a corporation.[52] According to the *doctrine of realization*, an individual's investment income needs to be realized before it is included in the individual's taxable income.[53] If there was no corporate level tax, a business conducted in the corporate form could reinvest all of its profits tax free (no act of realization has been occurred) whereas the sole proprietorship could only reinvest after-tax profits.[54] Such a disparity in the tax burden of the two types of businesses would not comply to the tax policy goal of efficient tax statutes.

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[50] The law discribed under III. A. 2 refers to the Internal Revenue Code of 1986 as amended by the Revenue Reconciliation Act of 1993. The explanations deal with corporations that do not qualify to an S corporation or that do not elect to be one, i.g. the C corporation, section 1361 (a) (2) IRC.

[51] KAHN & LEHMAN, *supra* note 47, at 26, (The authors state that "[t]here is an inescapable appeal to the straightforward notion that every separate entity that conducts a business should be taxed currently on its income, regardless of what kind of entity it is.")

[52] *Id.* at 27.

[53] *Id.*

[54] *Id.*

a) The Corporation's Taxable Income

The calculation of a corporation's taxable income is similar to the one of individuals. Nevertheless, some significant differences exist. The corporation's taxable income is defined as *its gross income minus allowable deductions*, section 63 (a). Due to the nature of a corporation, the allowable deductions are not identical to the deductions for individuals. A corporation cannot claim standard deductions,[55] and does not receive personal exemptions.[56] With regard to capital losses (losses from sales or exchanges of capital assets, sections 165 (f), 1211 (a)), for corporations such losses are only allowed to the extent of gains from such sales or exchanges.

b) Tax Rates

There are different tax rates that apply to individuals and corporations.

aa) Tax Rates on Individuals

The tax rates for individuals are stated in section 1 (a) to (d) Internal Revenue Code of 1986 as amended by the Revenue Reconciliation Act of 1993. There are five different rates, starting at 15 %, and going over 28 %, 31 %, and 36 % to 39.6 %. Depending on whether the taxpayer files a *joint return as a married individual* or a *surviving spouse* (subsection (a)), a return as the *head of the household* (subsection (b)) or as an *unmarried individual* (subsection (c)) or whether the taxpayer files a *separate return as a married*

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[55] Section 63 (b) IRC reads: "[...] an *individual* who does not elect to itemize his deduction [...]".
[56] BABETTE B. BARTON ET AL., TAXATION OF BUSINESS ENTERPRISES 5 (17^{th} ed. 1995) (Corporations are inanimate separate entities that do not need food, shelter, medical attention and therefore may not claim such deductions.)

individual (subsection (d)), the amounts of income change to which the five categories of rates apply.

E.g., for the married individual filing a joint return, the five tax rates apply to the following amounts of taxable income:[57]

Not over $ 36,900	15 % of taxable income
Over $ 36,900 to $ 89,150	$ 5,535 plus 28 % of excess over $ 36,900
Over $ 89,150 to $ 140,000	$ 20,165 plus 31 % of excess over $89,150
Over $ 140,000 to $ 250,000	$ 35,928.5 plus 36 % of excess over $ 140,000
Over $ 250,000	$ 75,528.5 plus 39.6 % of excess over $ 250,000

In the order of *heads of household*, *unmarried individual*, and *married individual filing separate returns*, the income tax burden increases gradually for these type of taxpayers.[58]

Tax law provides special treatment for *long term capital gains* or *capital losses*. Under section 1 (h) IRC, *long term net capital gain* is taxed at a maximum rate of 28 %. Section 1 (h) IRC simply caps the tax rates. This means that capital gain income realized by a person otherwise taxed at 31 %, 36 % or 39.0 % is taxed at 28 %, whereas capital gain is taxed at only 15 % if the taxpayer's remaining income is taxed at that rate.

Capital gains or *losses* result from a sale or transaction of a *capital asset*. Section 1221 (1) to (5) IRC defines *capital asset* as property held by the taxpayer whether or not connected with his trade or business except inventory, self-created art work, copyrights, letters, notes, accounts receivable from the sale of inventory or services and under in subparagraph (5) closer described circumstances publications of the United States Government. The notion behind this special treatment is "that the concept of capital gain and loss excludes gain and loss attributable to the sale of inventory and services, i.e.,

[57] *See* section 1 (a) IRC.
[58] For details *see* section 1 (b) to (d) IRC.

ordinary business and wage income."[59] Finally it is important to mention that section 1211 IRC provides that *capital losses* may only be offset in the case of a corporation against *capital gains* and in case of an individual against *capital gains* plus up to $ 3,000 of ordinary income.

bb) Tax Rates on Corporations

Section 11 (b) IRC as amended by the Revenue Reconciliation Act of 1993 provides the applicable tax rates on corporate income:

Not over $ 50,000	15 %
Over $ 50,000 to $ 75,000	25 %
Over $ 75,000 to $ 100,000	34 %
Over $ 100,000 to $ 335,000	39 %
Amounts exceeding $ 100,000 up to $ 235,000 are taxed at 39 % due to the phase out provision of section 11 (b) (1) last paragraph IRC. This provision phases out the benefit of the lower tax brackets of 15 % and 25 % for income up to $ 75,000.	
Over $ 335,000 to $ 10,000,000	34 %
Over $ 10,000,000 to $ 15,000,000	35 %
Over $ 15,000,000 to $ 18,333,333	38 %
Amounts exceeding $ 15,000,000 up to $ 3,333,333 are taxed at 38 % due to the phase out provision of section 11 (b) (1) last paragraph IRC. This provision phases out the benefit of the lower tax bracket of 34 % for income up to $ 10,000,000.	
Over $ 18,333,333	35 %.

Section 11 (b) (2) IRC provides an exception to paragraph (1). The income of *qualified personal service corporations* as defined in section 448 (d) (2) IRC is taxed at a flat rate of 35 % regardless of the amount of taxable income.

Like individuals, corporations can also benefit from the lower tax rates in connection with income from capital gain.[60]

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[59] DODGE ET AL.,*supra* note 10, at 37.

[60] For explanation of taxation of income from capital gains, *see supra* III. A. 2. b) aa).

cc) Relationship Between Corporate and Individual Tax Rates

Throughout the history of the income tax and the corporate tax, the maximum corporate tax rate was almost always significantly lower than the top individual tax rate. Therefore, individuals were tempted to "shift income from themselves to their corporations in order to have the income taxed at the lower corporate rates."[61] To discourage individuals from such actions, the Code contains under the headline of Subtitle A, Chapter 1, Subchapter G "Corporations Used to Avoid Income Tax on Shareholders" provisions regulating the *personal holding company tax*[62] and the *accumulated earnings tax*.[63]

During the period from 1987 to 1992, the relationship of the top corporate and individual tax rate was inverted.[64] The *Revenue Reconciliation Act of 1993* restored the former relationship, setting the top corporate rate at 35 % and the top individual rate at 39.6 %.

c) Distributions to Shareholders

aa) Statutory Pattern of Distributions

There are several possibilities for shareholders to receive their share of the corporate earnings. The Code provides tax rules for different types of distributions from the corporations to the shareholder as well as tax rules for the sale of stock. For the shareholders, such income is either taxed as ordinary income or at the lower long term capital gains rates. As a general rule, "current distributions are subject to ordinary income

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[61] BARTON ET AL., *supra* note 56, at 7.
[62] *See* sections 541 to 547 IRC.
[63] *See* sections 531 to 537 IRC.
[64] The Revenue Code of 1986 provided for corporations a maximum tax rate of 34 % while the top tax rate for individuals amounted to 28 %. The *Revenue Reconciliation Act of 1990* increased the individual rate to 31 %.

tax rates while many redemptions of stock, like the sale or exchange of stock, are taxed at lower long-term capital gains rates."[65] Following is a brief overview of the IRC provisions dealing with corporate distributions to shareholders:

The Code deals with liquidating distributions[66] in section 331 IRC, treating them like distributions on the sale of stock. Section 336 IRC provides the tax consequences for the corporation. Sections 332 and 337 IRC regulate the case if the shareholder is a corporation which owns 80 % or more of the stock of the liquidating corporation, extending non-recognition of gain or loss.

Redemption of the stock of the shareholder, i.e. a sale of the stock back to the issuing corporation is either treated as a sale or as a current distribution. Sections 302; 303; 304 IRC govern the consequences on the shareholder side, whereas section 311 IRC regulates the consequences on the corporate level.

For stock dividends, i.e. the distribution by a corporation of its own stock, the question is whether such distributions are taxable at all. This issue is addressed in sections 305; 306; and 307 IRC.

A corporation may be used to shelter income from the individual's taxable income. An individual in the top income tax bracket of 39.6 % could chose to conduct a business in the corporate form for the only reason to reduce income taxes since the maximum tax rate for corporations is 35 % at the moment. Congress decided that under certain circumstances it is not suitable to use the corporate form to save income taxes. Especially the sections 531 to 537 IRC[67] and 541 to 547 IRC[68] deal with the improper use of corporations.

Finally there is the ordinary current distribution of property to the shareholder, regulated under section 301 IRC. This kind of distribution is going to be discussed in the

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[65] BARTON ET AL., *supra* note 56, at 141.
[66] Section 331 (a) IRC defines such distributions as "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation [...]".
[67] This part of the IRC regulates the *corporations improperly accumulating surplus.*
[68] This part of the IRC regulates the *personal holding companies.*

following paragraph, since it is the equivalent to the dividend distribution under German corporate and income tax law that is subject to the imputation procedure.

bb) Distribution of Property Under Section 301 IRC

Section 301 (a) IRC regulates a distribution of property made by a corporation to a shareholder with respect to its stock. The amount distributed is the amount of money received plus the fair market value of the other property received.[69] An assumption of liabilities in connection with the distribution reduces its amount.[70] The term *property* is defined as money, securities, and any other property except stock in the corporation making the distribution.[71]

The tax consequences of a section 301 IRC distribution depend on how much of the distribution is considered to be a dividend. Such portion is taxed as ordinary income.[72] A dividend for tax purposes is defined in section 316 (a) IRC as "any distribution of property made by a corporation to its shareholders" either out of its *earnings and profits* (e & p) accumulated after February 28, 1913[73] or out of its e & p of the taxable year. This indicates the existence of two e & p accounts, one for the accumulated and one for the current earnings. In order to determine whether a distribution qualifies to be a dividend, first current e & p is allocated ratably to all distributions made during the taxable year without regard to the chronological order of the distribution.[74] This is done at the end of the year, while there was no diminution of the account by reason of any distributions made during the taxable year. If the distributions exceed the amount of the current e & p

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[69] Section 301 (b) (1) IRC.
[70] Section 301 (b) (2) IRC.
[71] Section 317 (a) IRC.
[72] Section 301 (c) (1) IRC.
[73] The Sixteenth Amendment to the Constitution was ratified on February 3, 1913 and became effective February 25, 1913. This Amendment put aside any remaining doubts about the income and corporate tax being constitutional. Therefore, the date in section 316 IRC was chosen February 28, 1913, *see* KAHN & LEHMAN, *supra* note 47 at 84.
[74] *See* regulation 1.316-2 (b).

account, to the extent of the accumulated account such remaining distributions are qualified as dividends. For the accumulated account, there is no pro rata allocation but an allocation according to the order of distribution.

If the corporation does not have sufficient e & p to cover the distribution, such remaining amount does not qualify for dividend treatment. Under section 301 (c) (2) IRC, such a portion is treated as nontaxable return of capital to the extent of the basis for the stock on which the dividend is distributed.[75] In case the distributions also exceed such basis, the surplus is treated as gain from the sale or exchange of property, section 301 (c) (3) (A) IRC.

The tax consequences for the corporation in case of a section 301 distribution depend on whether the distribution is made in cash or in another form of property. A cash dividend triggers no corporate tax consequences at all. Only the e & p account needs to be reduced accordingly. If the corporation distributes property other than cash, section 311 (b) IRC provides that in case the fair market value of such property exceeds its adjusted basis, the gain is recognized to the corporation. On the other hand the Code disallows the recognition of losses for distributed property, section 311 (a).

cc) Dividend Received Deduction for Corporate Shareholders

As described *supra* under III. A. 2., the IRC provides a two tier tax structure for dividends distributed by a corporation to its shareholders. Generally, the corporation is taxed on its income, and if all or a portion of this income is distributed to the shareholders and qualifies for being a dividend under section 316 IRC, such a dividend is subject to the shareholders income tax. If there were no modifications in case that the shareholder is also a corporation (corporate shareholder), there would be possibly multiple tiers of taxation

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[75] BARTON ET AL., *supra* note 56, at 143.

before the ultimate individual owners of the business finally receive the dividend.[76] To prevent the Code from burdening corporate earnings on three or more levels Congress enacted section 243 IRC. Section 243 IRC does not entirely exempt dividends received by corporate shareholders from their income. Such a rule could have the effect to encourage individuals to hold their stock through closely held corporations (personal holding companies) which rather reinvest than distribute the earnings and by doing so indefinitely defer the shareholder-level tax.[77] Therefore section 243 IRC balances the interest of preventing corporate earnings from possibly being taxed three or more times with the interest to not enable shareholders to get rid of the shareholder-level tax by constituting a personal holding company.

The general rule of section 243 IRC provides that in the case of a corporate shareholder receiving dividends paid by a domestic corporation,[78] the recipient corporation is allowed a deduction in the amount of a specific percentage of the distribution. The percentage depends on the size of the interest the receiving corporation is holding in the distributing corporation. If the receiving corporation owns 80 % or more of the voting power and value of the stock of the payor corporation, it can take the entire amount of the distribution as a deduction, sections 243 (a) (3) and (b); 1504 (a) IRC. The Code provides another 100 % deduction for received dividends for small business investment companies operating under the Small Business Investment Act of 1958, section 243 (a) (2) IRS.

If the corporation owns an interest ratio of 20 % to less than 80 %, it is granted a 80 % deduction of the distributed amount.[79] Such a deduction reduces the possible maximum effective tax rate to 7 %[80] and is generally referred to as an "80 % dividend-received-

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[76] *Id.* at 158.
[77] *Id.*
[78] Section 7701 (a) (4) IRC defines a *domestic corporation* as one created in the United States or under the law of the United States or of any State.
[79] *See* section 243 (c) IRC.
[80] Presuming the highest possible tax rate for corporations of 35 %. 35 % on 20 % of the dividend results in a tax burden of 7 % for the entire distribution.

deduction". Corporations owning an interest of less than 20 % are allowed a deduction of 70 % of the distribution amount, leading to a possible maximum effective tax rate of 10.5 %.[81] Accordingly, such a deduction is referred to as a "70 % dividend-received-deduction".

These deductions are subject to certain statutory limitations. Section 246 (b) IRC provides a ceiling for the aggregate amount of a corporate shareholder's "70 %" and "80 % dividend-received-deduction". The "80 % dividend-received-deduction" shall not exceed 80 % of the corporate shareholder's taxable income "computed without regard to the deductions allowed by sections 172, 243 (a) (1), 244 (a), subsection (a) or (b) of section 245 [...]"[82] and some other deductions listed in section 246 (b) (1) IRC. The aggregate of the "70 % dividend-received-deduction" is restricted to 70 % of the corporate shareholder's taxable income of the year. To determine the taxable income in this context, the same calculation needs to be done as for the "80 % dividend-received-deduction" and in addition the income is reduced by the aggregate amount of dividends form 20 % owned corporations.[83] Therefore, generally the dividend-received-deduction regulated under section 246 IRC are subject to a ceiling of either 70 % or 80 % of the corporate shareholder's modified taxable income. Nonetheless, such restrictions do not apply for years in which the corporate shareholder has a net operating loss, section 246 (b) (2) IRC.[84]

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[81] Presuming the highest possible tax rate for corporations of 35 %, 35 % on 30 % of the dividend results in a tax burden of 10.5 %.
[82] *See* section 246 (b) (1) IRC.
[83] *See* section 246 (b) (3) (B) IRC.
[84] It is significant that in order to determine whether there exists a net operating loss for the taxable year, the corporate shareholder is allowed to use the entire amount of the 70 % and 80 %-received-deduction without the limitations of section 246 (b) (1) IRC, *see* Treas. Reg. 1.246-2(b); *See* KAHN & LEHMAN, *supra* note 47,at 77 (The authors illustrates in two examples when the corporate shareholder is allowed to use the full dividend-received-deduction or when the dividend-received-deduction is subject to the ceiling of section 246 (b) IRC).

d) Corporate Level Penalty Taxes

As described under III. A. 2. b) cc), the individual tax rates are significantly higher than the tax rates for corporate taxpayers. Such a condition serves as an incentive "to use the corporate form as a device for splitting or shifting income into lower brackets" to realize substantial tax savings.[85]

Moreover, the lower tax rates on long-term capital gain income compared to tax rates on ordinary income encourages the choice to conduct business in a corporate form with the objective of converting such ordinary income into long-term capital gain "through liquidation of the corporation or through sale of its stock before a substantial amount of the income from those business activity had been realized."[86]

The Code provides in section 1202 IRC another favorable tax treatment in case of the choice of the corporate form to conduct business. Under section 1202 (a) IRC, a taxpayer other than a corporation can exclude 50 % of any gain attributable to the sale or exchange of qualified small business stock held for more than 5 years. Of course, this requires the taxpayer to use a corporate form which complies with the provision of a *qualified small business* under section 1202 (d) IRC. Finally, the taxpayer can hold the stock until he dies. As a consequence, the heirs receive the stock with a stepped-up basis, section 1014 (a) (1) IRC, thus sheltering the inherited gain from the shareholder level tax.

This examples show that the use of the corporate form can possibly be a means to avoid the individual income tax on income as well as a means to convert ordinary income into preferably taxed capital gain income. To battle these types of misuse, the IRC contains provisions dealing with personal holding companies,[87] unreasonable accumulations of income in a corporation,[88] and collapsible corporations.[89]

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[85] BARTON ET AL., *supra* note 56, at 259.
[86] *Id.*
[87] *See* sections 541 to 547 IRC.
[88] *See* sections 531 to 537 IRC.
[89] *See* section 341 IRC.

aa) Personal Holding Company Provisions

Under section 541 IRC, a personal holding company tax equals 39.6 % of the undistributed personal holding income of a personal holding company. The tax rate of 39.6 % equals the maximum individual tax rate under section 1 IRC, thus eliminating the advantage of being taxed under a lower corporate rate. There are two basic reasons for the implementation of the personal holding company tax. It shall discourage the use of the corporate form first "as a tax receptacle for receiving and accumulation investment income for the controlling shareholders",[90] and second "as a device for shifting to a separate taxable entity income produced by personal services rendered by a talented controlling shareholder."[91]

A corporation is considered to be a personal holding company under two prerequisites: The first prerequisite is that 60 % of its income must qualify as personal holding company income as defined in section 543 IRC. Personal holding company income includes generally dividends, interest, patent royalties, mineral royalties, copyright royalties, annuities, and amounts received under personal service contracts performed by a designated individual shareholder who at some time during the year owned 25 % or more of the outstanding stock of the corporation. Parts of the rents, interest, active business computer software royalties and other royalties are excluded.[92] The second prerequisite refers to the number of shareholders of the corporation. At any time during the last half of the taxable year more than 50 % in value of its outstanding stock must be owned directly or indirectly by or for not more than five individuals.[93] Section 542 (c) IRC excludes

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[90] BARTON ET AL., *supra* note 56, at 261; KAHN & LEHMAN, *supra* note 47, at 398. (The authors refer to such a corporation as an *incorporated pocketbook*, serving the purpose "to have the dividend and interest income taxed at corporate rates and to utilize the dividend-received deduction that is available for corporate shareholders).

[91] *Id.*

[92] *See* section 543 (a) (1) through (5) IRC.

[93] *See* section 542 (a) (2) IRC.

certain types of corporations from the personal holding company provisions, e.g. banks, savings and loan associations, life insurance companies, and some lending and finance companies.

bb) Accumulated Earnings Tax

Sections 531 through 537 IRC deal with the accumulation problem.[94] Purpose of these sections is to tax a corporation on its excessive accumulation of current earnings.[95] Section 531 IRC imposes an accumulated earnings tax equal to 39.6 % of the accumulated taxable income on corporations "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders [...] by permitting earnings and profits to accumulate instead of being divided or distributed."[96] Section 533 (b) states that holding or investment companies are prima facie evidence of the purpose to avoid the income tax avoidance with respect to shareholders. Again the rate of 39.6 % equals the maximum individual tax rate.[97] The rules do not apply to personal holding companies, foreign personal holding companies and corporations exempt from tax.[98]

If earnings and profits are permitted to accumulate beyond the reasonable needs of the business, such accumulation is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by a preponderance of the evidence can prove to the contrary.[99] Under this statutory presumption it is necessary to determine the reasonable needs of a particular corporation's business. Such a determination requires an

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[94] KAHN & LEHMAN, *supra* note 47, at 434 (The accumulation of retained earnings in a closely held corporation lead to an increase in the value of the shareholder's stock. Since no dividends are distributed, there is no income tax on the shareholder level. To realize his share of the corporate earnings, the shareholder can sell his stock in the following year or cause the liquidation of the corporation. In both cases, the shareholder would receive the benefit of the lower capital gain tax rates.
[95] *Id.* at 435.
[96] *See* section 532 (a).
[97] *See* explanation under III. A. 2. d) aa).
[98] For further details *see* section 532 (b) IRC with additional references.
[99] *See* section 533 (a) IRC.

evaluation of business judgments, and courts unlikely will challenge a businessman's decision as long as there is a reasonable substantiation given.[100] However, a professional corporation (like an incorporated law firm) will have difficulties to justify an accumulation of income in excess of the minimum amount of accumulation permitted under section 535 (c) (2) IRC.[101] According to this section, an amount of $ 250,000 ($ 150,000 in the case of certain personal service corporations)[102] can be at least accumulated without facing the risk of being taxed under the accumulated earnings tax provisions. Section 537 (a) IRC defines reasonable needs of the business as reasonably anticipated needs of the business, section 303 redemption needs of the business and the excess business holdings redemption needs of the business. Treas. Reg. 1.537-2 (b) states some examples that if supported by sufficient facts fulfill the requirements of being accumulated for the reasonable needs of the business.

B. Introduction to Corporate Tax in Germany

1. History

a) Development of the Corporate Tax Law

Before 1920, there did not exist a uniform code regulating corporate taxation. Until then, this area was a matter of state law. The individual states regulated this issue in their income tax codes. Generally, legal entities were taxed on their income as well as individuals were. Due to the low tax rates, there was only little meaning to the existing double burden on income.[103]

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[100] KAHN & LEHMAN, *supra* note 47, at 437.

[101] *See* Brumer, Moss & Cohen, P.A. v. United States, 37 AFTR 2d 76-802 (S.D. Fla. 1975).

[102] The personal services have to be in the area of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, *see* list in section 535 (c) (2) (B) IRC.

[103] The income tax code of Prussia from June 24, 1891 provided a maximum tax rate of 4 % on income exceeding 100,000 Mark per year of, see *Preuss. Ges. Sammlung* at 175. The income tax code of Saxon from July 2, 1878 contained a maximum income tax rate of 3 %, see *Gesetz- und Verordnungsblatt* at

The first uniform corporate tax code was implemented on March 30, 1920.[104] Under this code, retained earnings were taxed at a rate of 10 %. In case of a distribution, an additional tax up to 10 % of the distribution amount was collected. Besides, a simultaneous increase in the individual's income tax rate lead to an even higher double burden on distributed corporate earnings.[105]

On April 8, 1922, by another change of statute, the tax rate for commercial companies was raised to 20 % and subsequently the rate on distributions was raised to 15 %.[106] At the same time, dividend recipients were allowed to use between 10 and 15 % of the tax amount paid on the distribution as a tax credit to be offset against their individual income tax liability.

With the next changes of the statute on August 10, 1925, the additional tax on distributions was abolished.[107] For smaller corporations, progressive tax rates became applicable. On the other hand, there was no longer the possibility for dividend recipients to impute advanced paid corporate tax on their individual income tax liability. From then on a double burden lasted on distributed corporate income.

In 1934, another change of law provided the end of the beneficial treatment of smaller corporations.[108] In the following years, the corporate tax rate was raised and reached its peak after the 2. World War at 65 %.[109]

Legislators made a first significant step in the direction of the eventually upcoming *Tax Reform of 1977* by decreasing the applicable tax rate for distributed corporate income with the change of the law in June 1953.[110] From then on there was a split corporate tax

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175) raising this by change of statute on March 10, 1894 to a rate of 4 % on income exceeding 100.000 Mark per year, see *Gesetz- und Verordnungsblatt*, at 53.

[104] *See Reichsgesetzblatt I* 20.393.

[105] According to the income tax code of March 29, 1920, the highest tax rate on individuals' income was 60 %, *see Reichsgesetzblatt I* 20, 359.

[106] *See Reichsgesetzblatt I* 22, 472.

[107] *See Reichsgesetzblatt I* 25, 208.

[108] *See Reichsgestztblatt I* 34, 1031, 1287.

[109] At the same time, the maximum tax rate on individual income amounted to 95 %!

[110] *See Bundesgestzblatt I*, 53, 413.

rate. The general rate was fixed at 60 %, but decreased to 30 % for distributed dividends.[111]

The next major step to ease the double burden was made in 1958. This time, the law was changed to reduce the tax rate applicable to distributed income to 15 % whereas the tax rate on retained earnings was set at 51 %.[112] This was the state of the law up to the *Tax Reform of 1977.*

b) Reasons for Diminishing the Double Tax Burden

The change in law to a lower tax rate on distributions was not motivated by conceptual but rather by political and economic considerations. In connection with other legislative bills,[113] the pursued goal was to encourage the small investor to invest in company shares by setting the legal framework for a sufficient return of capital. As a result, the investor should be given the opportunity to own his or her share of the means of production of the German economy.[114] In addition to that, another of the federal government's official reasons for decreasing the tax rate on distributed earnings was to create an incentive for corporations to distribute higher dividends.[115]

c) Further Criticism of the Double Tax Burden

The above discussed changes in law of 1953 and 1958 resulted in a substantial decrease of the double tax burden. Still, there was ongoing criticism of the system.

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[111] In 1954, the general tax rate was decreased to 45 %, see *Bundesgestzblatt I* 54, 373.
[112] *See Bundesgestzblatt I*, 58, 473.
[113] *E.g.* the planned *Code on savings premiums* and the planned *Code on increase of capital out of equity.*
[114] *See Written Report of the Financial Committee about the Government's Bill to change tax statutes in the area of income tax and procedure law*, BT- Drucksache III, 448; *Christian Flaemig, Die Reform der Koerperschaftssteuer* [The Corporate Tax Reform], JuS 83, 85 (1977).
[115] BT-Drucksache III, 260.

The Academic Advisory Committee of the Treasury Department (Wissenschaftlicher Beirat beim Bundesminister der Finanzen) issued an expert opinion on the *Reform of the direct taxes* in 1967.[116] According to this expert opinion, from an economic point of view there should be no different tax treatment for retained and distributed corporate earnings, since even the retained earnings indirectly increase the shareholder's wealth. As a consequence, corporations should be taxed the same way as partnerships are taxed.[117] However, because of non resolvable practical difficulties to immediately allocate all of the corporate profits among its shareholders, the committee concludes it is impossible to directly include the retained earnings in the shareholder's individual income. Therefore it recommends to keep the tax at the corporate level but provide a possibility to impute the advanced paid corporate tax on the shareholder's income tax liability.

In the same direction aims the criticism of the Tax Reform Commission (Steuerreformkommission). In its expert opinion, issued in 1971[118], it pointed out the following disadvantages connected with the corporate tax system of 1958: Profits of business enterprises are taxed differently, depending on the legal form in which the business enterprise functions. Next, the system favors debt financing over equity financing and the double burden discourages potential investors to invest in the corporate sector. The commission also came to the conclusion that a direct inclusion of corporate profits in the shareholders' income would cause unmanageable difficulties for the tax administration and the business enterprises. The solution to the disadvantages is according to the commission a tax reform towards the *imputation system*.

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[116] *See* Schriftenreihe des BMF, Heft 9.
[117] This means generally one tax at the shareholder level.
[118] *See* Schriftenreihe des BMF, Heft 17.

d) The Government's Position on the Double Tax Burden Issue

The government was of the opinion that the latest substantial changes of the corporate tax law which led to a split tax rate for retained and distributed dividends were not sufficient to diminish the double tax burden on distributed income. According to the government's bill to further change the corporate tax law, the double taxation of distributed dividends needed to be entirely abolished.[119] The government as well suggested an imputation procedure to get rid of the double tax burden. There was however a conceptual difference to the suggestion of the Tax Reform Commission.

The government does not question the justification of a corporate tax in general. The German constitutional court ruled that corporate tax is the necessary consequence of legal entities participating as independent legal persons in the economic market since otherwise, retained earnings would never become subject to any taxation at all.[120] A direct inclusion of retained corporate earnings in the shareholder's income would disregard the existence of the legal entity. Such a piercing of the corporate veil is only acceptable under extraordinary circumstances.

The government agreed with the German constitutional court on this issue. It didn't see extraordinary circumstances in the situation of imposing the corporate tax on corporate earnings. Tax law rather has to accept the legal circumstances created by the civil law. Tax subject has to be the party that acts in the economic market, no matter whether it is a legal entity or a natural person.[121]

There were four basic reasons for the government to seek a reform of the corporate tax system.

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[119] *See* BT-VII/1470.

[120] BVerfGE 13,331,352.

[121] *See* BT-V/3500 p. 101 (In case of a legal entity, it is the corporation itself rather than its shareholders that is the tax payer. Although the shareholders have a certain influence on the corporation's business decisions, the corporation still is considered to be an independent entity being party to contracts itself.. Moreover, in most cases the management of the corporation has a greater influence on its activities than the individual shareholder.)

aa) Debt Over Equity Financing

The double burden of taxes on both the corporate and the shareholder level favors debt financing over equity financing. Interest paid on debts are deductible business expenses for the corporation. Only the creditor has to pay taxes on the amount received. Equity financing on the other hand causes a two level tax procedure in form of corporate tax and individual income tax in case of a distribution. If there is no longer a double tax burden, the gap between the costs for equity financing and debt financing is going to be much smaller. Although the costs for equity financing were still going to be a little higher than the costs for debt financing, the government was of the opinion that the substantial decrease in costs as a result from the tax reform will trigger the use of equity financing and thus improve the capital structure of the corporations.

bb) Prevention of Spread of Stock Ownership

The corporate tax law of 1958 basically discouraged the potential small interest shareholder from actually investing in stocks. Because of the tax disadvantages, an investment in stock did not seem favorable for the potential small interest shareholder. Thus, the tax law was an obstacle to the spread of stock ownership among a larger number of investors. The tax reform is supposed to benefit especially shareholders with low income. For such shareholders, their after tax dividend return increases the most. This is due to the *progressive* tax rates on the individual tax level and the fact that the corporate level tax determined at a *steady* tax rate is credited against every shareholder's income tax liability.

cc) Corporate Tax Law Lacks Neutrality

Third, because of the substantial differences of tax consequences for doing business in either the form of a partnership or a corporation, tax law is a major factor in considerations which form of business enterprise should be chosen in order to pursue a trade or business. At the same time, economic and commercial factors have decreased in meaning. The different taxation of the different business enterprises has an influence on the competition. Thus, the tax law ceases to be neutral. The abolishment of the double tax burden is supposed to decrease the influence of the tax law on the decision in which legal form a trade or business is pursued.

dd) Conflict of Interest Between Vast and Small Interest Shareholders[122]

There is the contradicting interest of shareholders owning a vast percentage of the outstanding shares to the shareholders owning only a small portion of the outstanding shares with regard to the decision to retain or distribute corporate profits. The former most likely favor the retention of profits, because they have a closer relation to the corporation so they will prefer to build reserves rather than distribute profits and at the same time look for new investments from other sources. The tax aspects support this notion, since for vast interest shareholders with a presumably high progressive income tax rate, the double tax burden on distributed profits would be higher than the single burden of only corporate tax on retained profits.

On the contrary, small interest shareholders prefer a distribution, since for them the double burden of diminished corporate tax on the distribution plus their individual income

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[122] *See* BGBl I, 2597; GUENTHER FELIX, MICHAELS STRECK, KOERPERSCHAFTSSTEUERGESETZ [Corporate Tax Statute] 11 (2nd ed. 1984).

tax presumably computed at a low tax rate will be lower than the burden of the corporate tax on retained profits.

The abolishment of such a double tax burden resolves the conflict of interest as far as it was caused by these tax considerations, since distributed profits will no longer bear a higher burden than retained profits.

2. Present State of the Corporate Tax and Income Tax on Dividends

The tax reform was eventually enacted on January 1, 1977. The provisions dealing with the taxation of corporate earnings, whether retained or distributed, have conceptually not changed ever since.

a) Sources of Corporate Tax Law

In 1997, there are four different codes that contain the basic provisions dealing with the taxation of corporations. The *Corporation Tax Statute* (CTS), the *Federal Income Tax Statute* (FITS), the *Commercial Code* (CC) and the *Corporate Acquisition Tax Code*.

The CTS consists of six parts. The First Part (sections 1 to 6) defines the types of organization to which the CTS applies. Corporations are the most important legal entities that are taxed under the CTS, because the revenue raised under the CTS is predominantly paid by corporations. The Second Part (sections 7 to 22) describes the determination of *income* for corporate tax purposes. The Third Part (sections 23 to 26) states the tax rates and provisions concerning the taxation of foreign income. The Fourth Part (sections 27 to 47) contains provisions that govern the *imputation procedure*. As a consequence of these rules, the corporate tax is integrated with the income tax. The Fifth Part (sections 48 to

52)w describes creation, determination, collection and refund of the tax. The Sixth Part (sections 53 to 55) contains authorization[123] and final provisions.

b) Tax Subject

Section 1 CTS lists all the corporate bodies, associations and conglomerations of assets which are subject to unlimited corporate tax liability. As a prerequisite, these legal entities are required to have a domestic place of management or seat in order to be subject to unlimited liability. As one of the corporate tax subjects, corporations are explicitly mentioned under section 1 (1) No. 1 CTS. [124]

c) Tax Object, Determination of the Corporation's Taxable Income

aa) Basic Principles of the Determination

Tax object is the corporation's taxable income, section 7 (1) CTS. What is considered as income and how income is to be determined is controlled by provisions of the FITS and the CTS, section 8 (1) CTS. In contrast to section 61 IRC of the U.S., which defines income as *income from whatever source derived*, the German FITS lists in its section 2 (1) No. 1-7 seven sources of income, which appear to be an exclusive listing. The seven sources are earnings from *farming and forestry*, from *trade and business*, from *self-employed activity*, earnings *received for services rendered as an employee*, earnings from *capital assets*, *earnings* from *rent and lease*, and finally *miscellaneous earnings defined in*

[123] Section 53 CTS authorizes the government to implement regulations dealing with the in the section listed matters.

[124] Other than to corporations, the CTS is applicable to *commercial cooperatives, mutual insurance associations, other juridical persons under private law, clubs and societies, institutes and foundations without legal existence and other assets dedicated to special purposes under private law and commercial enterprises owned by public law bodies*. *see* section 1 (1) CTS. This thesis will only address tax matters with regard to earnings of corporations.

section 22 FITS.[125] The sum of these 7 sources of earnings minus two allowable deductions under sections 13 (3)[126] and 24a[127] FITS lead to the *total amount of earnings*, section 2 (3) FITS. The *total amount of earnings* minus *special expenses*[128] and *extraordinary burdens*[129] is defined as *income*, section 2 (4) FITS. This method of determining an individual's *income* is also used in the case of determining a corporation's *income*.[130]

The following figure[131] visualizes the structure of income determination:

Sources of profit earnings	Sources of surplus earnings
Earnings from	Earnings from
farming and forestry *trade and business* *self-employed activity*	*services rendered as an employee* *capital assets* *rent and lease* *miscellaneous earnings*

|

<u>*Sum of earnings*</u>
./. deductions under sections 2 (3);13 (3); 24a FITS
<u>*Total amount of earnings*</u>, section 2 (3) FITS
./. special expenses, sections 10 to 10i FITS
./. extraordinary burdens, sections 33 to 33c FITS

<u>*Income*</u>, section 2 (4) FITS, 8 (1) CTS

It needs to be mentioned that according to section 8 (2) CTS, for all taxpayers who are required to keep books in accordance with provisions of the CC all income is considered as earnings from *trade or business*. Corporations are by legal definition of section 6 CC merchants, and all merchants are required to keep books in accordance with the provisions of the CC. Therefore section 8 (2) CTS applies to corporations with the consequence that

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[125] For the purpose of this thesis, there is no need to further describe this seventh source of income.
[126] This is a specific deduction in connection with the first income source *farming and forestry*.
[127] This is a *relief deduction* for persons who are at least 65 years of age.
[128] The *special expenses* are regulated in sections 10 to 10i FITC.
[129] The *extraordinary burdens* are regulated in sections 33 to 33c FITC.
[130] Section 8 (1) CTS reads: "What is considered as income and how income is to be determined is controlled by the provisions of the FITC and this statute."

corporation's earnings are always necessarily earnings from *trade or business*. Since earnings from *trade or business* is one of the sources of profit earnings, the FITS's sections concerning the determination of profit apply.

To determine a corporation's taxable income, the corporation has to create an annual report, consisting of a balance sheet and a Statement of Operations, section 242 (1) to (3) CC. This leads to the corporation's net-worth determined according to provisions of the CC. Section 4 (1) FITS provides that for tax purposes, profit is the difference between the corporation's net-worth at the end of the preceding business year and its net-worth at the end of the current business year. According to section 5 (1) FITS, the net-worth determined under CC rules in connection with the unwritten *principles of proper accounting* is to be used for the computation. This is true as long as there are no divergent provisions in the FITS.[132] In case of divergent provisions of the FITS, the according adjustments have to be made to the financial accounting, section 60 (2) *Administrative Regulation to the* FITS (ARFITS), to get to the *profits* according to the tax accounting,.

The following table shows the determination of a corporation's taxable income:[133]

	Profit according to commercial balance sheet, financial accounting
+ ./.	Adjustments due to divergent FITS provisions, section 60 (2) ARFITS
./.	Tax exempt earnings, sections 3, 3a FITS
./.	non-recognized earnings, section 8b CTS
./.	refunds for non-deductible expenses[134]
+	disguised dividends
+	sum of all non-deductible business expenses, sections 3c; 4 (5) FITS; 9 No 3; 10 CTS

	Earnings from trade and business

[131] HELMUT HAAS, KOERPERSCHAFTSSTEUER, 11, (4th ed. 1996).

[132] The following example shall illustrate one of the differences between accounting rules of the CC and the FITS with regard to the determination of profit: A taxpayer (in this case the corporation) who purchases a business value can take a depreciation for the entire purchase price in the year of purchase under accounting rules of the CC, section 255 (4) CC. For tax purposes, the taxpayer must spread the depreciation of a business value over a period of 15 years, section 7 I FITS.

[133] Haas, *supra* note 131, at 14.

[134] Non-deductible expenses are defined in section 10 CTS, *e.g.* taxes on income.

For corporations as corporate taxpayers, by definition of law all earnings are *earnings from trade and business,* section 8 (2) CTS. Therefore, *earnings from trade and business* necessarily equal the *sum of earnings.* Corporations cannot take advantage of the deduction of section 13 (3) CTS, because this deduction requires earnings from the source *earnings from farming and forestry.* Also, the section 24 (a) FITS deduction applies only to individuals. Therefore, the *sum of earnings* equals the *total amount of earnings.* Because of the legal nature of corporations, the only possible *special expense* is the *loss deduction* under section 10d FITS. This section provides that the *losses* are to be deducted like *special expenses* from the *total amount of income.* All of the other *special expenses* and *extraordinary burdens* occur in connection with private expenses. A corporation by definition does not have a private sector. In the case such expenses occurred, they already decreased the corporation's profit as business expenses. Consequently, the *total amount of income* minus *losses* (under section 10d FITS) equals the *corporate income.* For corporations as tax subjects under the CTS, the so determined *corporate income* is equivalent to its *taxable income.*[135]

bb) Special Provisions for Integrated Companies

The CTS provides in sections 14 to 19 special provisions for integrated companies. Section 14 CTS states the prerequisites under which two corporations are considered to be integrated companies. First, section 14 CTS requires a *financial, economic* and *organizational integration* between a dominant enterprise and a subsidiary corporation. The financial integration exists if the dominant enterprise has an uninterrupted and direct participation in the integrated subsidiary from the beginning of the latter's financial year such that the dominant enterprise holds the majority of the voting rights of the shares of

[135] Sections 24; 25 CTS provide two more tax exempt minimum thresholds, that are according to sections 74; 75 Regulations to the CTS not applicable to corporations.

the integrated subsidiary.[136] The *organizational integration* is deemed to exist if again from the beginning of the integrated subsidiary's year it is secured that the subsidiary enforces its business decisions according to the expectations of the management of the dominant enterprise.[137] *Economic integration* requires the integrated subsidiary to be in a state of a economic purpose dependency to the dominant enterprise.[138] This is the case if the integrated subsidiary acts like an dependent branch of the dominant enterprise, serving the latter's economic interest.[139]

Besides these three elements of integration, the subsidiary company has to enter into an agreement for the transfer of profits whereby it obligates itself to transfer its entire profit to another domestic commercial enterprise, the dominant enterprise.[140] Such an agreement for the transfer of profits must be for a period of at least five years, must be carried out for this period and must be effective beginning at the latest by the end of the financial year of the integrated subsidiary for which the legal consequences for the integrated companies shall apply.[141]

Such consequence is that the income of the integrated subsidiary is to be attributed to the dominant enterprise, section 14, first sentence CTS.[142]

The dominant enterprise must be a resident individual, a non-tax-exempt juridical entity, association or conglomeration of assets as defined in section 1 CTS[143] with

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[136] *See* section 14 No 1 CTS.
[137] Section 14 No 2 CTS states as an example that such *organizational integration* is always present if the integrated subsidiary has entered into a subordination agreement as described in section 291 (1) of the Stock Corporation Law which subordinates the management of its business to the dominant enterprise or if the integrated subsidiary is an integrated company under the provisions of sections 319 through 327 of the Stock Corporation Law.
[138] *See* section 50 of the Regulation to the CTS.
[139] *Id.* (This can be done by developing and producing products especially for the dominant enterprise).
[140] *See* section 14, first sentence CTS.
[141] *See* section 14 No 4 CTS.
[142] Section 16 CTS provides an exception to this general rule: The integrated subsidiary is itself taxable on its income to the extent of the equalization payments and the applicable distribution burden of the dominant enterprise. Such equalization payments are *e.g.* payments to make up for the formation of the agreement for the transfer of profits.
[143] Section 1 CTS list all corporate bodies that are subject to unlimited tax liability.

domestic place of management and seat, or a partnership as defined in section 15 (1) No 2 FITS with domestic place of management and seat.[144]

d) Tax Rates

For corporations under section 1 (1) No 1 CTS, the Code as of 1997 provides two different tax rates. Which one of the tax rates eventually apply depends on whether the corporation retains its earnings or whether the corporation distributes its earnings to the shareholders in form of dividends. The corporation tax rate on retained earnings is 45 % of the taxable income, section 23 CTS. This tax amount is called the *statutory burden.*

The distribution of earnings in form of dividends has an effect on the applicable corporate tax rate. The amount of the dividend is going to be taxed at a rate of 30 %, section 27 (1) CTS. This tax amount is called the *distribution burden.*

These provisions cause the following consequences: First, the corporate tax is determined according to section 23 (1) CTS at a tax rate of 45 %. If the corporation decides to distribute dividends, the corporate tax will decrease from 45 % to 30 %. Thus, the *statutory burden* is lowered by 15 % to the *distribution burden.* In contrast, if there is no corporate tax on the corporation's income because of an exemption provision, in case of a distribution the corporate tax will increase from 0 % to the *distribution burden* of 30 %.[145] Such tax exemption provisions apply only to corporate income that is not distributed in form of dividends.

As a result, the application of a lower tax rate (30 % instead of 45 %) leads to a larger amount that can be distributed, whereas the application of a higher tax rate (30 % instead of 0 %) decreases the amount that can be distributed.

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[144] *See* section 14 No 3 CTS.

[145] This is not valid for tax exempt *foreign income*. Sections 40 No 1; 30 (2) No 1 CTS provides that for *foreign income* there is no increase of corporate tax under section 27 CTS.

e) Imputation Procedure

Corporations are taxable entities, section 23 CTS. Dividends distributed by corporations to their shareholders are income to these shareholders. That income is subject to the individual income tax if the shareholder is a natural person. If the shareholder is a corporation, such income is going to be subject to corporate tax again. This is true for domestic income. Therefore, under German corporate tax law, there is no *dividend received deduction* for corporations receiving a distribution paid out of the domestic income portion of the distributing company's equity.[146] Thus, the corporate profits are subject to taxation on two levels, the corporate and the individual level. On the individual level, tax object is not only the distribution but also the *distribution burden*. Thus, subject to the shareholder's income tax is the distributed profit before the deduction of the *distribution burden*. The *imputation procedure* removes such a double burden in two steps: On the corporate level, for distributed profits a *distribution burden* of 30 % is established. On the individual level, the corporate tax (the distribution burden of 30 %) is imputed on the individual's income tax liability. *Imputation* means a deduction of the corporate tax from the shareholder's income tax.[147] As a result, the corporate tax is abolished. The distribution plus the *distribution burden* is eventually subject exclusively to the shareholder's income tax, taxed at the shareholder's individual income tax rate.[148]

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[146] Section 8 b CTS provides an exception for distribution that are paid out of the foreign income portion of the distributing companies equity. If the distributing as well as the receiving company are both taxpayers subject to unlimited tax liability, such a distribution is disregarded for the determination of the receiving company's income.

[147] *HAAS*, *supra* note 131, at 47.

[148] *GEORG CREZELIUS*, *STEUERRECHT II*, 245 (2nd ed. 1994).

aa) Corporate Level Taxation

Once the corporation's taxable income is determined, under section 23 (1) CTS the applicable tax rate is 45 % (*statutory burden*). As far as foreign earnings are included in the determined taxable income, such foreign earnings are likely to be subject to the according corporate tax of the particular country. Therefore, foreign earnings are already burdened by such a foreign corporate tax. Under section 26 (1) CTS or, if in existence, under a special Tax Treaty between the countries, the amount of the foreign corporate tax can be deducted from the German corporate tax liability if such a foreign corporate tax corresponds to the German corporate tax. The deduction is allowed only to the extent that the portion of the income would have been taxed under German law.

Example: A corporation has income of DM 100,000 of which DM 10,000 are foreign earnings. The foreign earnings of DM 10,000 are taxed at the according corporate tax rate of the foreign country (e.g. 40 %), which results in a tax liability of DM 4,000. These facts lead to the following statutory burden under sections 23 (1); 26 (1) CTS, alternatively a Tax Treaty.

Taxable income		DM 100,000
Statutory burden (45 %, section 23 (1) CTS)		DM 45,000
Foreign corporate tax deduction under section 26 (1) CTS or Tax Treaty	./.	DM 4,000
Remaining tax liability		DM 41,000

From the perspective of the corporation, the deduction abolishes the foreign corporate tax. If the foreign tax rate was higher than the German tax rate of 45 % (say the foreign income of DM 10,000 was taxed on a rate of 50 % leading to a foreign corporate tax of DM 5,000) the allowable deduction would only be as high as the German corporate tax liability would have been for this portion of income. In the case of income of DM 10,000, the highest possible deduction is therefore DM 4,500.

Taxable income		DM 100,000
Statutory burden (45 %, section 23 (1) CTS)		DM 45,000
Foreign corporate tax deduction under section 26 (1) CTS or Tax Treaty	./.	DM 4,500
Remaining tax liability		DM 40,500

Under the latter fact pattern, the corporation ends up paying DM 500 of corporate tax more than in the former fact pattern, although at first glance the lower *remaining* tax liability in the latter fact pattern seems to indicate a lower overall tax payment. The higher tax liability in the first fact pattern is due to the circumstance that in the first scenario it can use the entire amount of already paid foreign corporate tax of DM 4,000 as a deduction, whereas in the second scenario only DM 4,500 of the already paid DM 5,000 as foreign corporate tax are allowed as a deduction. As long as the foreign corporate tax does not exceed the German corporate tax that would have been determined for the specific amount of income, the entire foreign tax can be used a deduction. Therefore such a deduction leads to the abolishment of the foreign corporate tax up to the extent such income would have been subject to the applicable German corporate tax rate of 45 %.[149]

In the case of tax exempt corporate income, the applicable tax rate is 0 %.

The *imputation procedure* contains the provisions to make sure that distributed earnings - with the exception of the above mentioned foreign earnings - are taxed at the *distribution burden* of 30 %.[150] The key provision is section 27 (1) CTS:

> "If a resident corporation makes a distribution of profits, then the corporation tax will be decreased or increased by an amount equal to the difference between the tax burden to which the equity which is deemed to be used for the distribution under section 28 was subject in the hands of the corporation (statutory burden) and a burden of 30 % of the profit before deduction of the corporation tax (distribution burden)."

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[149] HAAS, *supra* note 131, at 43.
[150] *Id.* at 47.

The provision provides that the corporation tax will be decreased or increased. The following examples illustrate the effect of section 27 (1) CTS.

Example for decrease in corporate tax:

A-corporation has profits of 1000 DM in 01. A-corporation is subject to unlimited tax liability. A tax exemption provision does not apply.

Profits before corporate tax:		1,000 DM
Corporate tax, section 23 (1) CTS	./.	450DM
After corporate tax (*statutory burden)* profit		550 DM

In this case, the *statutory burden* of 45 % applies to compute the tax liability of the corporation. If the corporation decides to distribute the entire or parts of the *after corporate tax profit,* according to section 27 (1) CTS, the *distribution burden* of 30 % has to be established.

Profits before corporate tax		1,000 DM
Corporate tax, section 23 (1) CTS	./.	450 DM
After corporate tax profit		550 DM
Tax decrease (15/55 x 550.00 DM)	+	150 DM
Capital gains tax (25 % of the dividend of 700.00 DM [550.00 DM + 150.00 DM])[151]	./.	175 DM
After tax dividend		525 DM

The difference between the *statutory burden* of 45 % and the *distribution burden* of 30 % is 15 %. In the case of a distribution of profits subject to the *statutory burden,* the tax burden decreases by said 15 %. The relation between the tax decrease and the distribution

[151] Capital gains tax is no tax of its own but a special form of income tax collection in form of a withholding tax. Under sections 20 (1) No 1; 43 (1) No 1; 43a (1) No 1 FITS, dividends are subject to capital gains tax at a rate of 25 %. The recipient of the dividend has to report income in the amount of the dividend plus the amount of the capital gains tax. Eventually, the 25 % tax burden is credited to the dividend recipient's income tax liability, section 36 (2) No 2 FITS. Purpose of this capital gains tax is to fight the taxpayers' tendency not to report capital gain as income in their tax reports. From a material point of view, the capital gains tax is an advanced payment on the recipient's income tax (*see* Crezelius, *supra* note 146, at 104.

(before the capital gains tax) can be expressed by the fraction of 15/70. The relation between the tax decrease and the *after corporate tax profit* corresponds to the fraction of 15/55.

In the **example**, since the entire *after corporate tax profit* is distributed, the amount of tax decrease (equals the amount of distribution increase) is determined by 15/55 x 550 DM = 150 DM. The *statutory burden* of 450 DM decreases by 150 DM to the *distribution burden* of 300 DM. The decision to distribute the entire *after corporate tax profit* leads automatically to the highest possible distribution amount, because now there is no portion of the corporate income left that is taxed at the *statutory burden* of 45 %.

The considerations are different when only a part of the *after corporate tax profit is distributed.* If only the amount of the distribution (*distribution)* and its origin from *after corporate tax profits* is known, the amount of the tax decrease is determined by the fraction 15/70 of the *distribution*. Taking the fact pattern of the **example** and presuming that A-corporation decides to distribute 350 DM, the tax decrease is determined by 15/70 x 350 DM = 75 DM. This calculation is based on the fact that a distribution always corresponds to the number 70 and that a distribution of 70 decreases the corporate tax by 15. The remaining numbers are the following:[152]

Distributionwithout distribution burden		350 DM
Distribution burden (3/7 of 350 DM)	+	150 DM
Distribution plus *distribution burden*, ration 7/3		500 DM
Retained profits		500 DM
Statutory burden of 45 %	./.	225 DM
Net profits after *statutory burden*		275 DM

If 350 DM of 1,000 DM are distributed, the corporate tax amounts to 375 DM (150 DM *distribution burden* plus 225 DM *statutory burden*). Compared to the corporate tax of 450 DM (45 % of 1.000 DM) in the case of 1,000 DM of retained profits, the

difference amounts to 75 DM. This difference of 75 DM equals the calculated decrease in corporate tax by applying the fraction of 15/70 to the distribution amount of 350 DM.

Example for increase in corporate taxation

A-corporation has profits of 1,000 DM in 01. The entire amount is tax exempt.[153] Therefore there is no *statutory burden* of 45 %. If 1,000 DM are distributed, the *distribution burden* of 30 % has to be established, section 27 (1) CTS.

Profits, tax exempt	1,000 DM
Distribution burden (30 %)	300 DM
Possible distribution	700 DM

With regard to the tax exempt profits, in case of a distribution the corporate tax increases by 3/10 (from 0 % to 30 %). Only 7/10 of the tax exempt profits can be distributed, since 3/10 are needed to pay the *distribution burden*. With regard to the distribution, the corporate tax is increased by 3/7.

E.g., if the corporations decides to distribute 350.00 DM, the *distribution burden* is 150 DM (3/7 of 350.00 DM).

Example for simultaneous increase and decrease of corporate tax

A-corporation made in 01 profits of 2,000 DM. Profits of 1,000 DM are tax exempt. A-corporation decides to distribute the entire amount of profits.

If the corporation distributes simultaneously profits that already bear a *statutory burden* of 45 % (this amount is reported in the *equity 45 account*, section 30 (1) No 1 CTS) and profits from tax exempt earnings (this amount is reported in the *equity 0 account*, section 30 (1) No 2 CTS), the result is a decrease in corporate tax with regard to the amount

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[152] In this calculation, the capital gains tax is not considered. The capital gains tax amounts to 25 % of the distributed 350.00 DM = 87.50 DM. For the purpose of this example, the capital gains tax is of no relevance.

[153] *E.g.*, earnings listed in section 3 FITS are tax exempt. As far section 3 FITS applies to corporations' earnings, such earnings are tax exempt from the corporate tax.

already bearing the *statutory burden* and an increase in corporate tax with regard to the amount that represents tax exempt earnings.

Profits		2,000 DM
Tax exempt profits	./.	1,000 DM
Taxable corporate income		1,000 DM
Statutory burden of 45 %	./.	450 DM
After *statutory burden* profits		550 DM

Since the entire *after statutory burden profits* are distributed, the corporate tax decreases by 15/55 of 550 DM, which equals 150 DM. The distribution of the formerly unburdened profits leads to a corporate tax increase by 30/100 of 1,000 DM = 300 DM.

Statutory burden		450 DM
Decrease	./.	150 DM
Increase	+	300 DM
Corporate tax for 01		600 DM

The overall tax burden on the distribution of the profits of 2,000 DM amounts to 600 DM. This corresponds to the *distribution burden* of 30 % (30 % of 2,000 DM = 600 DM).

bb) Structure of the Available Net Equity for Distributions

The examples under aa) show that depending on whether equity used for the distribution was subject to corporate tax in the hands of the corporation (statutory burden) or whether the distribution was made out of tax exempt earnings, there is an increase or decrease in corporate tax during the process of establishing the *distribution burden.* In order to properly determine the *distribution burden*, the corporation has to be able to prove whether the distribution amount is taken from the portion of the equity which is burdened with the *statutory burden* or whether the distribution amount is taken from the portion of the tax exempt equity. Thus the CTS requires a certain structure of the equity account.

First, section 29 (1) CTS defines equity as "business capital indicated by the difference between the assets and liabilities on the tax balance sheet without adjustment of the corporation tax which would result from section 27 CTS[154]". According to section 29 (2) CTS, at the end of each financial year the equity is to be divided into equity available for distribution (available net equity) and other equity. *Available net equity* is the excess of equity over stated capital as determined at the close of the financial year preceding the corporate resolution concerning distributions.[155] Thus section 29 CTS determines the amount of the *available net equity*.

Section 30 CTS (1) CTS asks for a certain structure of the equity:

> "At the end of each financial year the available net equity is to be allocated according to its statutory burden. The individual portions are to be based on the allocation established in the past financial year. [...] the portions of available net equity are to be separately accounted for based on the extent to which they have originated from
>
> 1. portions of income which after December 31, 1993 were subject to unreduced corporation tax [equity with a tax burden of 45 %, such account is called *equity 45*],
>
> 2. portions of income which after December 31, 1993 were subject to reduced corporation tax [equity with a tax burden or 30 %, such account is called *equity 30*][156] and
>
> 3. increases in net worth which were not subject to corporation tax or which increased the equity of the corporation in a financial year ending prior

[154] Section 27 CTS regulates the decrease or increase in corporate tax in case of the distribution of dividends.

[155] Section 29 (2) CTS concludes that if there is no corporate resolution concerning distributions, the actual distribution will be used in its place.

[156] Portions of income which are subject to reduced corporate tax of 30 % originate from a division according to section 32 CTS. As seen under *supra* III.B.2.e)aa), *e.g.* the deduction of foreign corporate tax can actually lead to a decrease of the *statutory burden*, when the creditable foreign tax is lower than the German *statutory burden* of 45 % would have been. Such a lower burdened portion of income can no longer be listed appropriately in the *equity 45* account. In this situation, section 32 (2) CTS rules that portions of equity which have born a reduced tax burden are to be allocated as follows: A portion of equity whose reduced *statutory burden* is less than the *distribution burden* of 30 % is to be divided into one portion whose burden is equivalent to the *distribution burden* and one portion bearing no corporation tax burden. Is the reduced *statutory burden* higher than the *distribution burden* of 30 %, the portion of equity is to be divided into one portion whose burden is equivalent to the *distribution burden* of 30 % and one portion bearing the unreduced *statutory burden* of 45 %.

to January 1, 1977 [equity with a tax burden of 0 %, called *equity 0* account].[157]"

The structuring of the equity according to section 30 CTS enables the corporation to determine the tax burden of the equity used for the distribution. In case that a corporation has an *equity 45*, an *equity 30* and an *equity 0* account, section 28 III CTS regulates the order in which distributions are deemed to be distributed, that is in the order such accounts are listed under section 30 CTS. This means that first the *equity 45* account is used for distributions, then the *equity 30* account and finally the *equity 0* account in the order *equity 01 through 04*. Purpose of such a legal fiction is to primarily reach a decrease in corporate tax for the corporation.[158]

cc) Shareholder Level Taxation

The shareholder is either a natural person or a legal entity. For the natural person shareholder, if his interest in the corporation is part of his private fortune, a distribution qualifies as *earnings from capital assets*, section 20 (1) No 1 FITS. If his interest in the corporation belongs to his business capital, distributions are part of the source of income that the business capital is part of.[159]

Is the shareholder a corporation, the distribution is necessarily *earnings from trade and business*. As already mentioned, all the corporation's earnings are by definition of law *earnings from trade and business*, section 8 (2) CTS.

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[157] The *equity 0* is furthermore subdivided into four accounts, labeled *equity 01* through *equity 04*, see section 30 (2) No 1 through No 4 CTS. *Equity 01* contains foreign income earned in a financial year after December 31, 1976, *equity 02* is for increases in net worth which are not subject to corporate tax and do not fall under No 3 and No 4, *equity 03* is for available net equity originating in a financial year ending before January 1, 1977, and *equity 04* contains capital contributions by the shareholders which have increased equity in a financial year ending after December 31, 1976.

[158] Haas, *supra* note 131, at 81.

The distribution is taxed with 25 % capital gains tax, sections 43 (1) No 1; 43a (1) No 1 FITS. The shareholder has to report the distribution amount as income including the capital gains tax.[160] However, the already paid capital gains tax is going to be credited against the final income tax liability of the shareholder, section 36 (2) No 2 FITS.

Example

A-corporation distributes 700 DM. Capital gains tax is 25 % of 700 DM = 175 DM. The shareholder actually receives 525 DM (700 DM - 175 DM). His income for income tax purposes is however 700 DM.

Besides the distribution of 700 DM, the *statutory burden* of 300 DM (3/7 of 700 DM) has to be included in the taxpayer's income, section 20 (1) No 3 FITS. Identical to the corporate gains tax, the *statutory burden* is eventually credited against the final income tax liability of the shareholder, section 36 (2) No 3 FITS.

Since the law allows the taxpayer to use the capital gains tax and the corporate tax as a tax credit against his personal income tax liability, the consequences are the following:

Distribution (section 20 (1) No 1 FITS), including capital gains tax of DM 175)		DM 700
Distribution burden (section 20 (1) No 3 FITS)		<u>DM 300</u>
Taxable income		DM 1,000
Income tax rate of 50 %[161]		
Income tax		DM 500
Credit of capital gains tax (25 % of DM 700), section 36 (2) No 2 FITS	./.	DM 175
Credit of corporate tax , section 36 (2) No 3 FITS	./.	<u>DM 300</u>
Tax liability		DM 25

Depending on the individual income tax rate of the shareholder, the corporate and capital gains tax as creditable taxes might lead to a tax refund for the shareholder. This is due to the fact that a corporate distribution bears a tax burden of 47,5 % before the shareholder credits the distribution burden and the capital gains tax against his income tax

[159] According to section 20 (3) FITS, that can be the income sources *farming and forestry, trade and business, self-employed activity* and *rent and lease.*
[160] Haas, *supra* note 131, at 111.

liability. The 47,5 % tax burden is determined by adding the distribution burden of 30 % plus the capital gains tax of 17,5 %.[162] Thus, as long as the shareholder's individual tax rate exceeds 47,5 %, the creditable tax amount will still leave a remaining tax liability for the shareholder. Is the shareholder's individual income tax rate less than 47,5 %, the creditable taxes will lead to a tax refund, as the following example illustrates:

Distribution (section 20 (1) No 1 FITS), including capital gains tax of DM 175)		DM 700
Distribution burden (section 20 (1) No 3 FITS)		DM 300
Taxable income		DM 1,000
Income tax rate of 25 %[163]		
Income tax		DM 250
Credit of capital gains tax (25 % of DM 700), section 36 (2) No 2 FITS	./.	DM 175
Credit of corporate tax , section 36 (2) No 3 FITS	./.	DM 300
Tax refund		DM 225.

[161] This income tax rate is chosen arbitrarily for this example.

[162] The capital gains tax is 25 % of the after corporate tax distribution, which corresponds to 17,5 % of the before corporate tax distribution. The after corporate tax distribution is 70 % of the entire distribution, since the corporate tax rate is 30 %. 25 % capital gains tax of the after corporate tax distribution of 70 % is 17,5 %. Thus, in relation to the entire before corporate tax distribution amount, the capital gains tax is 17,5 %.

[163] The income tax rate is chosen arbitrarily for this example.

IV. Problem of "Double Taxation"

A. The Term "Double Taxation"

The term double taxation is used in two different contexts.

To better understand these contexts, a description of the basic elements of taxation is given. Regardless of the kind of tax that is raised, the following elements are always needed in this process. In order to determine a tax liability, four elements need to be taken into account. The tax subject[164], the concrete tax object,[165] the tax rate and the tax creditor.[166] By applying the tax rate to the tax object, the tax liability of the tax subject towards the tax creditor is determined.

As the term "double taxation" indicates, somebody or something is being made subject to the process of taxation twice. Using the terms introduced in the previous paragraph, the first "double taxation" scenario can be described as follows: Two different tax creditors impose a tax on a tax subject's identical portion of his concrete tax object. This results in a double tax liability for the tax subject with regard to the identical portion of the concrete tax object. In other words the tax subject (the taxpayer) and a portion of the concrete tax object (part of the taxpayer's taxable income in the case of the income or corporate tax) are the elements that are subject to double taxation. It should be noticed that in this scenario the tax subject that is potentially subject to a double taxation is *one* taxpayer. An

[164] This is the taxpayer who is liable for the determined tax. In case of the Federal Income Tax, the tax subject is an individual, in case of the corporate tax, the tax subject is a legal entity.

[165] The concrete tax object needs to be distinguished from the tax base. The concrete tax object is the amount that is determined out of the tax base. Afterwards, the tax rate is applied to the concrete tax object in order to determine the tax liability. For U.S. income tax and corporate tax purposes the tax base is according to section 61 (a) IRC generally "all income from whatever source derived." Concrete tax subject would be the final taxable amount of income after taking all the inclusion, exclusion and deduction provisions into account.

example for such a scenario could be a German corporation (the taxpayer) having a domestic place of management or seat earning domestic as well as foreign income in the United States. Because of its domestic place of management or seat it is subject to unlimited tax liability under the German CTS.[167] Unlimited corporation tax liability extends to all categories of income,[168] therefore also including foreign income. Presuming that the United States levy a corporate tax on such income, such portion of the income could be taxed twice to the corporation.[169] As explained in footnote 167, the CTS as well as the tax treaty between Germany and the United States deal with this scenario of possible double taxation, eventually providing effective relief from a potential double burden of corporate or individual income.[170]

The second scenario in which "double taxation" is discussed refers to the situation where *two different* tax subjects are taxed on *one* portion of the tax object. This might occur in the case of a corporation distributing its after tax profits to its shareholders. Both are separate taxable entities.[171] Corporations have to pay a corporate tax on their corporate income.[172] If they decide to distribute parts or all of the after corporate tax income, such distributions are under certain prerequisites taxable as income to the

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[166] In the case of federal income taxes, tax creditor is the internal revenue service as subdivision of the federal government.
[167] *See* section 1 (1) CTS.
[168] *See* section 1 (2) CTS.
[169] For a German corporation, it is rather unlikely to be taxed twice on its foreign income. The CTS provides in section 26 (1) that if a taxpayer is subject to unlimited tax liability and realizes foreign income that is subject to a tax corresponding to the domestic corporation tax, then the assessed and paid foreign tax is to be credited against the domestic corporation tax which is attributable to the income having its source in that country. Moreover, a tax treaty between the countries (like the tax treaty between the United States and Germany) might allow to use the foreign corporate tax as a deduction against the corporate tax liability according to the domestic corporate tax statute.
[170] *See* explanation *supra* on page 36.
[171] BARTON ET AL., *supra* note 56, at 40.
[172] *See* section 11 IRC. It should be noticed that section 1363 (a) IRC provides that no corporate tax is imposed on an electing small business corporation, called an "S Corporation". However, this thesis deals with corporations that are not eligible for the "S Corporation" election. E.g., this is true for corporations with more than 35 shareholders (section 1361 (b) (1) (A) IRC) or for corporations that have more than one class of stock (section 1361 (b) (1) (D) IRC).

shareholders under the I.R.C.[173] Thus, in the United States distributed corporate income is subject to taxation on the corporate as well as the individual shareholder level. As described *supra* under III. B. 2. e, according to the German tax law, due to the imputation procedure regulated in the CTS such distributions are not subject to taxation on the corporate level. The conclusion that under U.S. tax law the same portion of the tax object is subject to taxation twice although there are undoubtedly two different tax subjects requires an economic evaluation of the situation.[174]

Since the tax treaty between the United States and Germany provides relief for double taxation in the first scenario for both American and German corporations, in this chapter the thesis deals only with the issue of double taxation occurring in the second scenario.

B. Criticism of the Double Taxation for Distributed Corporate Earnings in the U.S.

As seen in the previous chapter,[175] following the tax reform of 1977, the German corporate tax law does no longer provide double taxation on distributed corporate earnings. Consequently, criticism of the double taxation in the context of corporate distributions is only a matter in the United States.

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[173] *See supra* p. 15; To the extent the IRC qualifies such distributions as dividends, the distributions are included in the recipient's gross income, sections 301; 316; 61 (a) (7) IRC.

[174] Otherwise it could be argued that there is no identical portion of a concrete tax object, since first the concrete tax object belongs to the corporation, and second it is the shareholder's concrete tax object.

[175] *See supra* III. B. 2.

1. Adverse Criticism of the Double Taxation

The double taxation is generally criticized on three grounds. These are the grounds of tax inequity, economic inefficiency and administrative complexity. As a solution to the problem, the critics suggest an integration of corporate and shareholder taxes.

a) Double Taxation and Tax Inequity

As described *supra* under II. B., taxpayers should be taxed according to their ability to pay, and such ability to pay is determined by the taxpayer's income.[176] Furthermore, in accordance with the basic principle of equality under the law, all individuals with the same income should be taxed alike, irrespective of the source from which the income was received.[177] Critics of the double taxation argue as follows:

The United States tax law generally requires a realization of gain leading to an increase in the ability to pay before the individual is taxed on such an increase in wealth.[178] Such requirement is called the realization doctrine. In case of the corporation and shareholder relationship, the realization doctrine prevents the shareholder from being taxed on retained earnings of the corporation. Although such accumulated income adds to the value of each shareholder's stock,[179] tax law requires a sale or other disposition as a realization act before the asset appreciation[180] is taken into account in the individual's income tax base.[181] The corporate tax serves the purpose to reach such an asset appreciation that otherwise

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[176] Kwall, *see supra* note 29, at 627; MUSGRAVE & MUSGRAVE, *supra* note 4, at 232-246.
[177] *See supra* II.B.1; Kwall, *supra* note 29, at 627-28.
[178] *Id.*; The realization doctrine was first applied in Eisner v. Macomber, 252 U.S. 189 (1920); Scott A. Taylor, *supra* note 1, at 244.
[179] Kwall, *supra* note 29, at 629 (Kwall contends that "gain on a sale of stock generally includes undistributed corporate earnings because those earnings add to the value of corporate stock, *id.* at 622 n. 45; C. McLURE, *supra* note 28, at 20 n. 3 (1979)).
[180] From the perspective of the shareholder, his interest in the corporation in form of shares are assets.
[181] Taylor, *supra* note 1, at 246 (The author points out that "[a]s a matter of personal wealth, a ten dollar dividend from a share of stock is no different from a ten dollar increase in the value of the same stock."

would be sheltered by the realization doctrine. In other words, the corporate tax takes the function of simulating the individual income tax that would be collected if dividends were distributed.[182] Such a justification for the corporate tax works only to the extent that accumulated earnings are taxed. As far as corporate income that is not intended to be distributed is concerned, a corporate tax is believed to further the tax policy goal of equity. To the extent that distributed earnings bear a corporate tax, there is a greater burden on such income compared to the burden on income from other sources,[183] leading to an overtaxation of distributed income.

The following table visualizes the increased tax burden under the presumption of a uniform corporate and individual tax rate:[184]

Uniform tax rate	Aggregated burden on dividends
90 %[185]	99 %
80 %	96 %
70 %	91 %
60 %	84 %
50 %	75 %
40 %	64 %
30 %	51 %
20 %	36 %
10 %	19 %

As the table shows, the aggregate tax burden on dividends in case of the two tier taxation is significantly higher than it would be if there was only an income tax at the

[182] A counter argument to this justification of the corporate tax is provided by Musgrave. He questions the extent to which a corporate tax levied on retained corporate income furthers equity. Such a tax may cause corporate income to bear the same burden as other forms of income. However, the equitable ideal focuses on burdens borne by *people*, not by *income*, *see* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE, 173-75 (1959).
[183] Kwall, *supra* note 29, at 630; Taylor, *supra* note 1, at 243.
[184] The table is part of the table contained in Kwall, *supra* note 29, at 632 n. 99.
[185] Presuming a uniform tax rate of 90 % and distributed corporate income of 100, on the corporate level this would lead to a tax liability of 90, leaving 10 for the distribution. The distributed 10 would be subject to 90 % income tax, leaving 1 as a net distribution. Thus the aggregate burden on dividends in this example is 99 %.

shareholder level. Such an additional burden violates the "equitable ideal that all individuals with equal incomes should bear equivalent tax burdens".[186]

b) Double Taxation and Economic Inefficiency

As described *supra* under II.B.2., the tax policy goal of economic efficiency requires tax norms to be as neutral as possible with regard to influencing people's decision making. There is a notion that economic efficiency is disturbed to the extent that economic decisions are distorted by the tax system, and that any tax-induced change in behavior is unfavorable.[187] Thus, as far as double taxation influences economic decisions, such a system no longer complies with the neutrality ideal.[188] In the legal literature,[189] three arguments are made to contend that double taxation practically has an impact on economic decision making and therefore distorts the tax policy goal of economic efficiency. First, double taxation leads to finance corporate investment with debt rather than new equity, second double taxation has the effect to discourage individuals from investing in the corporate sector, and finally double taxation prevents corporations from making economically profitable investments.

aa) The Debt Versus Equity Financing Argument

There are two ways to establish the capital structure of a corporation. The investors who decided to invest in the corporate sector can generally chose between a debt or equity investment in a corporation. The investor choosing the debt financing method obtains as a

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186 Kwall, *supra* note 29, at 633.
187 *See* S.Rep. No. 313, 99th Cong., 2d Sess. 7-8 (1986).
188 D. BRADFORD, UNTANGLING THE INCOME TAX 178-79 (1986); Kwall, *supra* note 29, at 641.
189 Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 HARV. L. REV. 717 (1981); C. MCLURE, *supra* note 28; C. McLure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 HARV. L. REV. 532 (1975).

creditor "the right to the return of the investment on a fixed schedule with a fixed rate of return and with a superior claim to that of any shareholder."[190] On the other hand, the investor choosing to invest in the corporation's equity "obtains a right to share in the (potentially unlimited) net profits from the venture once all those holding superior claims have gotten theirs."[191]

The tax law treats these two forms of investment differently. The tax burden on a debt financed investment is lower than the tax burden on an investment in a corporation's equity. The corporation's interest payments on the use of the debt capital is treated like a business expense, allowing the corporation to take a deduction from its tax base.[192] Payments in form of dividends on the other side do not give rise to a deduction for the corporation.[193] The following example shall illustrate the different consequences of the tax law on the two investment forms:[194]

For the purpose of demonstrating the different tax burdens, it is presumed that all investments generate a ten percent pre-tax return[195], that the cost of both forms of investment is five percent[196] and that there is a uniform tax rate of 30 %.

	Equity Finance	Debt Finance
Amount invested	$ 1,000	$ 1,000
Pretax gross return	$ 100	$ 100
Cost of capital of 5 %	$ 50	$ 50
Return net of cost of capital	$ 50	$ 50

[190] KAHN & LEHMAN, *supra* note 47, at 48.
[191] *Id.*
[192] *See* section 163 IRC; BARTON ET AL., *supra* note 56, at 41; Taylor, *supra* note 1, at 253.
[193] KAHN & LEHMAN, *supra* note 47, at 49; Taylor, *supra* note 1, at 253 n.76 (Taylor points out that "the nondeductibility of dividends is to be inferred from the absence of a provision permitting a deduction for them."); Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983) (The court evaluates such payments as "the analog of personal consumption").
[194] Kwall, *supra* note 29, at 643 (The author uses this example to illustrate the opinion of the "legal literature".
[195] Kwall contends that this presumption is made in the legal literature, *see id.* at 642 n. 157, referring to Warren, *supra* note 189, at 725; Eric M. Zolt, Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium, 860 (1988).
[196] Kwall points out that "[t]reating the cost of debt and equity capital as identical is consistent with the legal literature, which does not take into account different degrees of risk." *See supra* note 29, at 643 n. 164.

Corporate tax of 30 %	$ 30	$ 15
Return net of tax	$ 20	$ 35

Note that for the equity investment, since dividends are not deductible, the corporate tax rate is applied to the pretax gross return of $ 100, whereas for the debt investment, the tax rate is applied to the return net of cost of capital of $ 50, an amount reduced by the deduction of the interest paid. As the example illustrates, the corporate tax burden on the pretax gross return in case of an investment in the corporation's equity it substantially higher than the corporate tax burden in case of a debt investment. Under the presumption that corporate management tries to increase the amount available for distributions as much as possible,[197] the different tax consequences cause investors and corporations to rather chose corporate debt than equity financing.

The result of such a corporation's bias in favor of debt financing is an increase in the risk of bankruptcy.[198]

bb) Discouragement of Investments in the Corporate Sector

Identical to the debt equity argument, the presumption is made that equivalent pretax returns can be earned no matter where an individual invests capital.[199] The result that returns to capital invested in the corporate sector bear a two level and therefore higher tax burden than returns on investments in a non-incorporated business naturally leads to a bias towards investing in non-incorporated enterprises.

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[197] According to Kwall, such a presumption is made in the legal literature, *see id.* at 643 n. 166. The author refers to Warren, *supra* note 189, at 730-31.

[198] BARTON ET AL., *supra* note 56, at 41; Jennifer Arlen, Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 YALE L.J. 325, 329 (1995); U.S. DEPARTMENT OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, Vol 1, at 118-19 (1984).

[199] *See supra* note 195.

The following example illustrates the assertion, presuming that there is a pretax return of 10 % and all income is taxed at a rate of 30 %.[200]

	Corporate Investment	Non-corporate Investment
Amount invested	$ 1,000	$ 1,000
Pretax return (10 %)	$ 100	$ 100
Corporate tax (30 %)	$ 30	$ 0
Return net of corp. tax	$ 70	$ 100
Individual tax (30 %)	$ 21	$ 30
Return net of indiv. tax	$ 49	$ 70

The legal literature presumes that the shareholders are the ones who eventually bear the burden of the corporate tax.[201] Therefore the double taxation is a factor that discourages individuals to invest in the corporate sector. By the way, the reasoning to support this argument is identical with the reasoning used in the tax inequity argument.[202]

cc) Corporations Will not Pursue Profitable Investment Opportunities

The argument that corporations will not pursue profitable investment opportunities because of the double taxation issue is developed out of the 'debt versus equity' argument. First of all, it needs to be presumed that the ability to invest in a corporation's debt is limited[203] and thus there are situations when the corporation is compelled to use equity financing. If the investment is made in the equity of the corporation, as shown earlier the cost of the capital is not deductible.[204] From a certain point on, the non-deductible cost of the equity capital results in an overall loss for the investment. Such a loss only occurs because of the non-deductibility of the equity cost in connection with the tax on the

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[200] *See* Kwall, *supra* note 29, at 642.
[201] Warren, *supra* note 189, at 725; Zolt, *supra* note 195, at 860.
[202] *See supra* IV.B.1.a).
[203] Warren, *supra* note 189, at 734-35.
[204] *See supra* IV.B.1.b)aa).

corporate level. The same numbers as in the example under *supra* IV.B.1.b)aa) (except the percentage for the cost of capital) will be used to illustrate the different consequences.[205]

	Equity Finance	Debt Finance
Amount invested	$1,000	$ 1,000
Pretax gross return (10 %)	$ 100	$ 100
Cost of capital (8%)	$ 80	$ 80
Return net of cost of capital	$ 20	$ 20
Corporate tax (30 %)	$ 30	$ 6
Return net of tax	./. $10	$ 14

The 'certain point' in the example would be a cost of equity capital of 7 %. At that percentage the return net tax would be 0. If the cost of equity exceeds the 7 %, the return net of tax will be a negative number and therefore a loss. In the example, the cost of capital exceeds 7 % (cost of capital is presumed to be 8 %). These numbers result in a loss of $ 10, whereas the same investment would generate a profit of $ 14 (see column "Debt Finance") if the cost of capital was deductible and thus not subject to corporate tax.

Under these circumstances, it can be concluded that the "corporation is likely to refrain from undertaking that investment because its inability to deduct the cost of equity capital would cause the corporation to suffer an after-tax loss from the investment, notwithstanding the pretax profit."[206]

c) Double Taxation and Administrative Complexity

According to parts of the legal literature, administrative complexity is one of the disadvantages of the double taxation.

A tax system that is so complex that it is difficult to handle faces major problems,[207] like e.g. that rather ordinary transactions result in unforeseeable tax consequences.[208] The

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[205] Kwall, *supra* note 29, at 645.
[206] *Id.* at 644.
[207] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 778 (1937).
[208] Taylor, *supra* note 1, at 246.

double taxation in combination with the realization principle are the two main factors that lead to the complexity of the present tax law system in the U.S.[209]

The realization doctrine requires sale or other disposal of appreciated property as an appropriate realization event.[210] The so realized gain is going to be subject to taxation. Besides the realization doctrine, there is another method of determining the amount of income, commonly referred to as accretion model or Schanz-Haig-Simons definition of income. According to this definition, income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[211] The difference between the two methods is that the accretion method includes the value of the appreciated property to the extent of the appreciation in the current income, whereas the realization method takes such appreciation into account only after the appropriate realization event.

Taylor gives a simple example to illustrate the accretion method:[212]

> "T, the taxpayer, has $ 1 million and spends it to buy at the beginning of the year 10,000 shares of X Co. stock worth $ 1,000,000 ($ 100 per share). During the year the stock pays $ 30,000 in dividends and increases in value to $ 1,050,000 by the end of the year. During the year, T spends $ 25,000 on consumption (living expenses), leaving T with $ 5,000 in unspent cash at the end of the year.
>
> Under the accretion model, T has spend $ 25,000 on consumption. Therefore, part 1 of the equation is $ 25,000. T's increase in net worth, part 2 of the formula, is $ 55,000, computed as follows:

	Beginning net worth	Ending net worth
Cash	$ 1,000,000	$ 5,000
Stock	0	1,050,000
Total	$ 1,000,000	$ 1,050,000

> Difference (increase in net worth) = Ending net worth minus Beginning net worth, or $ 55,000 = $ 1,055,000 - $ 1,000,000."

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[209] *Id.*

[210] B.BITTKER, L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, section 40.1 (2d ed. 1990).

[211] HENRY SIMONS, PERSONAL INCOME TAXATION 50 (1938).

[212] Taylor, *supra* note 1, at 248.

Under the realization doctrine, only the dividend of $ 30,000 is income. The $ 50,000 stock appreciation will be considered as income after a realization event such as a sale or exchange.[213]

The focal point of the criticism is the variety of complex provisions contained in the code which allow otherwise realized gain to go unrecognized and therefore untaxed.[214] There would be no need for such a sophisticated system if "an accretion model were followed for the integrated taxation of individual shareholders."[215] At this point, three issues regulated under the current corporate income tax law are specifically introduced as examples for overly complex tax provisions.

First there is the issue of dividend and non-dividend distribution, which depends on whether the corporation makes the distributions out of earnings and profits.[216] Such earnings and profits are complicated to determine since they are not necessarily identical with the corporation's taxable income.[217] Section 302 IRC is another example for a complex provision dealing with the question of dividend or non-dividend distribution. Redemption of stock (meaning the corporation's repurchase of some of its stock from its shareholders) as a matter of form looks like a sale and therefore should trigger capital gains treatment to the extent the purchase price exceeds the shareholder's adjusted basis. Section 302 IRC regulates that proportionate distributions are to be treated like dividend distributions, while the proportionality test is exceedingly complex, especially taking the family and entity ownership attribution rules into account.[218] Another field of complexity is

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[213] *Id.* at 249 (Taylor describes the effect of the realization doctrine as "bunching huge amounts of income around realization events", and he compares the realization model to "damming up a river" and the realization event as "the bursting of the dam". Thus, the corporation and the shareholder may be "flooded with income").
[214] *Id.* at 250.
[215] *Id.*
[216] *See supra* III.A.2.c).
[217] Taylor, *supra* note1, at 251-52 ("[T]he corporation's taxable income is adjusted to reflect those items given special treatment under the tax law in a way that deviates from financial accounting concepts." Interest on certain bonds is for example not included in the corporation's gross income, whereas it increases the corporation's earnings and profits.); *see* section 312 IRC.
[218] *Id.*

the issue of constructive dividends in connection with unreasonable compensation for corporation's employees who happen to be shareholders at same time. Salaries paid by the corporation are usually deductible as business expenses and reduce the corporation's taxable income.[219] Under certain circumstances, the IRS can argue that unreasonable high salaries are as a matter of substance dividend payments to the shareholders. Proving such constructive dividends is factually complex.[220]

Second there is the issue of corporate divisions and reorganizations. A corporate division serves the purpose to divide a shareholder's investment in a single corporation into an investment in two or even more corporations.[221] Such a division is regarded to simply result in a "change in corporate structure with a retention of the business assets at the corporate level, [and thus] the rationale justifying nonrecognition of gain or loss in section 368 (a) (1) [IRC] reorganizations is applicable."[222] At the same time, if as a matter of substance the distribution resembles a dividend, there are rules denying the tax free treatment,[223] and producing at the same time a huge amount of complexity.[224] One example for such a complex rule is section 355 (a) (1) (B) IRC, stating that the division cannot be used as a device to distribute earnings and profits, which is the case if there is a valid business purpose other than the avoidance of federal income tax at both the corporate and the shareholder level.[225]

The same degree of complexity can be found in corporate reorganizations.[226] Although corporate reorganizations involve huge potential tax consequences (corporations' assets and shareholders' stock are likely to contain unrealized and therefore yet untaxed

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[219] *See* section 162 (a) (1) IRC.
[220] *See* Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142 (1980).
[221] BARTON ET AL., *supra* note 56, at 485.
[222] *Id.* 485-86.
[223] *See* section 355 IRC; Treas. Reg. 1.355-1 through 1.355-5; Rev. Proc. 86-41, 1986-2 C.B. 716
[224] Taylor, *supra* note 1, at 255.
[225] Treas. Reg. 1.355-2(d)(3)(ii) (The corporate business purpose for the transaction is evidence of nondevice.)
[226] B. BITTKER, J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, section 14.01-14.58 (5th ed. 1987).

appreciation), the transaction is not taxed if it qualifies for reorganization treatment as provided in sections 368 (a) (1) (A)-(C); 354 (a); 361 (a) IRC. In addition to the requirements stated in the provisions, there are the judicially developed prerequisites of a business purpose, a continuity of interest and the continuity of enterprise.[227] If one or more of these prerequisites are not met, both the corporation and the shareholders will be taxed on their realized gain.[228]

Third there are the rules concerning accumulated earnings and personal holding companies. The provisions of the accumulated earnings tax are fairly complex because of the "reasonable business needs" prerequisite.[229] By careful planning (the plan on substantial expansion in the near future) the corporation can avoid the application of the accumulated earnings provisions.[230] The complex personal holding company tax[231] can also be avoided (the corporations have to produce ample amounts of income that does not qualify as personal holding company income). Since well advised individuals can avoid both penalty taxes, these taxes are "essentially a trap for the unwary".[232]

d) Tax Integration as a Form of Relief to Double Taxation

Critics of the double taxation consider integration of corporate and shareholder taxes as a appropriate solution to make sure that corporate earnings are ultimately taxed identically to earnings in non-corporate form.[233] Integration leads to the elimination or at least the

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[227] Gregory v. Helvering, 293 U.S. 465 (1935); Treas. Reg. 1.368-1(d); BARTON ET AL., *supra* note 56, at 366, 383-418.
[228] Section 1001 (c) IRC.
[229] Taylor, *supra* note 1, at 257; For more details *see supra* III.A.d)bb).
[230] United States v. Donruss Co., 393 U.S. 297, 303-06 (1969).
[231] For details *see supra* III.A.d)aa).
[232] Taylor, *supra* note 1, at 258.
[233] AMERICAN LAW INSTITUTE, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993); U.S. TREASURY DEPT., A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992); U.S. TREASURY DEPT., REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS-TAXING BUSINESS INCOME ONCE (1992); George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 TAX L. REV. 431 (1992); Michael L. Schler, Taxing Corporate Income Once (or Hopefully not at all), 47 TAX L. REV. 509 (1992);

mitigation of the double taxation of corporate earnings.[234] The various possible mechanisms of integration can be divided into basically three groups, *i.e.* shareholder-level responses to the receipt of dividends, corporate-level responses to the distribution of dividends, and the allocation of all corporate earnings no matter whether retained or distributed among the shareholders.[235] The first two groups are also referred to as *dividend relief methods,* since they only reduce double taxation on distributed earnings, whereas the last group is labeled *complete integration method* which eliminates double taxation of both dividends and retained corporate earnings.[236]

The shareholder-level response can take the form of an exclusion from income,[237] an offsetting deduction against shareholder income, or a credit against shareholder taxes.

The corporate-level response can take the form of allowing corporations to deduct parts or all of their dividend payments to mitigate double taxation by distributing their profits. Another possibility is to tax the part of the corporate income that is distributed at a lower rate.

As described in the previous chapter, the German tax law provides double tax relief by a combination of a shareholder-level and a corporate level response, having a split tax rate on the corporate level and allowing the shareholder to use the tax paid on the corporate level as a credit against his individual tax liability.

Hugh J. Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base, 47 TAX L. REV. 565 (1992); Emil M. Sunley, Corporate Integration: An Economic Perspective, 47 TAX L. REV. 621 (1992); Pechman, *supra* note 3, at 179-89; Warren, *supra* note 189; MCLURE, *supra* note 189.

[234] BARTON ET AL., *supra* note 56, at 40.

[235] KAHN, LEHMAN, *supra* note 47, at 31.

[236] STAFF OF JOINT COMM. ON TAXATION, REDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES, 101st CONG., 1st SESS., at 84-88 (1989); Lorence L. Bravenec, A Nontraditional Approach to Corporate Integration, 44 TAX NOTES 1381 (1989).

[237] The Treasury Department recommends the exclusion from income because of the simplification concerns over any form of the imputation credit method. Under the dividend exclusion method, the shareholders exclude dividends from income because such dividends are already taxed on the corporate level. This provides huge integration benefits and requires little structural change in the IRC. *See* U.S. TREASURY DEPARTMENT, *supra* note 233, at vii-x.

2. Supporting Criticism of the Double Taxation

Criticism of the double taxation is based on the arguments that its consequences violate the tax policy principles of having an equitable and efficient tax system. Supporters of the present double taxation system add in addition to the two major tax principles a third element to the discussion, which is the requirement that the tax system has to raise a given amount of revenue.[238] The legal literature as a critic of the system fails to consider this requirement.[239] Supporters state that the realistic reform goal is "to minimize on a system-wide basis the adverse impact on equity and efficiency of a tax system required to generate a given amount of revenue."[240] Since the repeal of the double taxation would lead to a substantial loss of revenue,[241] the missing amount of money has to be collected somewhere else.

The question now is whether the previously under IV.B.1 discussed gains in equity and efficiency outweigh the negative impact that the need of utilizing an alternative revenue source has on the tax policy principles.

According to the supporters of the double taxation, a tax reform repealing double taxation would have the following negative impact on tax equity and efficiency. Presuming that individuals with high incomes have a tendency to invest their wealth in stock and receive a high proportion of the dividend income they are the ones benefiting from

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[238] Kwall, *supra* note 29, at 615.

[239] *Id.*; *See e.g.* Klein. The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics, 1965 WIS. L. REV. 576,578-79 ("Similarly disturbing is the opinion offered by some experts ... that the corporate tax can be defended on the ground that it is a good source of revenue - a view that ... apparently is based upon some well concealed antidemocratic value judgments.").

[240] Feldstein, On the Theory of Tax Reform, 6 J. PUB. ECON. 77, 98-102 (1976); Kwall, *supra* note 29, at 616.

[241] Robert J.Leonard, A Pragmatic View of Corporate Integration, 42 TAX NOTES 889, 894 (1987):*E.g.* the Treasury estimated that its own 1984 proposal to deduct half of the dividends paid to shareholders would lead to a $ 38 billion revenue loss for the fiscal year of 1990. *see* 1 TREASURY DEP'T REPORT. TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 248 (1984); *see* also Brady Offers Sermon on Capital Gains Cut and Corporate Integration to the Converted, 44 TAX NOTES 1311 (1989) (Treasury official concedes that revenue loss from integration would be about $ 40 billion).

integration.[242] To make up the loss in revenue without altering the allocation of the tax burdens among income classes, higher income classes must be taxed at a higher tax rate.[243] Such a change in law would distract the equity principle because higher tax rates increase the differences in tax liability between individuals who pay taxes on their entire income and similarly situated individuals who can take advantage of tax preferences to lower their tax liability.[244] The efficiency principle would be effected since the higher tax rates "would increase the desirability of those economic alternatives that exploit tax preferences and thereby augments the extent to which the tax system distorts economic decisions."[245] After all, to increase the tax rate in order to compensate for the revenue loss due to the repeal of the double taxation causes more distraction to the tax principles of equity and efficiency than the present state of the law.

C. Results of the German Tax Reform of 1977

On the occasion of the ten year anniversary of the German corporate tax reform, legal experts and scholars generally evaluated the reform and commented on how far the reform succeeded in fulfilling the government's objectives.[246]

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[242] AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 328 (1982) (Integration "would only be accomplished at a substantial cost in … progressivity, since a high proportion of dividends flow to high income, wealthy individuals."; JOINT COMM. ON TAXATION, FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 57 (1989) ("High tax rat taxpayers will tend to concentrate their wealth in the form of equity"); Kwall, *supra* note 29 at 618 n. 16, n. 107).

[243] Kwall proves this point by referring to economists who came to the conclusion that the elimination of double taxation in a revenue-neutral manner connect an increase in individual income tax rates to integration. *See* Kwall, *supra* note 29, at 617 n. 18; Feldstein, The Welfare Cost of Capital Income Taxation, 86 J. POL. ECON. 29, 46-48 (1978); Fullerton et al., Corporate Tax Integration in the United States: A General Equilibrium Approach, 71 AM. ECON. REV. 677, 683-90 (1981).

[244] Kwall, *supra* note 29, at 617, 633-41.

[245] *Id.* at 617, 645-56

[246] *E.g.* Brigitte Knobbe-Keuk, *Bilanz der Koerperschaftsteuer-Reform 1977, Was ist erreicht, was bleibt zu tun?* [Study on the corporate tax reform of 1977, What is accomplished, what still needs to be done?] GmbH-Rundschau [GmbHR] 125 (1987); Klaus Brezing, *Die Behandlung auslaendischer Einkuenfte und steuerfreier inlaendischer Einnahmen, Der fundamentale Fehler im KStG 1977* [Treatment of foreign

1. Objective of Spreading the Stock Ownership

One major political goal of the reform was to increase the attraction of investments in the corporate sector for individuals with lower income and thus spread the ownership of the means of production among more individuals.[247] The tax reform did not fulfill this goal.[248] The portion of the private household's wealth invested in stocks declined even further after the tax reform. This can be concluded according to the study from Haegert/Lehleiter[249] and the study from Iber. [250] Haegert/Lehleiter came up with the following table:

Wealth of private households in billion DM

Year	Total wealth	Stock portion of total wealth absolute	in %
1972	594	24	4.04
1973	667	26	3.90
1974	751.3	26	3.46
1975	909.4	28	3.08
1976	1011.3	28.5	2.82
1977	1112.6	29.9	2.69
1978	1218	30.9	2.54
1979	1342.5	30.5	2.27
1980	1465	31.2	2.13
1981	1602.5	31.9	1.99
1982	1729.5	32.8	1.9
1983	1834.6	34.7	1.89

The result of Iber's study backs up the conclusion that can be drawn from the previous table. He determined the structure of stock ownership in the time frame 1963 till 1983, shown in the following table:

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earnings and tax exempt domestic income, The fundamental mistake of the *corporate tax law of 1977*] GmbHR 152 (1987).

[247] *See supra* III.B.1.d)bb).

[248] Knobbe-Keuk, *supra* note 246, at130.

[249] Haegert/Lehleiter, ZfbF 37 (1985).

[250] Iber, *Zur Entwicklung der Aktionaersstruktur in der Bundesrepublik Deutschland (1963-1983)* [About the development of the structure of shareholders in Germany (1963-1983)], ZfB Vol.55, 1101 (1985).

Structure of stock-ownership (in %)

Year	1963	1973	1983
Private Households	26	24.3	16.7
Foreign investors	15.5	10	8.3
Public administration	13.5	10.8	9.5
Banks	6.1	7.8	7.7
Insurance companies	4	4.3	7.2
Businesses	35	42.8	50.6

Both tables show that the tax reform failed to serve as an incentive for private households to increase investing in the corporate sector. The main reason for this fact is that although dividends are no longer burdened by two levels of tax, there always remains the risk of falling stock prices.[251]

2. Objective to Remove the Disadvantages of Equity Financing

The tax reform succeeded in repealing the preferential corporate tax treatment of debt financing compared to equity financing.[252] However, the corporation's costs for investments in its equity are still higher than the costs for investments in its debt.[253] One factor is the German *net asset tax*. Corporations as well as shareholders are both tax subjects under the net asset tax.[254] Equity is part of the tax object of the net asset tax. Once a corporation distributes dividends, such dividends are subject to the net asset tax on the shareholder level. The net asset tax does not provide an imputation system as it is regulated in the corporate tax code. Therefore, a corporation's equity capital is still subject to double taxation under the net asset tax. A second factor is the German trade tax. The trade tax discriminates equity financing because of preferential treatment for a corporation's long term debt and the interest it has to pay on long term debts, *see* sections 8 No 1, 12 (2) No 1 Trade Tax Code.

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[251] Knobbe-Keuk, *supra* note 246, at 131.
[252] *Id.*
[253] *Id.*

The government was well aware of these factors, since it predicted them in the materials explaining the reasons for the reform.[255] The government was also of the opinion that already a substantial decrease in the costs for equity capital will eventually lead to an improvement of the corporations capital structure.

[254] CREZELIUS, *supra* note 148, at 360.
[255] KOERPERSCHAFTSTEUERGESETZ 1977, MATERIALIEN [CORPORATE TAX STATUTE 1977, MATERIALS]. 10 (2nd ed. 1977).

3. Objective to Improve the Neutrality of Corporate Tax Law

The tax reform of 1977 failed to establish a perfectly neutral corporate tax system.[256] However, the government never intended such a comprehensive reform. The government's objective for the reform was limited from the start to abolish the economic double burden on distributed corporate earnings.[257] The reform accomplished this goal although it needs to be mentioned that to this extend it was a rather technical matter. Still, tax issues are of extreme importance when it comes to making the decision whether to chose the corporate or the partnership form to conduct business. In 1987 the three major issues were the allowance only for corporations to build reserves for a pension fund tax free, the allowance only for corporations to use the management salaries as a deduction in the process of determining the German trade tax liability[258] and the advantage for corporations that only half of the long term debts and half of the interest on such long term debts were burdened with the German trade tax.[259] At that time, partnerships were not eligible for such preferential tax treatment.

A detailed analysis of the just mentioned tax issues is beyond the scope of this thesis, but their mentioning serves the purpose to make the following point: Changing the corporate and the individual income tax law from a two tier to a one tier tax system does not cause the overall tax system to be of perfect neutrality. There are too many other tax issues inducing certain behaviors that respond to after-tax effects.

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[256] Brigitte Knobbe-Keuk, *Aktuelle Probleme des mittelstaendischen Unternehmens*, Steurberater-Jahrbuch [Current Problems of Midsize Businesses, *in* YEARBOOK OF THE PROFESSIONAL TAX CONSULTANTS], 127, 141-42 (1988).
[257] Knobbe-Keuk, *supra* note 246, at 132.
[258] Trade Tax is the municipal business tax based on profits and capital, *see* ERNST & ERNST, WEST GERMANY; A DIGEST OF PRINCIPAL TAXES, 14 (1970).
[259] Knobbe-Keuk, *supra* note 246, at 132.

4. Summary

After the tax reform of 1977, there is technically no longer a double tax burden on dividends distributed by a corporation. However, the reform did not trigger the effects to the extent that the government expected and hoped for. It is true that aspect of taxing distributed dividends twice is no longer an issue when it comes to the question which form of enterprise should be used to conduct a business. Moreover, the tax reform led to a decrease of the corporation's cost for equity financing. This is due to the implementation of the imputation procedure in the 1977 tax reform.

However, the tax reform of 1977 cannot be blamed for falling short of the expectations. Whoever thought of more comprehensive results is simply to blame for having expected too much.[260]

[260] *Id.* at 133.

V. Conclusion

The legal literature in the United States agrees on criticizing the double taxation of distributed corporate earnings on three grounds as producing inequity, economic inefficiency and administrative complexity. If limited to the scope of the general tax principles of equity and efficiency, the assessment of the double taxation as the present state of the corporate tax law comes to the reasonable conclusion that such tax principles are distorted. However, the legal literature intentionally disregards the fact that these two tax principles are not the only means of measurement to evaluate tax provisions. In addition, the purpose of taxation which is to raise a given amount of revenue needs to be taken into account. Critics simply ignore this circumstance.[261] As long as only the tax principles are considered, it seems that by technically calculating the numbers it can be proved that any of the integration methods will lead to a more equitable and efficient tax system. This approach loses its appeal once it is realized that tax law has the indispensable function to raise revenue. So far, the legal literature failed to counter the presumption that a repeal of double taxation will most likely lead to an increase of federal income tax rates to make up for the loss in revenue, and that such a subsequent step would result in an even greater distortion of the equity and efficiency tax principles.

The experiences gained from the German tax reform of 1977 are that the repeal of the double taxation was only one step in the direction towards a more neutral and thus efficient tax system. This is due to the fact that in deciding whether the corporate or the non-corporate form should be chosen to conduct one's business, there are many more tax

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[261] *E.g. see* Taylor, *supra* note 1, at 310. He concludes: "The largest obstacle hindering ecactment of an integration plan is the looming federal deficit. If an integration plan actually increased revenue, then the likelihood of its passage would be very favorable. **Unfortunately, most integration plans produce**

issues to be considered than only the question of how distributed corporate dividends are taxed. As a consequence of the German tax reform of 1977, the economical double burden on distributed dividends does no longer exist. This was achieved by implementing the 'imputation procedure' in the corporate tax law. However, abolishing the double tax burden was rather a technical matter that could have been accomplished in many different ways, as the number of suggestions for integration methods indicates. It is therefore more important to point out that the tax reform fell short in fulfilling the government's major objectives to create a corporate tax law that eventually leads to a wider spread of stock ownership among the population and that the reform was only one step into the direction towards a system that no longer favors investments financed with debt over investments financed with equity.

Experiences gained from the German tax reform of 1977 lead to the conclusion that a reform focusing exclusively on the abolishment of the economic double tax burden on distributed corporate income is not capable of automatically leading to a more efficient and equitable tax system.

In addition to these experiences, the United States have to take into consideration the lack of revenue as a consequence of such a reform and so necessary counter actions that need to be taken to make up for such a deficit. Such counter actions are likely to be a raise of tax rates in other tax areas, which can be considered another major distortion of the tax principles equity and efficiency.

Taking all these observations into account, the thesis concludes that a tax reform that will abolish the two level taxation of distributed corporate income cannot be justified with the argument that the reform will lead to a more efficient and equitable tax system.

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moderate to large losses in revenue. The author's proposal does not attempt to respond to any of these budget deficit difficulties." (Emphasis added).

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