The United States Federal Income Tax laws continue to employ the so-called "classical system" which treats corporations and their investors as separate taxable entities and imposes tax at both the corporate and shareholder levels on earnings that are distributed by the corporation as dividends. There is no relief from this double tax on individual shareholders. Dividends are not deductible by the corporation. In contrast, corporate earnings that are distributed to lenders as interest are deductible by the corporation and taxable to the lender. Investors who choose non-corporate forms of business, such as the sole proprietorship or partnership, or closely-held corporations that qualify to elect to be taxed as "S Corporations" (formerly known as Subchapter S Corporations), are taxed on a pass-through method and the undistributed as well as distributed earnings of the business are taxable, currently, to the shareholders, at their rates and according to their relevant individual tax characteristics. For the ordinary corporation, however, the corporate income tax is not "integrated" with the individual income tax.

For years arguments have been raised in favor of "integrating" the corporate and individual income taxes in the United States. It is claimed that the United States unintegrated, classical system, by imposing a double layer of tax on distributed corporate earnings, discriminates against the choice of the corporation as a form of business entity, discriminates in favor of interest as distinguished from dividends and hence encourages "thin capitalization" and excessive use of debt finance, encourages the retention of corporate earnings, and rewards their eventual distributions in forms that are not taxable as ordinary dividends, causes under-financing of the corporate sectors of the economy, taxes corporate income unfairly and contributes to economic inefficiencies and a loss of welfare in the United States, not to mention international competitive disadvantage. The integration movement gathered energy in the late 1970s, but then diminished and was relatively quiet, until the late 1980s. Concern about excessive use of debt and the failure of over-leveraged companies in the late 1980s and the early 1990s revived the question of how to tax corporate earnings distributed either as dividends or as interest, and whether to "integrate" the corporate income tax with the individual income tax. In a country with a low rate of investment, there was

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concern that the historical system discouraged new equity financing of corporate investments.

On January 6, 1992, the U.S. Treasury Department issued a report entitled "Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once." This report results from the revival of the debate, and help set the agenda for the policy discussion in the ensuing year. The Secretary of the Treasury had been instructed by the Tax Reform Act of 1986 to study reforms of the taxation of corporate income. It was earlier expected that the study would consider less fundamental approaches to corporate income tax reform. The Treasury decided to undertake a more comprehensive study of integration of the corporate and individual tax and to address fundamental questions about how the corporate income tax might be restructured to reduce tax distortions of important corporate financial decisions and to achieve a more efficient system, especially given the prevalence of integrated corporate income tax systems elsewhere in the world.

During the preceding year, the prestigious American Law Institute also was beginning to undertake a study of integrating the corporate and individual income taxes. By October of 1992, a draft of the ALI "Reporter's Study" on "Integration of Individual and Corporate Income Taxes" was made available to the Council of the American Law Institute. (Earlier drafts had been discussed by special study groups and consultants to the American Law Institute.)

The American Law Institute "Reporter's Study" proposed a shareholder imputation credit method of integration of the corporate and individual income tax for the United States in a form resembling that recently enacted in New Zealand, and familiar in Australia and the European Community. Under this method of integration, the corporate income tax would remain in place, and dividends would be taxable to shareholders, but the shareholders would receive a credit for the corporate tax paid with respect to the earnings out of which distributions were made to them as dividends. The ALI Reporter, Prof. Alvin Warren of the Harvard Law School, produced an excellent analysis and proposal for shareholder imputation credit integration in the United States, thoughtfully argued and superbly worked out, although not cast in the form of legislation. The ALI proposal benefitted from the work of the "Carter Commission" of Canada, the Royal Commission which produced an attractive proposal for shareholder credit integration in 1966, including a plan for voluntary "allocation" of retained earnings. In the United States, the rate relationships newly established by the 1986 Tax Reform Act, relationships between the top individual income tax rate and the top corporate income tax, made the Carter Commission "allocation" idea, and the shareholder credit method of integration in general, especially feasible and desirable in the United States. Taking into account the experience and legislative variations among shareholder credit integration systems in Western Europe and the rest of the world, the ALI study could look forward to attention by policy analysts and the Congress of the United States.

Somewhat surprisingly, the Treasury Department's study issued in January 1992 did not recommend, or prefer, the shareholder imputation credit method. The Treasury study outlined four prototypes for integration. One of these was the