A Treasury Tax Study ...

THE POSTWAR CORPORATION TAX STRUCTURE

TREASURY DEPARTMENT
Division of Tax Research

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One of the major issues of postwar tax policy concerns the position of the corporation in the tax structure. The corporation income tax has been widely criticized on grounds of alleged inequity and undesirable economic effects. The purpose of this report is to examine criticisms of the corporation income tax and the arguments in its favor, and to analyze proposals for fundamentally revising it. The report advances no policy recommendations but discusses considerations important to the formulation of such recommendations.

The report was prepared in the Business Tax Section of the Division of Tax Research by Mr. Richard Goode under the supervision of Mr. Gordon Keith. In its preparation, use was made of research memoranda prepared by other members or former members of the Division staff including Mr. Cary Brown, Miss Nancy Dunlap, Mr. Chester Hirsch, Mr. Merton Miller, Mr. Everet Straus, and Mr. Haskell Wald.

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Acting Director of Tax Research

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SUMMARY

I. Criticisms of the present corporation income tax and arguments in its favor

A. Introduction

Critics of the present corporate income tax argue that it is inequitable and economically undesirable. Defenders of the tax either deny these charges or find compensating advantages in the tax. The purpose of this report is to examine criticisms of the corporation income tax and arguments in its favor and to analyze proposals for fundamentally revising it. The report advances no policy recommendations but discusses considerations important to the formulation of such recommendations.

B. Effect of the corporation income tax on commodity prices and wage rates

The effect of the corporate income tax on commodity prices and wage rates is of vital importance in the debate as to the merits of the tax. Unfortunately, there is no general agreement as to whether the tax rests on corporations and stockholders or is shifted to consumers and wage earners. On the basis of usual price theory, many economists argue that a net income tax has no effect on prices or wages. Many others, however, doubt the applicability of this reasoning to the present corporate tax. Business opinion is divided, but in two extensive surveys a large majority of businessmen responding believed that the corporate tax cannot be passed along in the form of higher prices. Even if the corporate tax has in the past pushed up prices and held down wages, it does not necessarily follow that its reduction would automatically reverse these effects.

C. Analysis of criticisms of the present corporation income tax

On grounds of equity the corporate tax is criticized as double taxation of dividend income and as an impersonal tax not adjusted to the incomes of stockholders. These criticisms depend on the assumption that the tax is not shifted to prices or wages. If it is shifted, there is no double taxation, but the tax is regressive in the same way as a sales tax or payroll tax.

The chief economic argument advanced against the corporate tax is that it reduces both ability and willingness of corporations to invest. The tax is held to reduce investment ability by limiting capital available from security sales and from retained earnings. It is also held to reduce incentives to invest, especially in risky enterprises. If it were always possible to deduct losses on unsuccessful investments from other taxable income, the corporate income tax would not reduce the reward for risk taking in relation to the net amount risked. Although perfect loss offsets are not possible now (and can hardly be made so), existing opportunities for loss offsets mitigate the effects of the tax on incentives. Regardless of risk,tthe tax may in some circumstances reduce anticipated returns below the minimum necessary to induce investment. The corporate tax appears likely to restrict investment, but to what extent is highly uncertain. Alternative taxes would also directly or indirectly deter some investment.

Double taxation of dividend income, but not of interest income, is held to encourage corporations to borrow rather than to float stocks. Excessive fixed debts may aggravate economic instability.

D.tt Analysis of arguments in favor oftt tt
the present corporation income tax

The traditional justification for special taxes on corporations is that a public charter gives them special privileges and economic advantages. But the whole privilege theory of taxation has been challenged. Moreover, it has been argued that, since all who wish may incorporate at little expense, a corporate charter can have little economic value.

Some supporters of the present corporate tax system deny the validity of the double-taxation charge against it. They contend that there is a realistic legal and economic distinction between corporations and their stockholders and that separate taxation is justified.

The chief economic argument advanced in favor of the present corporate tax is that it reduces consumption less and savings more than would feasible alternative taxes. Dividends are heavily concentrated in relatively high-income groups, in the hands of individuals who habitually save large percentages of their incomes. It appears that the corporate tax, if not shifted, is in the aggregate a broadly progressive tax, which is less burdensome totconsumption than many other taxes. The corporate tax, however, is likely to be less progressive than the individual income tax. The fact that the corporation tax falls lightly on consumption is an advantage on the assumption that maintenance of enough total demand to assure a high level of income and employment will be an important long-runtt economic problem.

II. Problems encountered in adopting a new methodtt
of taxing corporate profits

Few critics would recommend simple elimination of the corporate incomettax without any further change. It is generally agreed that some provision must be made to prevent individual tax avoidance on income retained in corporations. Most plans for corporate tax reform are attempts to reduce inequality of taxation of corporate profits and other kinds of income. This involves reduction of both overtaxation and undertaxation.

An incidental problem of corporate tax adjustment is to minimize windfall gains to stockholders and the likelihood of setting off a speculative stock market boom. For this purpose, it has been suggested that any tax adjustment be spread over a number of years.

III.oo Methods of coordinating individual andoo corporate tax on corporate profitsoo

A.oo Elimination of corporate income tax andoo oadoption of full taxation of capital gainsoo

cOne approach to taxation of corporate profits would be to eliminateoo entirely the corporate tax and to rely on taxation of realized capital gains at regular individual rates to prevent tax avoidance with respect to undistributed corporate profits. A capital gain or loss would be realized whenever an asset was transferred by sale, gift, or bequest. Some method of averaging individual income for tax purposes would be required.

This approach would completely eliminate "double taxation" of distributed corporate profits. But undistributed corporate profits would be taxed less heavily than other income. Undistributed profits not reflected in the value of stock at the time of a transfer would not be taxed. Stockholders would have the opportunity of postponing throughout life a tax on their share of undistributed profits, and this would discriminate against other forms of saving. The capital-gains approach would favor corporate saving and internally financed investment as compared with consumption and non-corporate saving and investment. This would be likely to bring economic disadvantages as well as inequities.

B. Current taxation of all corporate profits at rates applicable to individual shareholders

Complete integration of individual and corporate taxes could be achieved by determining tax liability on corporate profits without regard to the legal distinction between corporations and stockholders. The partnership method, for example, would tax stockholders currently at their regular personal tax rates on both distributed and undistributed profits. This approach would completely eliminate double taxation, individual tax postponement, and tax discrimination against equity financing. It might or might not, on balance, increase incentives to invest. The partnership method would probably be administratively feasible for corporations with simple capital structures and a relatively small number of stockholders. Butoit probably would not be feasible for large corporations with complicated capital structures and a large number of shareholders. A plan similar to the partnership method would be to tax each corporation at the average rate its shareholders would pay on dividends if all profits were distributed. This plan would present the same administrative difficulties as the partnership method.

C. Adjustment for distributed profits at the corporate level -- credit for dividends paid

Another approach to coordination would be to give corporations a tax credit or deduction from taxable income for dividends paid. This approach would keep a tax on undistributed profits but would reduce or eliminate the corporate tax on distributed profits. In recognition of the problems of financing small business, some moderate amount of retained profits might be taxed as if distributed. Dividends paid in excess of current income could be applied against income of past or future years.

This dividends-paid-credit approach could completely or partially eliminate "double taxation," remove or lessen tax discrimination against equity financing, and reduce the weight of taxation on corporate profits. Tax reduction at the corporate level might stimulate corporate investment and help counteract any effort of management to shift the corporate tax by increasing commodity prices and reducing wages. The approach would present some administrative difficulties but no insuperable ones.

D. Adjustment at the individual level for corporate tax on distributed income

1. Withholding tax approach

Another approach to coordination would be to treat part or all of the tax paid by corporations as a withholding tax on dividend income. Individuals would include in taxable income cash dividends received plus withholding tax on them and would get credit for the tax withheld by the corporation. The withholding tax would apply to all corporate profits, but stockholders would get credit currently only for the withholding on the part of profits paid out in dividends. If withholding exceeded a stockholder's tax liability, he would get a refund.

The withholding approach could eliminate or reduce "double taxation" of distributed corporate profits, reduce individual tax postponement on undistributed profits, and lessen tax discrimination against equity financing. It might stimulate individual security purchases. The withholding approach might have a less favorable effect on corporations' incentives to invest than an adjustment at the corporate level, and it would be less likely to counteract any effort of management to pass on the corporate tax through higher prices or lower wages. A refined withholding method would present some rather serious administrative problems.

2. Dividends-received-credit approach

Another approach to coordination would be to exempt dividends from a substantial individual normal or first-bracket tax rate or to give stockholders an equivalent tax credit. This approach would give no relief to stockholders not subject to individual income tax. It would offer considerable benefits to high-income stockholders, since in effect a part of the corporation's tax payment would be applied to their personal tax liabilities but would not be included in their taxable income. At the extreme it would tax distributed profits at lower rates than other kinds of income. Thus, the plan would offer an inducement to wealthy individuals to buy stocks. It would do little to counteract possible undesirable effects of the corporate tax on management policies as to investment, prices, and wages. The dividends-received-credit approach would be administratively simple.

3. Partial exclusion of dividends received from individual taxable income

Still another adjustment would be to exclude a part of dividends from individual taxable income and tax the remainder at regular individual rates. This plan would result in a distribution of tax benefits somewhat similar to that under the dividends-received-credit method. It also would give no relief to stockholders not subject to individual income tax but would offer even greateroadvantages to wealthy stockholders. The equity and economic effects and administrative features of the dividend-exclusion approach would in general resemble those of the dividends-received-credit method.

°E. Summary comparison of methods of coordination andoo estimates of revenue yield of illustrative plans

Complete equality of taxation of distributed corporate profits and other kinds of income could be achieved by any of four basic approaches. These are: (1) elimination of the corporate income tax, while relying on the capital gains tax to reach undistributed profits; (2) taxation of stockholders as if they were partners; (3) elimination of the corporateoo tax on distributed profits but not on undistributed profits; (4) adjustment of the individual tax of stockholders to take account of the tax paidoo by the corporation. But only the partnership approach or some variationoo of it could tax undistributed corporate profits in exactly the same way asoo other kinds of income. Specific versions of the third and fourth basicoo approaches may aim at reducing inequalities of taxation of corporate profits and other kinds of income rather than at complete equality of taxation.oo Starting from approximately the present relation between corporate and in- oo dividual tax rates, all approaches to coordination of individual and corporate taxes would be likely to result in some loss of revenue. Generally,oo the more nearly "complete" the coordination or integration, the greater oo would be the loss of revenue.oo

THE POSTWAR CORPORATION TAX STRUCTURE

I.tt Criticisms of the present corporation income taxtt and arguments in its favortt

A.tt Introductiontt

There are major differences of opinion as to postwar taxation of corporate income. Many desire radical changes in the present system. Others wish no basic revision. Not all those who favor ultimate elimination of the corporate tax would recommend this step immediately. Moreover, many who approve the present type of corporate tax favor lower rates and other modifications.

Arguments against the present corporate income tax hold that it is inequitable and economically undesirable. The equity argument most often stressed is that the corporation income tax, together with the individual income tax, results in double taxation of distributed corporate profits. The corporation tax is also alleged to discriminate with especial severity against low-income stockholders.

Economic arguments hold that the corporate tax decreases willingness of individuals to buy securities and thus limits capital available to corporations. Furthermore, it is contended that the corporate tax reduces the ability and willingness of management to invest and take risks. Another line of argument against the corporate income tax is that it raises prices and lowers wages. Moreover, it is held that the corporate tax encourages corporations to borrow rather than to float new equity securities and that this may accentuate economic downswings. Some fear that the tax may discourage use of the corporate form, which they believe to be an especially efficient type of business organization.tt

Defenders of the present method of taxing corporations and stockholders either deny charges brought by critics or find compensating advantages in the corporation income tax. As to equity, they hold that special privileges and benefits of incorporation warrant special taxation. They argue that the corporate tax, broadly viewed, is a desirable progressive element in the revenue system. Some supporters of the corporate tax doubt the realism or importance of the double-taxation criticism against the present system.

On economic grounds, advocates of the corporate tax argue that it has the merit of falling lightly on consumption. These supporters of the corporate income tax are convinced that feasible alternative sources of revenue would be almost certain to burden consumption more heavily. They believe that national income and employment will be higher if a given amount of revenue is raised from the corporate tax than from likely alternative taxes. It is also argued that a significant portion of corporate profits is economic surplus, unnecessary to vigorous functioning of the economy. Taxation of such surplus is regarded as a desirable source of revenue.

Still others, without denying validity to criticisms of the tax, think the corporation income tax is such an important revenue source that it must be maintained. 1/ In the opinion of these observers, future revenue requirements will be so great that no established major tax can safely be abandoned or reduced more than in proportion to other tax cuts. They contend that the public will be unwilling to tolerate substantial reduction of taxes on corporate profits while other taxes are maintained well above their prewar levels.

The following discussion will examine criticisms of the corporate tax and arguments in its favor and then analyze proposals for fundamentally revising it. No attempt will be made to advance definite policy recommendations, but considerations relevant to formulation of such recommendations will appear. 2/

B. Effect of the corporation income tax on commodity prices and wage rates

Validity of most criticisms of the corporation income tax as well as of most arguments in its behalf depends on an assumption about where the tax actually comes to rest. Clearly, the "double-taxation" argument, for example, implies that the corporation tax remains to a considerable extent where it is imposed -- on profits (and hence on stockholders). On the other hand, another complaint against the corporate tax is based on the opposite belief that a significant part of it is passed on to consumers and wage earners through price and wage adjustments. Other arguments against and in favor of the tax depend also, if less obviously, on one or the other opinion about who really pays it.

Unfortunately, this crucial question cannot be definitely answered. There are differences of opinion among businessmen and among economists, and no statistical evidence is available. Nevertheless, it seems advisable to review briefly the possible effects of the corporation income tax on commodity prices and wage rates.

If the corporation tax either raises commodity prices or depresses wages it is said to be shifted. There are two possible kinds of explanations of shifting. The simpler concept, apparently referred to by most businessmen, is that producers faced with a profits tax will deliberately

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1/ See Appendix A for a tabulation of revenue collections from corporate income and excess-profits taxes, individual income taxes, and total internal revenue during the fiscal years 1925-1945. In appraising these figures, it should be remembered that a part of the revenue collected from corporate taxes merely replaces revenue which would otherwise be collected under the individual income tax.

2/ Special incentive tax plans -- taxes on hoarding, deductions for investment, accelerated depreciation, and the like -- will not be discussed.

decide to increase prices or reduce wages in order to protect their net returns. The other version of shifting, usually favored by economists, is that shifting is effected through unplanned operation of market forces. According to this latter view, a tax may result in higher prices if it brings about a curtailment of supply. Similarly, a tax may lower wages if it reduces possible returns to business from employing labor. Normal business behavior may result in shifting, even though there is no conscious attempt to pass on the tax.

1. Prices

Business opinion is divided. Spokesmen for business often assert that the tax is shifted. However, on the two occasions when a sizable number of American businessmen were questioned, a large majority of those who expressed a definite opinion said that the corporate tax cannot be passed along in the form of higher prices. 1/ The reason most frequently cited for this opinion was that the force of competition and general market conditions set prices and do not allow the tax to be added. The minority of respondents who expressed the opinion that the tax increases prices regarded it as a cost which must be covered by prices.

Economists have usually held that a tax on net profits does not directly affect prices or wages, although some have challenged this view. The opinion that a profits tax does not stimulate a price rise is based fundamentally on the conviction that the tax is not in the economic sense a cost of production. Under competitive conditions, prices are supposed to be set by market forces beyond the control of individual firms. In cases of monopoly, prices are presumed in any case to be set at the most profitable level in the light of demand and costs.

Economists have usually argued that the objective of all producers can be assumed to be maximum profits. They contend that any firm -- whether in a competitive, monopolistic, or mixed market -- which has set its price and output most advantageously before a tax is imposed on true profits, will find the tax no reason for changing either price or output. It is argued that the tax will reduce the amount of profits which can be retained, but that it will still be advantageous to have the maximum obtainable profits before tax. Maximum profits before tax, it is held, will yield maximum net income after subtraction of tax.

But some part of the "net income" subject to Federal corporation income tax is actually a return necessary in the long run to induce continued operation and expansion. This necessary return may be regarded, from the social point of view, as a cost of production. If it is reduced,

1/ National Industrial Conference Board, The Shifting and Effects of the Federal Corporation Income Tax, Vol. 1 (New York, 1928), pp. 153-155; National Industrial Conference Board, Effects of Taxes Upon Corporate Policy (New York, 1943), pp. 57-58.

investment and production will be restricted. Because of the consequent decrease in supply it may be argued that prices will be forced up. The extent of the price movement would be influenced by general economic conditions and urgency of demand for particular commodities.

Even if the corporate tax restricts investment and ultimately reduces production, a general price rise does not necessarily follow. A significant decrease in investment, not compensated for by more consumption, will mean a decline in national income and consumer demand. A declining national income makes a fall of prices more likely than an increase. Nevertheless, some prices may increase while others decline.

The outcome of the discussion is by no means clear and definite. It does seem, on the strength of testimony of businessmen and economists, that an immediate and significant increase in prices can hardly be expected after adoption or increase of a corporate tax. Over the long run, developments are less clear. It is difficult to demonstrate that a corporate income tax will induce a significant increase in the general level of prices even over a long period of time. Nevertheless, it is hard to prove that the tax will have no effect on prices.

The practical problem for postwar tax policy is not the one just discussed. The problem is, would elimination or reduction of the corporate tax lead to a price decline? It seems unlikely that a general fall in prices would follow immediately and automatically. Such an adjustment would probably have to be forced by competition or threat of competition. Its extent and timing would depend on market conditions. The attitude of businessmen would also be important.

2. Wage rates

The effect of the corporate tax on wage rates is even more difficult to ascertain. It may well be that vigorous labor unions could capture a significant share of profits freed by lower corporate taxes. But profits and the corporate income tax in relation to the wage bill vary widely from firm to firm. Hence, a wage increase which would absorb a reduction of the tax would have to differ greatly among firms. Any uniform wage increase in an industry or area, unless restricted to the tax reduction of the least profitable firm, would in some cases exceed the tax cut and in others fall short of it. A uniform wage increase, representing an increase in the costs of all firms, might well lead to a price increase.

C. Analysis of criticisms of the present corporation income tax

1. Equity arguments against the corporate tax

a. Double taxation

If the corporation income tax is not passed on in higher prices or lower wages, it reduces profits available for dividends. Dividends may not immediately be reduced by the full amount of the tax, but ownership claims of stockholders will be decreased. Since dividends received by individuals are subject to regular individual income tax rates, combined operation of corporation and individual income taxes appears to result in double taxation.

(1)ee <u>Combined impact of corporate andee individual taxes on corporate profitsee</u>

Before considering further the implications of the double-taxation criticism of the present corporate tax system, it may be desirable to examine more carefully the mechanics of the system. The corporation income tax applies to corporate profits as a whole. The individual income tax, of course, applies only to dividends paid to taxable stockholders. It does not apply to the portion of corporate profits taken by the corporate tax. For this reason, the total tax rate on distributed profits cannot be obtained by simply adding together the corporate and individual tax rates. For example, if the corporate tax rate were 40 percent 1/ and the individual tax rate of the stockholder were 20 percent, the total tax on corporate profits would not be 60 percent but would be 52 percent (40-percent corporate tax on the whole profits plus 20-percent individual tax on theee 60 percent of profits left after the corporate tax). Furthermore, the individual tax does not apply to profits so long as they are retained by theee corporation and not paid out in dividends.ee

Chart 1 shows how the corporate and individual income taxes combine to make up the total tax on corporate profits, assuming for illustration a 40-percent corporate tax. The total tax is the aggregate of corporate and individual taxes on a dollar of profits earned for a share of stock owned by any given stockholder. In the two panels at the top of the chart, the corporate tax is shown on the left-hand scale, the individual tax on the middle scale, and the total tax on the right-hand scale.

The first panel (upper left) of Chart 1 shows the total tax on corporate profits on the assumption that the corporation retains none of its profits but pays all of them out in dividends and taxes. The corporate tax of 40 percent, shown on the left-hand scale, leaves 60 percent of total profits to be paid out in dividends.

1/ The 40-percent corporate tax rate and the individual tax rates mentioned here and elsewhere in the text are intended solely for purposes of illustration. The illustrations were developed when the combined corporate normal tax and surtax was 40 percent. The illustrations have not been revised with the reduction of the corporate tax rate to 38 percent in the Revenue Act of 1945, partly because of the convenience of dealing with even numbers obtained by use of a 40-percent rate. No recommendation is implied as to proper rates for either the corporate or individual tax.

The dividends are in turn subject to individual income tax in the hands of stockholders at different rates, which depend on the income and personal circumstances of the individual. A range of individual tax ratestt from 0 up to 100 percent is shown for the sake of illustration, withoutt implying that a 100-percent top rate is likely or desirable. As hastt already been pointed out, these individual rates apply only to the portion of profits paid out in dividends. This is shown on the chart by the placing of the individual tax scale.tt

The total tax on corporate profits, stated as a percent of total profits, can be read from the right-hand scale of the first panel of the chart. The total tax ranges from 40 percent, when dividends are paid to a stockholder not subject to individual income tax, to a theoretical maximum of 100 percent, when the stockholder is assumed to be subject to a 100-percent individual tax rate. For example, in the case of a stockholder subject to a tax rate of 20 percent, the total tax, shown on the right-hand scale directly opposite that individual rate, is found to be 52 percent.

The second panel of Chart 1 (upper right) illustrates the effect of retained profits on the total tax. In this panel, the assumption is that the corporation retains 30 percent of its total profits and pays 30 percent out in dividends. The fact that the retained profits are not currently subject to individual income tax is indicated on the chart by the shrinkage of the individual rate scale. Although the individual tax rates still range from 0 to 100 percent, the range as a percentage of total corporate profits has been cut in half. It will be found that every individual tax rate above 0 on the middle scale falls opposite a lower total rate on the right-hand scale than in the first panel. For example, opposite 20-percent individual rate the total rate is 46 percent rather than the 52 percent shown in the first panel.

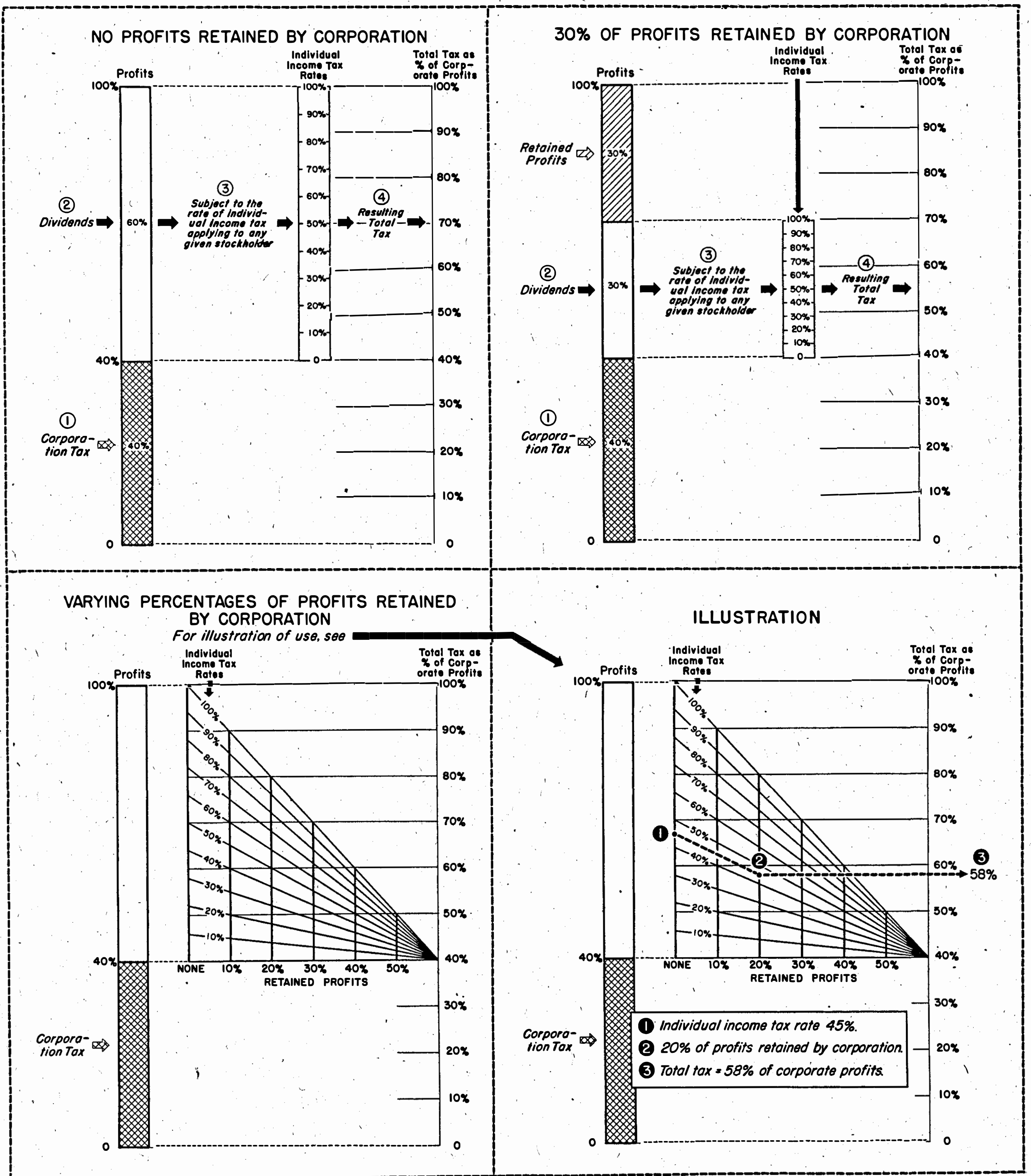
The third (lower left) panel of Chart 1 generalizes the illustration of the principles shown in the upper half of the chart. This panel shows the total tax on corporate profits for any assumption as to: (1) the individual tax rate applicable to the stockholder and (2) the percentage of tprofits retained by the corporation. (On the assumption of a 40-percenttt corporate tax, the most a corporation could retain would be 60 percent oftt its total profits.) Use of the third panel is illustrated in the fourthtt (lower right) panel. The shrinkage of the individual income tax base as profits are retained by corporations is shown by the slope of the varioustt individual-tax-rate lines downward to the right. For example, the 20-percent individual-rate line is opposite 52 percent total tax (on thett right) when no profits are retained by the corporation; opposite 46 percent total tax when 30 percent of profits are retained by the corporation;tt and it comes together with the other lines at 40 percent total tax whentt 60 percent of profits are retained by the corporation. With 60 percent oftt profits retained by the corporation, no dividends are paid to become subject to individual tax, and the 40-percent corporate tax is the only tax.tt

Chart I

TOTAL TAX ON CORPORATE PROFITS UNDER PRESENT PLAN

40% CORPORATE TAX

Aggregate of corporation and individual income tax based on:
A. Varying percentages of profits retained by corporation.
B. Rate of individual income tax applying to any given stockholder.



(2) Effect of corporate tax on prices and yields of various kinds of assets

A number of adjustments of prices and yields of stocks and other assets are likely to diffuse and modify the original impact of the corporate tax. When a corporate tax is first imposed or when rates are increased, the resulting decline in profits available for dividends will be reflected to a considerable extent in prices of stocks. If there is no change in investors' standards for an adequate rate of return on securities, stockholders at the time when the tax is imposed will suffer capital losses or will fail to realize capital gains which otherwise would have accrued to them. New purchasers of stocks will take the tax into account, if they expect it to continue, and accordingly will offer less for stocks. If market adjustments were perfect, new purchasers would acquire stocks at prices fully discounting prospective corporate taxes. These new purchasers would in effect escape the corporate tax in force when they bought their stock, if the tax were expected to be continued indefinitely in the future. Old stockholders would have borne the tax once and for all. Actually, investors will in time change their standards for an adequate return, and securities markets are imperfect. Therefore, price adjustments will not be instantaneous nor complete. Nevertheless, imposition of a corporate tax can be expected to reduce the price of stocks below the level which otherwise would have prevailed.

Price adjustments will not be confined to stocks, but will extend to other assets. When a corporate tax is first imposed some individuals will try to shift their investments from stocks to bonds and other assets, and some new investors who previously would have bought stocks will select bonds or other assets. Prices of bonds, real estate, and other assets will be bid up, and the fall of prices of stocks cushioned. Yields from all kinds of investments will suffer. Conversely, the effect of a reduction in corporate tax will be likely to spread to prices and yields of all kinds of investments and not be confined to stocks.

It seems that in the long run, taking into account probable changes in the prices of assets, the corporate tax is more likely to result in general reduction of investment yields from all sources than in specific "double taxation" of dividend income. Similarly, reduction or repeal of the corporate tax would be likely to bring about some general increase in investment yields. This reasoning is more clearly applicable to extensively traded securities listed on national exchanges than to unlisted stock and other assets. Nevertheless, less readily marketable assets would probably be subject to much the same basic influences as listed securities.

To the extent that the tax is shifted to consumers and wage earners there is no double taxation of dividend recipients. On this assumption, the corporate tax is no more a double tax on shareholders than, say, excises on alcoholic beverages are "double taxes" on stockholders in breweries, wineries, and distilleries.

b. Regressivity

It is contended that the corporate tax, whether finally borne by consumers and workers or by stockholders, is regressive, or at best proportional. If the corporation income tax is passed on to consumers in higher prices, it is regressive and inequitable in the same way as a sales tax. A tax which raises prices strikes low-income groups with greater weight than those with high incomes, because low-income families must spend a larger portion of their incomes on current consumption. If the corporate tax reduces wages it is also regressive, because wages are in general a larger portion of low incomes than of high incomes.

If the corporate tax rests on stockholders, it appears at first sight to be proportional. The tax takes no account of differences in the income of stockholders of corporations. It reduces the amount of profits available to corporations for dividends, and to the extent that this cuts actual dividend payments it brings about the same percentage reduction in dividends paid to all holders of a given stock, regardless of differences in their income. This is held to be especially burdensome to low-income stockholders, in violation of the principle of progressive taxation.

Moreover, a uniform reduction in corporate profits available for dividends brings about a smaller reduction in the amount which a high-income stockholder could retain out of a dollar of corporate profits than in the amount which a low-income stockholder could retain out of a dollar of profits. This is true because the corporate tax, when it reduces dividends, decreases the amount of personal income subject to the progressive rates of individual income tax. If, in the absence of a corporation tax, a well-to-do stockholder would have received additional dividends, they would have been subject to a high rate of individual income tax. A less prosperous stockholder would have paid a smaller individual tax or perhaps none at all. 1/ From this point of view the corporate tax appears to be regressive.

1/ For example, assume that the X corporation has profits of $1 per share before taxes. A 40-percent corporate tax will reduce earnings available for dividends to 60¢ per share. Assume further that stockholder A is subject to a marginal individual tax rate of 50 percent, stockholder B to a marginal rate of 20 percent. If all earnings available for dividends are distributed, the combined corporate and individual tax on the $1 of profits earned on A's share of stock will be 70¢ (40¢ corporate tax plus 30¢ individual tax). The combined tax on the $1 of profits earned on B's share of stock will be 52¢ (40¢ corporate tax plus 12¢ individual tax). If no corporate tax were imposed on distributed profits and as a result dividends paid by the X corporation were $1 per share instead of 60¢, the total tax on the $1 of profits earned on A's share would be 50¢ and on the $1 earned on B's share, 20¢. Thus, the corporate tax increases total taxes on the $1 earned on A's share by 20¢ (70¢ as compared with 50¢) and on the $1 earned on B's share by 32¢ (52¢ as compared with 20¢).

From still another point of view, the first impression — that the corporate tax is proportional — appears to be justified. The varying amounts by which the corporate tax reduces the possible net yield of a share of stock for stockholders in different income brackets represents the same fraction of the net yield which would be possible if there were no corporate tax. The corporate tax reduces dividend income which could be retained by a stockholder after individual income tax by the same percentage in every income bracket. 1/ Percentagewise, the corporate tax has the same effect on both gross dividend income and disposable dividend income for all stockholders, whatever their individual income tax rate.

The analysis so far concerns the amount of corporate tax on a dollar of profits allocable to stockholders with different total incomes. It takes no account of the varying importance of dividends as a portion of total income in different individual income classes. When account is taken of this last-mentioned factor, it is found that to the extent that the corporate tax reduces dividends it represents, in the aggregate, a larger percentage of income of high-income groups than of low. 2/ On the basis of this fact, it is sometimes said that the corporate tax, instead of being proportional or regressive, is in a sense a broadly progressive tax. This characterization of the tax abstracts from differences among individuals in the same income class. The tax is not progressive in the sense that it falls heavily on <u>all</u> high incomes and lightly on <u>all</u> low incomes. The reference is rather to broad statistical aggregates or averages. 3/

2. <u>Economic arguments against the corporate tax</u>

a. <u>Effects on individual security purchases</u>

The corporate tax, if not shifted, probably results in a general reduction in investment yields. This reduction will be less than proportional to the tax rate, and within a relevant range of rates may be rather small. But, any reduction in investment yields, however small, is likely

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1/ In the example cited in the immediately preceding footnote, the 20-cent increase in total taxes on the $1 of profits earned on A's share of stock is 40 percent of the 50 cents which A could retain if there were no corporate tax. The 32-cent increase in the total tax on the $1 earned on B's share is likewise 40 percent of the 80 cents which B could retain if there were no corporate tax. The reduction in every income bracket would be the same 40 percent of potential disposable dividend income, 40 percent being the corporate tax rate. This abstracts from the fact that many stockholders fall in a lower surtax bracket because dividends are reduced by the corporate tax.

2/ See pp. 15-16 and Appendix B.

3/ For a further consideration of the significance of this point, see p. 16.

to deter some individuals from buying securities. It is not easy to evaluate the quantitative extent of this reaction or its economic importance. One uncertainty relates to the extent of the flexibility of individual investors' standards for an adequate return. Investors will probably revise downward their standards in time, but how fast or how far this revision will go cannot be definitely known. Moreover, the economic significance of decreased willingness of individuals to purchase securities will depend on the extent to which corporations need to raise capital by new security issues. The large part of corporate gross investment which is financed from internal sources will not be directly affected by a decrease in the market for securities. However, the corporate tax, if not shifted, will probably also restrict corporate net saving and reduce funds available from internal sources.

b.ttEffect on business incentives to investtt

Of more direct economic importance is the possible effect of the corporation income tax on investment by corporations in plant and equipment.

(1)ttPremium for risk takingtt

A primary deterrent to investment is risk of loss of principal. If investment is to be attracted, the prospective return must be great enough to overcome fear of loss. While by no means all investment decisions are based on nicely calculated evaluations of risk and return, usually the more hazardous the undertaking, the greater must be prospective gains in order to induce investment. That part of total prospective return required to compensate for possible loss of principal may be termed premium for risk taking.

The corporate tax, by reducing profits which can be retained on successful ventures, may cut into the necessary anticipated premium for risk taking. The exact effect of a reduction of this premium cannot be determined, since investment decisions depend on highly subjective appraisals of opportunities. Clearly, the result will be to restrain investment, to some indeterminate degree.

The tax, however, does not always reduce the reward for risk taking, in relation to the amount which would be lost if the investment were unsuccessful. If losses are fully offset against other taxable income of current, past, or future years, the percentage return on the net amount at risk will not be affected by the tax. Under these conditions, government shares both in gains of success and losses of failure. 1/

1/ See A. P. Lerner, "Functional Finance and the Federal Debt," Social Research, Vol. 10 (1943), pp. 45-46; Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," Quarterly Journal of Economics,tVol. LVIII (1944), pp. 388-422.

A 40-percent corporate tax will reduce a $100 return on an investment of $1,000 to $60 after tax. But if the $1,000 investment were totally lost and could be deducted from other taxable income, the concern's taxes would be reduced $400. Thus, the net amount actually at risk would be $600. Sixty dollars, the return after tax, would be 10 percent of the net amount risked -- the same percentage return as if there were no corporate tax.

Under present law, however, loss offsets are not always possible. Often a firm does not have sufficient income in the current year to cover fully a loss on an unsuccessful venture, and carryforwards and carrybacks of losses are limited. Even an unlimited carryforward or carryback would not assure full loss offsets for firms which never realized income equal to the amount of unsuccessful investments. 1/ Nevertheless, existing possibilities for offsetting losses considerably reduce the burden of the tax on risk taking. Admittedly, loss offsets are more likely for large, established firms with diversified activities than for small, new enterprises with only a few lines of production. In this respect, the corporate tax favors large and well-established businesses.

(2) Minimum return

Regardless of risk, the prospect of some minimum return is necessary to induce investment. Unless investors anticipate some gain 2/ they will not go to the trouble of investing, even though there is little or no danger of losing their principal. Possible loss offsets will not compensate for reduction of the minimum return.

No fixed limits can be set to the minimum anticipated return necessary to call forth investment by corporations. That return is usually assumed to be roughly equal to interest obtainable on high-grade bonds. If a corporation cannot reasonably anticipate at least that rate of return from investment in plant and equipment, such investment is likely to be unattractive. As has already been suggested, however, the corporate tax

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1/ To a limited extent stockholders may be able to offset against other income capital losses resulting from a decline in the value of the unsuccessful corporation's stock. Under present law, however, capital losses can be offset mainly against capital gains and only to a very limited extent against dividends and other kinds of income.

2/ The gain may be a positive profit or a reduction of losses which would be sustained if the investment were not made. For example, a firm may find it necessary to purchase certain urgently needed new equipment, even though no immediate profit is anticipated, in order to stay in business with the hope of later profit or more favorable liquidation.

itself may reduce prevailing rates of return on bonds and other assets and thereby reduce alternative rates of return available to corporations and stockholders. The extent of the resulting reduction in the minimum return necessary to induce corporate investment is the uncertain outcome of many influences. But whatever adjustments take place in the minimum return, it is clear in principle that the corporation tax will always in some cases infringe upon that minimum return. It is not possible to say how important quantitatively this will be, but it seems probable that some new corporate investments, which would have been made if there had been no tax, will not be undertaken, however complete the opportunity for offsetting losses against taxable income.

(3) Reaction of management

The foregoing discussion indicates that the corporation tax must be assumed in some cases to reduce the anticipated net return on investment below the level ordinarily necessary to stimulate investment. Corporation managers may elect to pay all earnings out in dividends or to hold funds idle. Management may even choose gradual disinvestment by failing to replace worn-out equipment or drawing down inventories. However, current production with existing facilities may be expected to continue. In some cases, management may be more interested in the power and prestige that go with large-scale operations than in the exact size of the net return on invested capital and may therefore continue to reinvest funds despite a low net return.

It should be emphasized that these are merely qualitative statements. They indicate the character of the influence of a tax on corporate profits but not the extent of that influence. The extent of the influence of the tax will depend on subjective evaluations of future prospects, alternative opportunities, and many other unpredictable conditions.

(4) Non-corporate investment

If investment by corporations is diminished, unincorporated businesses may take advantage of some opportunities foregone by corporations. Increased investment by partnerships and sole proprietorships may partly offset the decrease in corporate investment, but is unlikely to compensate fully for such a decrease. In the first place, corporate organization is highly advantageous in many fields; in some practically essential; and in such areas non-corporate investment is unlikely to take up the gap left by a decline in investment by corporations. In the second place, a decline in corporate investment will depress general economic conditions and will make investment opportunities less attractive.

(5) Necessity of comparing effects of
corporate tax and other taxes

The effect of the corporate tax is clearly to limit investment to some unknown degree -- when a situation in which there is no corporate tax is compared with a situation in which a corporate tax is imposed. It is more realistic, however, to compare effects on investment of raising a given amount of revenue from a corporation income tax and of raising the same sum from another source. Alternative sources of revenue -- individual income taxes, excise taxes, and other taxes -- also directly or indirectly restrain investment. It would be easy to consider each tax in turn, to find detrimental effects, and to decide to discard it. The difficult problem is to compare various measures and to determine the role of each in the revenue system.

c. Effect on methods of corporate financing -- debt versus equity

Another criticism of the corporation income tax is that it encourages financing by bonds and other borrowing in preference to stock issues. Interest paid is deductible from taxable income, but dividends paid are not. With a 40-percent corporate tax rate, a company must earn approximately $1.67 in order to pay $1 of dividends out of current profits. To pay $1 of interest it need earn only $1.

Thus the corporation tax may be one factor making debt financing attractive. Other reasons of equal or perhaps greater weight are a desire to avoid dilution of control of existing stockholders and an attempt to tap funds at the disposal of insurance companies and similar institutions compelled by law and custom to prefer bonds. Actually, opportunity for floating bonds may not be open to many corporations. Rigidity of debt contracts will deter many even when the opportunity exists.

To the extent that debt financing is stimulated, ability of corporations to withstand economic stress may be impaired. Widespread defaults and bankruptcies, which might be induced by excessive fixed debt, would have unfavorable repercussions on the economy in a period of recession.

Statistical data on debt and equity financing over the past 25 years indicate no marked trend either toward or away from long-term debt financing. 1/ Of course, there is no way of knowing what means of financing would have been used if there had been no corporate income tax.

d. Effects on form of business organization

The corporation income tax is often said to place a special burden on the corporate method of doing business. This is held to discourage formation of new corporations and to lead to disincorporation of existing firms. Thus, social advantages of an efficient form of organization may be lost. Some critics urge that the corporate income tax is inconsistent with a principle which they consider important -- that the tax system should not be a factor in choice of form of business organization.

1/ See Appendix C for data on new domestic corporate security issues by types, 1921-1945.

Undoubtedly, the corporation income tax, together with the individual income tax, influences the form of business organization. The tax system, however, does not always decrease advantages of incorporation. Under some circumstances the tax system favors corporations; under other circumstances it favors unincorporated business. The way the scales tip depends on relative rates of corporate and individual income tax, size of business, income of owners, percent of profits retained by the business and length of retention. For example, in some cases taxation of net business savings at corporate tax rates instead of individual rates is highly advantageous. 1/ In other cases, escape from taxation of distributed income at the business level is a decisive advantage to unincorporated firms. 2/

e. Significance of shifting

The possible unfavorable economic effects previously described are easiest to comprehend on the assumption that the corporate tax is not shifted but rests on stockholders. In fact, these effects seem incompatible with a successful, consciously planned effort by business to compensate for the tax by higher prices or lower wages. However, in another sense, the restrictive effect of the tax on investment might be a cause of "shifting" through automatic operation of market forces. This would not mean that corporations and their stockholders were completely freed of the tax. On the contrary, the fact that the tax rested on them in the first instance would be what set the shifting process in motion.

1/ Take, for example, a business with net profits of $60,000, owned in equal proportions by five individuals, who wish to retain all available profits in the business to finance expansion. If the business were incorporated, the tax on the retained profits would be, say, 38 percent, or $22,800. If the business were organized as a partnership, the tax on retained profits might be higher or lower, depending on how much income the owners had from sources other than the business. If each of the owners were married with two dependent children and had $5,000 of net income from other sources, the total individual income tax (at 1946 rates) on the $60,000 of retained profits would be $19,520. This would be approximately a 32.5-percent effective rate, as compared with a 38-percent corporate rate. In this case, the corporate form would be somewhat disadvantageous so far as taxes for the current year alone are concerned. If, however, each of the owners had $15,000 of income in addition to the profits of the business, the total individual income tax on the retained profits would be $30,025 or more than 50 percent, as compared with the 38-percent corporate rate. In the latter case, more retained profits would be available for financing the business if it were incorporated than if it were a partnership. But an offset against this current advantage would be the probability of a later individual tax on dividends paid from the retained earnings of the corporation or on capital gains attributable to retained earnings.

2/ Under the present system the tax is always higher on distributed corporate profits than on profits from an unincorporated enterprise.

If, however, the corporate tax is shifted to prices or wages, probably its most important economic effect is to reduce consumption. Under conditions of actual or incipient deficiency of total demand, such a reduction of consumption would make maintenance of a high level of national income and employment more difficult. It is also true that a tax which reduces consumption has an indirect, but nonetheless severe, dampening effect on investment. If consumption is held down, market prospects will be worsened and many investment plans will be prevented from ever coming into being.

D. Analysis of arguments in favor of the present corporation income tax

1. Equity arguments in favor of the corporate tax

a. Special privilege as a basis of corporate taxation

The traditional justification for special taxation of corporations is that corporations are given special privileges and economic advantages by government. Corporations are held to be creatures of law which owe all their rights and powers to public grant. A number of economically important characteristics of corporations are often advanced as a basis for taxation. These include limited liability of stockholders, easy transfer of ownership, perpetual life, and consequent access to national capital markets.

Two fundamental objections have been raised against the privilege theory. First, it is argued that powers granted corporations are in the public interest and should not be negated by taxation. Second, it is pointed out that incorporation is now open to all on relatively easy terms and from this it is deduced that an ordinary corporate charter can have little distinct economic value.

b. Progressive character

Defenders of the corporate tax contend that, broadly speaking, it adds to the progressivity of the tax system. In the aggregate, dividends are a much larger fraction of high incomes than of low, and the greater part of dividends is received by people with relatively high incomes. Thus, if the corporate tax reduces dividends, it reduces high incomes, in the aggregate and on the average, by a greater percentage than it reduces low incomes. On the basis of this analysis, it is argued that the corporate income tax is a broadly progressive tax and that its use adds to the progressivity of the whole tax system. The same contention can be made if the ultimate effect of the corporation income tax is to reduce all property incomes and not merely dividends.

It is true that the corporate income tax is broadly progressive, in the sense in which its advocates seem to be using the term. However, even within that frame of reference, neither the degree of progression nor the weight of the tax is so great as might be supposed merely from inspection of the distribution of dividends among individual income classes. The progressive rate structure of the individual income tax, to a considerable extent, offsets the significance of the fact that dividends are a larger fraction of high incomes than of low.

Assuming the 1942 distribution of dividends and other income by individual income classes and a hypothetical individual income tax schedule (rates from 15 to 65 percent), it appears that in the aggregate a 40-percent corporate tax on distributed profits would be equivalent to additional effective rates on taxable individuals ranging from about 0.8 percent on those with net incomes below $4,000 to 7.5 percent on those above $200,000. 1/

The progression implicit in the corporate income tax is different and much less refined than that of the individual income tax. Under a progressive individual income tax, the aim is to tax high incomes more heavily than low, and to tax all persons in the same income bracket and in similar personal circumstances at the same rate. The corporation tax does fall more heavily on the average on high-income groups, but it does not fall with equal weight on all persons in the same income bracket and in similar personal circumstances. This is true because of the great differences in stock holdings among persons in the same income bracket. Some wealthy people own no stock and are not directly affected by the tax. Some people with low incomes depend largely on dividends and hence are directly affected by the corporate tax to a much greater extent than the average figures for their income level indicate. With present rate schedules, the individual income tax is more progressive than the corporate tax, more uniform among individuals in the same income group, and hence by usual standards more equitable.

c.ee<u>Economic distinction between corporationsee and stockholdersee</u>

Some defenders of the present corporation income tax deny significance to the charge of double taxation which is brought by the critics of the existing system. They assert that at present in many large corporations the distinction between the corporation and its stockholders is more than a legal formality. They maintain that to disregard the so-called corporate fiction and to consider a corporation as no more than an aggregation of individual stockholders overlooks an important aspect of the institution. In many instances stockholders have little control over corporate policies and receive a return which may not be responsive to moderate changes in tax rates and annual profits. From these conditions the conclusion is drawn that the corporation is a going concern separate and distinct from its stockholders, with its own rights and duties, and with separateetax-paying ability.

1/ See Appendix B and pp. 8-9.

If there is a basis for drawing a realistic distinction between a corporation and its stockholders, a separate corporate tax is more reasonable than would otherwise be the case. The fact that some realistic distinction can be drawn does not in itself, however, argue for separate taxation of corporations and their stockholders, unless one takes it for granted that all economic entities should be taxed. The argument seems to be more in the nature of a rebuttal of the charge of double taxation than an independent support for the corporate income tax.

d. Significance of shifting

The contention that the corporation income tax is a broadly progressive tax is based on the belief that the tax is not shifted to any important extent. If this is not true, the major contention falls. The privilege theory seems ordinarily to be based on the same assumption as to incidence of the tax.

The fact that the corporate tax was shifted would not necessarily be inconsistent with the philosophy which holds that the corporation is a suitable taxable object, distinct from its stockholders. It might be argued that the tax is a proper cost of doing business -- a payment for the cost of government services to business in general and to corporations in particular. According to this approach, it would be fitting and normal that the tax in common with other costs should enter into determination of prices, wages, and all shares of income.

2. Economic arguments in favor of the corporate tax

a. Impact on consumption and savings

The chief economic argument in favor of the corporation income tax advanced by its supporters is that it reduces consumption less and savings more than would feasible alternative sources of revenue. To the extent that the corporate tax reduces retained profits of corporations it falls entirely on current savings and has no direct effect on current consumption. The part of the tax which falls on individual dividend recipients reduces both potential consumption and potential savings, but the reduction in potential consumption resulting from a given amount of revenue is relatively small and the reduction in potential savings relatively great. This conclusion is based on the broadly progressive character of the tax and the observed fact that families in each successively higher income group save a larger fraction of their incomes than do those with lower incomes. The following discussion relates solely to the net corporate tax on profits distributed to individuals, since there is more difference of opinion about this part of the tax than about the part which falls on undistributed profits. 1/

1/ See Appendix D for estimates of corporate and individual net savings, 1929-1945.

In comparison with the corporate tax, excises and payroll taxes are probably regressive and hence probably fall more heavily on consumption. This is on the assumption that the corporate tax falls mainly on stockholders and that excises and payroll taxes fall mainly on consumers and workers in general. The individual income tax may be more or less progressive than the corporate tax, depending on the rates and exemptions adopted. In any case, the progressivity of the individual tax will be more even and more uniform among individuals in similar circumstances. Whether the individual income tax will fall more or less heavily on consumption than the corporate income tax depends mainly on the relative progressivity of the particular tax structures under consideration.

The fact that a tax falls heavily on savings and lightly on consumption is an economic argument in its favor on the assumption that maintenance of enough total demand to assure high levels of employment and national income will be a matter of public concern in the future. To the extent that a tax reduces potential consumption it cuts down demand for the products of industry and agriculture. To the extent that a tax comes out of potential savings it does not directly reduce demand. It may, however, indirectly reduce the investment component of total demand by impairing the incentive to invest or by reducing funds available for investment. It is now widely, but not universally, agreed that under conditions likely to prevail after the end-of-war transition period it will be economically advantageous to select taxes which result in a minimum of reduction in total demand, whether for consumption goods or for investment goods.

The question as to whether it is feasible to replace the corporate tax without increasing the tax burden on consumption can be resolved to a question as to whether the individual income tax could be increased to replace the corporate tax. 1/

The increase in individual income tax necessary to duplicate the corporate tax would depend on the distribution of dividends by income classes and the individual income tax already in effect. Given these conditions, it is possible to estimate the adjustment in the individual income tax necessary to achieve the same allocation of taxes by income classes as that resulting from the corporate tax on distributed profits. For illustration the following may be assumed: (1) 40-percent corporate tax; (2) the 1942 distribution of dividends by individual income classes; (3) hypothetical individual income taxes at rates of 15 percent to 65 percent already in effect, with present exemptions. Under these conditions, the part of a 40-percent corporate tax on profits distributed to individual income taxpayers would be roughly equivalent to additional individual surtax rates ranging from 2 percentage points on surtax incomes of less than $2,000 to 7 percentage points on all surtax income in excess of $8,000. 2/ An

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1/ In this context "increasing" the individual income tax may mean only that reductions in the tax otherwise feasible would no longer be so.

2/ See Appendix B.

increase of individual income tax rates of this amount would replace the corporate income tax on profits distributed to stockholders subject to individual income tax from approximately the same individual income classes as the corporate tax now comes, if it is not shifted. The individual tax, of course, would not come from the same individuals, but it would come from the same income classes. Presumably it would have much the same effect on consumption as the part of the corporate tax which it would replace. With individual income tax rates at the outset higher than those assumed above, the corporate tax would be equivalent to a smaller additional individual tax. If individual income tax rates were lower at the outset, they would have to be raised more to replace the corporate tax on distributed profits.

These comparisons relate only to the part of the corporate tax imposed on profits distributed to persons already subject to individual income tax. They are based on the assumption that funds freed by remission of the corporate tax on distributed profits would be paid out as additional dividends. To the extent that the remitted tax was retained by corporations and dividends not increased, taxable individual income would not rise, and revenue lost could not be replaced by the personal tax changes indicated. Moreover, the part of the corporate tax on profits distributed to non-taxable individuals and institutions, and foreign stockholders would have to be made up in some other way.

b. ttImpact on investmenttt

As to investment, supporters of the corporate tax raise doubts about the extent of any possible adverse effects of the tax. They believe that within fairly broad limits corporate investment is not highly sensitive to the tax rate. They argue that a large part of profits is not needed to induce a satisfactory level of investment.

It is undoubtedly true that some profits are higher than necessary to induce adequate investment and production. It is equally certain that some expectation of profits is required to stimulate private investment. The corporation income tax strikes both socially necessary and unnecessary profits.

c.tt Significance of shiftingtt

The economic arguments, like most of the equity arguments, in behalf of the corporate income tax rest on the assumption that the tax strikes mainly corporations and investors rather than consumers and wage earners. If this is not true, the economic effects of the tax are quite different from those attributed to it by its supporters. Nevertheless, it is arguable that the corporate tax compares favorably with alternative taxes, even if it is to a considerable extent shifted. The same reasoning which maintains that the corporate tax is shifted could seemingly be extended to an important portion of the individual income tax as well as to most othertt fiscally productive levies. Thus a large part of the apparent advantages of one or the other tax would be cancelled out. If this is the true state of affairs proponents of the corporation tax might well rest their case on the basis that the tax is a relatively convenient way of collecting revenue -- revenue which comes in part from consumers, in part from workers, in part from stockholders, and in part from corporate hoards.

II.tt Problems encountered in adopting a new methodtt of taxing corporate profitstt

If the case against the present corporation income tax is found suf-tt ficiently persuasive to demand some basic change, new problems arise. These relate to possible incidental evils of individual tax avoidance and windfall gains and to timing of changes.

A. Prevention of individual tax avoidance through corporate undistributed profits

Few critics would advocate simple elimination of the corporation income tax without any further changes. If the tax were merely abolished outright, the corporate form would become a tax-free haven for individual savings. By retaining profits the corporation could postpone indefinitely taxation of these earnings. If the retained earnings were realized by stockholders in the form of capital gains, they would be subject under present law to a preferentially low tax rate. If the owner died without realizing the retained earnings as capital gains, under present law his heirs could do so without paying any income tax. Similar, but less extreme, results would ensue if the corporate tax were not abolished but simply reduced to a very low rate.

Considerations of equity and economic policy require that any reform of the corporate tax include some method of preventing individual tax avoidance through use of the corporate entity. One relatively simple but drastic method of preventing use of the corporate machinery for tax avoidance would be to forestall corporate saving by prohibitory taxation. However, this Procrustean treatment might be as bad as, or worse than, the ills it would be designed to cure. Retained profits are a legitimate and important source of funds for contingencies and for expansion.

In any corporate tax reform some way must be found to minimize inequalities of taxation of distributed and undistributed profits and of dividends and other income. There are four basic approaches:

1.tt The corporation tax may be abolished and full taxation of capital gains relied upon to prevent individual tax avoidance with respect to undistributed profits;

2.tt The corporate entity may be ignored in determiningtt tax liabilities and corporate profits may be taxed as if stockholders were partners;

3. The corporation may pay a tax on its profits with a reduction in that tax for distributions of profits, that is, for dividends paid;

4. The corporation may pay a tax on all of its profits, and individuals may be given a tax adjustment in relation to dividends received.

A later section of this memorandum will discuss considerations of equity, economic effects, and administration relating to specific versions of the four basic approaches to coordination of taxation of corporate profits and other kinds of income.

B. <u>Windfall gains to stockholders and effect on stock prices</u>

Decrease of the rate of taxation of corporate profits below the level now anticipated by investors would be likely to bring windfall gains to stockholders at the time of the change. Fundamentally, these windfalls would consist of an unexpected increase in the actual or potential income of stockholders. Another and more spectacular manifestation of the windfalls would be an increase in stock prices. Such a development might be induced either by drastic reduction of the present corporate tax or by adoption of any method of coordination of individual and corporate taxation which lessened taxation of dividend income.

It should be noted that a general adjustment at either the corporate or individual level with the objective of eliminating or reducing "double" taxation would result in a decrease in taxation of distributed profits. If corporations were granted a tax reduction when dividends were paid, they would be able to pay larger dividends out of a given amount of profits before taxes, or they would have larger undistributed profits after paying the same dividends. On the other hand, if individuals were given a tax credit for part or all of the tax paid by corporations on income distributed in dividends, most investors would get a larger net yield. If the same amount of dividends were paid as before, all stockholders (whether or not subject to individual income tax) would gain.

It is impossible to say just what rate of taxation of corporate profits is now anticipated by investors and reflected in present market prices of stocks. It seems reasonable to suppose, however, that market prices are, in general, based implicitly on the expectation that corporate profits, whether distributed or retained, will continue to bear a substantial tax in addition to regular personal income tax.

If, in the postwar period, the additional tax on dividend income no longer exists or if it proves to be smaller than was expected, the current and anticipated yields of stocks at previous prices would rise sharply. Prices of stocks could be expected to be bid up until yields in relation to new prices were adjusted toward their previous levels. These developments would bring windfall gains to individuals owning stock. In some unknown number of cases, these windfalls would only make good losses suffered at an earlier date when the corporate tax was imposed or increased.

Sometimes it is suggested that the problem of windfall gains could be met by an increase in the tax rate on capital gains. This suggestion, however, focuses attention on one manifestation of windfall gains, rather than on the true windfall. Fundamentally, the windfall arising out of unexpected reduction or repeal of the corporate tax would be an increase in the income of stockholders. This in turn would lead to a rise in stock prices. An increase in the capital-gains tax would merely decrease the possible net proceeds of sale of the stock with its anticipated stream of additional income. This would not remove the real windfall gain to stockholders. The capital-gains tax would not apply to the additional income realized by stockholders before they transferred their stock, and the tax rate would doubtless be less than 100 percent. Admittedly, an increase in the capital-gains tax would decrease windfall gains which otherwise would be realized.

The apparent extent of windfall gains and effects on stock prices would be influenced by the economic outlook at the time of reduction of the corporate tax. Tax reduction at a time when corporate profits were falling might merely prevent a decline in dividends and stock prices instead of causing an increase. Tax reduction when corporate profits were rising might appear to result in especially large windfall gains.

The general character, if not the extent, of probable windfalls is easy to discern. More difficult to foresee would be the economic and social consequences of a sharp upturn of the stock market, which might occur if the tax adjustment were made in a time of prosperity. On the one hand, a rising market might generate a state of business optimism which would stimulate real investment and increased production. On the other hand, the upward movement might waste its force in a cumulative speculative boom with undesirable consequences for the economy.

Windfalls to individuals and the likelihood of touching off a cumulative speculative boom might be somewhat reduced by spreading tax reductions or adjustments over several years. Security prices could be expected to adjust fully to a staggered decrease in corporate taxes, but a sudden impact might be avoided and secondary or cumulative effects minimized. 1/ If the price increase were distributed over a period of years, benefits might be divided among more individuals. However, if a plan of gradual reduction were definitely announced, the effect on security prices might be almost as great as if it had been put into operation immediately.

1/ The effects might be similar if corporate taxes were reduced at one stroke, but only after discussion over a period of years during which investors came to anticipate the reduction with a gradually increasing degree of confidence.

C. Timing of tax adjustments in relation to their effects on commodity prices and investment

1. Commodity prices

Timing of corporate tax adjustments would also be important in relation to possible effects on commodity prices. Reduction of taxes would be much less likely to be passed on to consumers in the form of lower prices in a seller's market than in a buyer's market. In a time of high demand, if price reductions were not made, business profits would rise rapidly. If this development stimulated successful general wage demands by organized labor, prices might move still higher. In a potentially inflationary situation a cumulative upward spiral of both prices and wages could ensue. Moreover, corporate tax reductions or adjustments would be likely to invite increased pressure for other tax concessions, which might be inappropriate under potentially inflationary conditions.

Price reductions would be more likely when a buyer's market prevailed. However, in such circumstances the outlook for profits may be so bad that a tax reduction will stimulate less new investment than it would in times of greater consumer demand.

2. Investment

Profitability of investment depends fundamentally on favorable market conditions. If the outlook for demand is already reasonably good, tax reductions may have a considerable stimulating effect. On the other hand, during a period of slack demand or depression, businessmen may see little opportunity for profitable investment, regardless of tax rates. Under these conditions, tax reductions may stimulate relatively little new investment.

Despite the apparent conflict between timing requirements for inducing price decreases and for stimulating investment there is no fundamental dilemma. On balance, tax reductions appear most desirable in times of low economic activity or when a decline threatens. The immediate stimulus to investment may be small, but any response will be of the right kind. Under inflationary conditions caution is indicated in reducing corporate and other taxes. In these circumstances many kinds of investment, as well as increased consumption, may be undesirable. Profit opportunities are likely to appear good with a substantial corporate tax and still better without it.

III. Methods of coordinating individual and corporate tax on corporate profits

A. Elimination of corporate income tax and adoption of full taxation of capital gains

One approach to taxation of corporate profits would be to eliminate the corporate income tax entirely and to rely on taxation of capital gains to prevent tax avoidance with respect to undistributed profits. Those who favor this approach would recommend full taxation of all realized capital gains at the regular individual income tax rates and full deductibility of realized capital losses from any other income. A gain or loss would be realized wherever an asset was transferred by sale, gift, or devolution at death. 1/ Full taxation of capital gains and full deductibility of capital losses are nearly always linked with proposals for averaging of taxable income over a period of years; sometimes, over the whole life of the taxpayer. For the sake of brevity, a system of the type described in this paragraph will be referred to as the capital-gains approach. 2/

1. Rationale

The capital-gains approach is based on the idea that corporations as such should not be taxed. The objective of the approach is to tax individual stockholders in the most satisfactory way. Advocates of the capital-gains approach seem to believe that stockholders have realized income, which can properly be taxed, only when they receive a dividend or transfer title to their shares at a gain. Although the economic power of stockholders may increase when the corporation retains profits, it may be argued that this is merely a case of an increase in property value and that there is no more reason to consider such an "unrealized gain" taxable income in the case of stock than in the case of any other asset.

2. Tax avoidance and postponement

An essential feature of the capital-gains approach is that realized capital gains should be taxed at the same rates as dividends received and other forms of income. This is intended to prevent stockholders from avoiding taxes by realizing their return from their investment in the form of capital gains attributable to retained corporate profits rather than in the form of dividends. The approach would be effective in taxing income actually withdrawn from the corporation, but full taxation of capital gains and dividends received would leave some corporate profits untaxed. Not all profits retained by corporations are reflected in the market value of stock. Changes in stock prices appear to be determined by prospects of future profits and dividends rather than by changes in retained earnings.

1/ Henry C. Simons, Personal Income Taxation (Chicago: University of Chicago Press, 1938), Chapters VII and IX; William Vickrey, "A Reasonable Undistributed Profits Tax," Taxes, The Tax Magazine, Vol. 23 (February, 1945), pp. 123-127. Simons recommends against allowing a loss deduction to donors with respect to estimated losses on property transferred by gift. Op.cit., p. 212.

2/ Proposals for regular taxation of capital gains and full deductibility of capital losses raise issues of broader scope than the problem of preventing tax avoidance on undistributed corporate profits. These broader questions will not be discussed in this memorandum.

If market developments or technological changes destroy a corporation's prospects for future profitable operations, its stock may become worthless, no matter how much profits it has retained in the past. Moreover, the stock of a successful corporation may be transferred at a low price when the stock market in general is temporarily depressed. In the first case, the profits retained in earlier years would never be taxed under the capital-gains approach. In the latter case, the retained profits would not be taxed to the original stockholder, but might be taxed to a subsequent stockholder who acquired the stock when the price was low.

One extensive study of common stock prices indicated that over the period 1871 to 1938, on the average every $2.50 of earnings retained by corporations was associated with an increase of $1.80 in the market value of their stock. 1/ Thus, over that whole period, on the average, more than one-fourth of retained corporate profits did not find expression in the market price of stocks and could not have been reached by full taxation of capital gains. Discrepancies in the case of individual companies and at particular times were doubtless much greater than for the 68-year average. 2/

A stockholder may enjoy important accretions of economic power and social prestige over a long period of time on the basis of ownership of stock in an expanding corporation without receiving any large amount of dividends or "realizing" any capital gain. He may be in complete control of the policies and operations of the corporation. In the end, the value of the stock may disappear, and, under the capital-gains approach, the stockholder would entirely escape taxation on the income which gave rise to his earlier advantages. Whether such a situation may properly be called tax avoidance is largely a matter of terminology.

It may be argued that discrepancies between the market value of stock and the amount invested in corporations are attributable mainly to defects in corporate accounting methods, and that the capital-gains method would correct for these defects and give stockholders the opportunity of averaging profits and losses over a long period of years. Even if this explanation of the discrepancies between market value of stock and investment or book value is accepted, it does not follow that stockholders should be

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1/ Alfred Cowles 3rd and associates, Common-stock Indexes (Bloomington, Indiana: Principia Press, 1939), p. 42.

2/ In 7 years during the 18-year period 1921-1938 inclusive, the aggregate market value of the large groups of common stocks studied by the Cowles Commission moved in the opposite direction from retained net earnings of the corporations which had issued the stocks. In 4 years when retained net earnings were positive, the market value of the stocks decreased; in 3 years when retained net earnings were negative, the market value of the stocks increased. In 8 of the remaining 11 years, retained earnings were positive and stock prices rose; in 3 years retained earnings were negative and stock prices fell. Derived from ibid.

given the benefits of an extended period of averaging, which are not available to other classes of income recipients. 1/

Even if all retained corporate profits were ultimately subject to tax as delayed dividends or capital gains, stockholders would have a significant advantage by reason of postponement of the tax. In the interval between earning of profits by the corporation and technical realization by stockholders, the corporation would be able to use the retained profits in the interest of stockholders. It has been argued that the advantages of such tax postponement could be neutralized by a repetitive annual tax on the accumulated retained earnings of corporations at a rate equal to a proper interest charge on the postponed tax. 2/ But no one rate of taxation could actually neutralize the advantages of postponement for all taxpayers. 3/ Moreover, changes in tax rates over time would destroy any putative equalization achieved by such a measure. If, however, no averaging or incomplete averaging of income for tax purposes were allowed, the prospect of raising one's self into a high surtax bracket at the time of realization of a capital gain attributable to retained corporate profits might deter stockholders in closely held corporations from retaining profits in the corporation in order to postpone taxes.

3. Discrimination among taxpayers

The capital-gains approach to taxation of undistributed corporate profits would offer an important advantage to stockholders as compared with other taxpayers. Owners of unincorporated businesses must pay taxes on their annual profits, regardless of whether the profits are withdrawn or retained in the business. Owners of incorporated businesses would be taxed only when they withdrew their profits or disposed of their shares. An attempt to correct this discrimination by offering unincorporated business the option of being treated like corporations -- that is, the option of not being taxed on retained profits -- would open up avenues for tax avoidance and present difficult administrative problems. Moreover, the equity objection would not be met unless all taxpayers were allowed an exemption for their savings. 4/ If this were done, the income tax would be transformed

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1/ A number of unresolved problems connected with the possibility of extending averaging for tax purposes to all income recipients and all types of income are now under study.

2/ Vickrey, op.cit.

3/ Because of imperfections in the capital market and differences in the discount rate among individuals and firms.

4/ If all persons in business, in either the corporate or non-corporate form, were allowed the option of paying no tax on their savings (retained profits), a grave discrimination would result against persons not in business but wishing to save in order to go into business. There would be a further discrimination against persons choosing to provide for their future by such techniques as annuities as compared with those choosing to invest their savings directly in business enterprises.

into a spendings tax. A discussion of the merits of the spendings tax is outside the scope of this memorandum, but it is safe to say that substitution of a spendings tax for the income tax would be a drastic solution to the problem of double taxation of corporate profits.

4.t General economic effectstt

Failure to collect a current tax on corporate retained profits would free an important part of savings from taxation. 1/ This would mean that the tax system would have to fall more heavily on consumption and investment not financed out of retained corporate profits than would otherwise be the case. It is likely that this would make maintenance of a high level of national income and employment more difficult.

5.ttEvaluationtt

The capital-gains approach would, of course, entirely eliminate double taxation of distributed profits. It would, however, result in a seriously defective method of taxing undistributed corporate profits. The system would open the way for a great deal of individual tax postponement. It would result in inequitable discrimination among taxpayers. One kind of saving would be free from current taxation, while other kinds of saving would continue to be currently taxed. By stimulating corporate savings and shifting the tax load to consumption and investment not financed out of corporate savings, the plan would be likely to accentuate the problem of achieving aggregate demand adequate to maintain a satisfactory level of national income and employment.

B. Current taxation of all corporate profits at rates applicable to individual shareholders

The most direct and thorough-going solution to the problem of coordination of individual and corporate taxes would be to tax currently all corporate income, whether distributed or not, at rates applicable to individual shareholders in the corporation. Dividends paid out of corporate profits previously taxed at the individual rates and capital gains traceable to such profits would not be subject to individual income tax in the hands of the stockholder. Under such a system distributed and undistributed profits and dividends and other income would always bear the same rate of tax. The tax might be formally imposed upon either stockholders or corporations.

1.ttPartnership methodtt

One plan using this approach is the partnership method. No tax would be levied on the corporation as such, but for tax purposes stockholders

1/ Appendix D gives figures on net savings of corporations, 1929-1945. Adoption of a tax plan such as that now under discussion might well stimulate large increases in corporate savings.

would be treated as if they were partners. Each stockholder would be required to include in his taxable income his pro rata share of corporate profits, both distributed and undistributed. Stockholders, having been taxed currently on their share of undistributed corporate profits, would not be taxed again if they later received dividends paid from profits accumulated while the partnership method was in use. If the system were followed to its logical conclusion, the individual would also be allowed to take account of his share of corporate losses. Although the tax liability would rest on stockholders, corporations might be required in some circumstances to make an advance payment on stockholders' liabilities.

The partnership method has been given a limited applicability by recent Federal tax law, 1/ and it has been somewhat more widely applied in the past. 2/ A special committee of the National Tax Association

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1/ Optional for personal service corporations for excess-profits tax, but not income tax, Internal Revenue Code, secs. 725, 391-396. The true partnership method may be distinguished from the "consent-dividends" provision of the Code (sec. 28), which allows corporations a credit for dividends paid, including in dividends that part of retained income upon which stockholders consent to be taxed as if actually received in the form of dividends. This latter treatment is applicable for purposes of surtax on improper accumulation of surplus (sec. 102 (d)(2)); surtax on personal holding companies (sec. 504 (a)); normal tax and surtax on regulated investment companies (sec. 362 (b)). Under the consent-dividends provision, stockholders may elect to be taxed on any portion of undistributed profits which they choose and need not be taxed on their full share. Different stockholders may consent to be taxed on different fractions of their share of profits. No provision is made for allocation of corporate losses. Still another variation of the approach which overlooks the formalities of separate legal existence of corporation and stockholders is the requirement that U. S. stockholders include in their gross income their pro rata share of undistributed Supplement P net income of foreign personal holding companies (Supplement P, especially sec. 337). In the last-mentioned case this requirement has no effect on tax liability, if any, of the foreign personal holding company itself.

2/ The Civil War income tax levied no tax on ordinary industrial and mercantile corporations, and individual stockholders were subject to tax on their share of profits in such corporations, whether distributed or not. In the 1864 Act, however, banks, trust companies, savings institutions, insurance companies, railroads, canals, turnpikes, etc., and their stockholders were not taxed in this way. In the case of these corporations, which probably were then more important than industrial and mercantile corporations, the corporation was required to pay a tax on its profits (before deduction of interest in the case of the transportation companies, but apparently not before interest in the case of the financial companies). Investors were not required to include in their taxable income undistributed profits, dividends, or interest from

/Footnote continued on page 29/

2/ such corporations, provided the income had been assessed for tax in the hands of the corporation. The tax paid by these quasi-public corporations was 5 percent, while the tax imposed on individuals was graduated from 5 percent up to 10 percent. (Sections 116-122, Act of June 30, 1864, Public No. 148, 38th Cong., 1st sess., chap. 173, 13 Stat. 223.)o In 1865 the law was amended to require stockholders in all kinds of corporations to include in their taxable income their share of profits, whether distributed or not. Stockholders in the quasi-public corporations mentioned in connection with the Act of 1864 were specifically required to include dividends received from such corporations in their taxable income, but were given a tax credit for the tax paid by the corporation. (Act of March 3, 1865, 38th Cong., 2nd sess., chap. 78, 13 Stat. 469.) In the 1913 Act, stockholders were made liable for "additional tax" (later called surtax) on their share of undistributed profits of corporations "formed or fraudulently availed of" for the purpose of accumulating profits to avoid surtax on stockholders. The fact that the corporation was a "mere holding company" or that profits were accumulated beyond the reasonable needs of the business were to be taken as <u>prima facie</u> evidence of fraudulent purpose to escape tax. (Section II, A, Subdivision 2, Act of October 3, 1913, Public No. 16, 63rd Cong., 1st sess., chap. 16, 38 Stat. 114.) The 1918 Act eliminated the term "fraud" from the provision relating to corporations used to avoid surtax but continued mandatory partnership treatment for them, with the same standards for <u>prima facie</u>oevidence of use to avoid surtax as were provided by the 1913 Act. (Section 220, Revenue Act of 1918,oo Public No. 254, 65th Cong., 3rd sess., chap. 18, 40 Stat. 1057.) Inoo 1921, the House Ways and Means Committee felt that the decision of theoo Supreme Court in the stock-dividend case, <u>Eisner</u> v. <u>Macomber</u> (252 U.S.oo 189), cast considerable doubt on the constitutionality of the mandatoryoo partnership method. (Report of House Ways and Means Committee, Houseoo Report No. 350, 67th Cong., 1st sess., pp. 12-13.) The Act of 1921oo substituted a special surtax on corporations used for the purpose ofoo avoiding surtax for the previous mandatory partnership method, but itoo also provided that if all stockholders agreed the Commissioner mightoo apply the partnership method, in lieu of <u>all</u> taxes on such a corporation. (Section 220, Revenue Act of 1921, Public No. 98, 67th Cong.,oo 1st sess., chap. 136, 42 Stat. 227.) It should be noted that the partnership option was open only to corporations formed or used for theoo purpose of avoiding surtax. This anomaly was noticed and commentedoo upon in the Senate debate on the 1921 Act, but the Senate rejected anoo amendment to make the partnership option generally available.oo (<u>Congressional Record</u>, Vol. 61, Part 7. p. 7483.) The optional partnership treatment for the one type of corporation was dropped in theoo Revenue Act of 1924, in connection with a general tightening of theoo provisions with respect to use of corporations to avoid individual surtax. (Report of Senate Finance Committee, Senate Report No. 398, 68thoo Cong., 1st sess; Section 220, Revenue Act of 1924, Public No. 176, 68th Cong., 1st sess.) The Secretary of the Treasury testified that only aoo "very few" cases had been found in which corporations were formed oroo used to avoid surtax, within the meaning of the Revenue Act of 1921.oo (Senate Finance Committee <u>Hearings</u> on Revenue Act of 1924, p. 291.)

recommended in 1939 that the partnership method be "extended to the limits of its legal and administrative possibilities." 1/

a.oo Rationaleoo

The partnership method is based on the idea that the corporation and its stockholders are substantially an economic identity. It overlooks formalities of separate legal existence and regards income of a corporation as income of its stockholders, whether paid out in dividends or retained. By implication, the partnership approach assumes that each individual stockholder has a large degree of effective control over dividend policies of the corporation, or at least that the stockholder's economic power increases in close relation to retained corporate earnings.

b.oo Technical and administrative featuresoo

(1)oo Allocation of income among stockholdersoo

Administrative problems in allocating profits among stockholders would be serious, even for corporations with simple capital structures. 2/ Strict application of the partnership principle would require that a share of earnings or losses be allocated to every person who was a stockholder at any time during the corporation's taxable year. However, it might beoo more expedient to limit allocation of undistributed profits to stockholders as of some fixed date, say the end of the corporation's accountingoo period. At best, there would be millions of shareholdings to deal with,oo if the partnershipomethod were extended to all corporations. 3/ For someoo

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1/ "Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations," Proceedings of the National Tax Association, 1939, p. 555. Although the Committee was not certain that a constitutional amendment would be required to permit adoption of the partnership method, it believed that an amendment should be sought without delay if deemed necessary. The Committee believed that application of the partnership method would be administratively feasible for a large number of corporations, perhaps for all but a few thousand.

2/ The "partnership approach" presents almost insuperable administrative problems if applied to other than closely-held corporations. If confined to corporations with few shareholders it might be feasible. A compulsory partnership approach would, however, eliminate to a large degree certain existing problems such as: (1) unreasonable compensation to shareholder officers; (2) improper accumulation of surplus (Section 102); (3) interest paid vs. dividends; (4) personal holding companies; (5) personal service corporations.oo

3/ The number of record shareholdings in American corporations as ofoo December 31, 1937, has been estimated at 22 to 25 million. Temporaryoo National Economic Committee Monograph No. 29, The Distribution ofoo Ownership in the 200 Largest Nonfinancial Corporations (76th Cong.,oo 3rd sess., Senate Committee Print, 1940), p. 170.oo giant corporations the list of stockholdings runs to hundreds of thousands. 1/ Moreover, many holdings of record are nominee holdings by brokers and others for a number of individual beneficial owners.

In the case of corporations with more complicated capital structures, difficulties would be encountered in allocating retained earnings among classes of stockholders. For example, profits retained in one year in excess of accumulated claims of preferred stockholders would presumably be allocated to holders of common stock. Yet in a later year these funds might be used to pay dividends on preferred stock. Correction of this situation would require reopening returns or adjusting current year's income for all stockholders of the earlier year. Complications would also arise in the case of intercorporate affiliations. 2/

(2) Special types of income, deductions, and credits

Partially tax-exempt income, capital gains, charitable contributions, income and profits taxes paid to foreign governments, and other items accorded special tax treatment would present difficulties. The partnership method in its purest form would require that these items be reported separately to stockholders and treated as if they had accrued directly to them. However, a plan which failed to trace these items through to stockholders would be simpler, and might be acceptable. Even though the partnership approach intends to treat stockholders and the corporation as one for tax purposes, it does not seem feasible or necessary to trace all items of receipts and outlays through the corporate organization.

(3) Adjustments of corporate income of prior years

Strict adherence to the partnership principle would compel reopening individual returns of all stockholders whenever profits reported for an

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1/ The following are a few conspicuous examples of corporations with a large number of shareholders of record (at various recent dates):

American Telephone and Telegraph Company	651,711
Cities Service Company	430,128
General Motors Corporation	423,705
United States Steel Corporation	240,641
General Electric Company	235,742

Moody's Investors Service, Moody's Manuals of Investments, American and Foreign, Industrial Securities, 1945, and Public Utility Securities, 1944.

2/ For example, Corporation X may hold shares in Corporation Y, Corporation Y may hold shares in Corporation Z, and Corporation Z may hold shares in Corporation X. In such a case, simultaneous equations would be required to determine the equity of individual shareholders in the income of the various corporations.

earlier year were altered by audit, court decision, or carrybacks. Nevertheless, in order to minimize administrative problems, relatively small excesses or deficiencies of prior year income might be treated as adjustments of corporate income in the year in which discovered. Individual returns would be reopened only in the event of major revisions of income of an earlier year.

(4) Adjustment of basis of stocktt

The philosophy of the partnership method would regard retained corporate profits as equivalent to additional investment by stockholders and would regard dividends in excess of current earnings as disinvestment. Accordingly, it would be appropriate to adjust, for purposes of capital-gains taxation, the basis of stock in corporations taxed as partnerships to reflect the amount of undistributed income which had been taxed to the stockholders. The basis of stock would have to be increased by the amount of profits retained by the corporation in any year when it was subject to partnership treatment. The basis of stock would be decreased by the amount of any dividends paid in excess of current income, provided the excess was paid from taxable income accumulated while the corporation was subject to partnership treatment. 1/

c. Area of applicability

Both conceptual and practical considerations suggest the advisability of limiting the area of applicability of the partnership method.

The partnership approach would be appropriate and practicable for thousands of small corporations, probably the great majority of all corporations. 2/ Such concerns are little more than chartered partnerships or

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1/ Some more or less arbitrary rule would be required to determine whether "excess" dividends were paid from taxable income accumulated while the corporation was subject to partnership treatment. Dividends in excess of current income might be considered to be paid from: (a) any available taxable income accumulated during use of the partnership method, to the full extent of that income; (b) from the most recently accumulated income; (c) from the earliest accumulated income.

2/ On the basis of a small sample of corporate tax returns, it has been estimated that 70 percent of the non-financial corporations with assets under $50,000 and 50 percent of those with assets between $50,000 and $250,000 are wholly owned by three or fewer corporate officers who are also full-time workers in the corporation. Joseph L.tt McConnell, "Corporate Earnings by Size of Firm," Survey of Currenttt Business, May, 1945, p. 7. Corporations in these size classes estimated by McConnell to be wholly owned by three or fewer officers constituted 55 percent of the total number of all non-financial corporations submitting balance sheets in 1941. Statistics of Income fortt 1941, Part 2, Table 6.

proprietorships with limited liability. Typically, they are closely held and have no access to national capital markets. However, for the relatively small number of large corporations with many stockholders, which do a large part of corporate business and realize a large portion of corporate profits, the partnership concept would be artificial. Individual stockholders in most such cases have little actual control over major policies or day-to-day operations of the corporation. Stockholders usually have no legal claim to earnings of a corporation until dividends are declared. Most individual stockholders in the giant public corporations have no effective control over dividend policy. In such cases, the legal distinction between income of stockholders and income of the corporation has a large degree of economic reality. Even though the individual stockholder has no control over dividend policy, it may be argued that retention of corporate profits increases the stockholder's economic power. In many cases, however, stock prices do not increase in close correspondence with growth of the corporation's assets. 1/ Even if stock prices did reflect undistributed profits, it would be a departure from usual practice to treat such unrealized gains as taxable income.

Moreover, in the interest of administrative feasibility at least the largest corporations with the longest lists of stockholders and the most complicated capital structures would probably have to be excluded from partnership treatment. One reasonable standard would be to apply the partnership method only to corporations with not more than some stated, fairly small number of individual stockholders (and no corporate stockholders), and with no more than one class of stock. A supplementary or alternative standard might be size of the corporation (probably measured in terms of assets).

d. Compulsory or optional partnership treatment

The partnership method might be made either compulsory or optional for corporations meeting requirements for its application. It should be recognized that the purposes which could be served by the partnership technique would differ, depending on whether it were mandatory or optional. Compulsory use of the method might have as one of its objectives prevention of use of the corporation as a means of postponing or avoiding individual income tax on investment income. An option to use the partnership method could not serve this purpose, but it could be regarded as a means of relieving double taxation and of reducing inequalities in access to capital resources.

e. Partnership method with final accounting at time of transfer of shares

It would be possible to adopt in conjunction withthe partnership method the principle of final accounting and adjustment of tax liabilities

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1/ See p. 25.

with respect to undistributed profits at the time of transfer of stock. This approach would be a compromise between the pure partnership method and the capital-gains approach which was discussed above. Stockholders would be taxed each year on their share of undistributed profits, and the basis of stock would be written up by the amount of the undistributed profits. At the time of transfer of stock by sale, gift, or bequest, a capital gain or loss would be realized. Any capital gain would be subject to regular income tax rates, and any capital loss would be fully deductible from taxable income. Apparently, some rather liberal method of averaging income would be needed.

The objective of this approach would be to gain the advantages of substantially current taxation of stockholders on their share of undistributed profits without extreme pressure for exactness in current allocations. If it were certain that the tax effects of under- or overstatements of current income of stockholders would be largely corrected at the time of transfer of the stock, minor and unsystematic inaccuracies of current reporting would give less cause for concern. If the income of stockholders were currently understated, it would be expected that this would be corrected by later taxation of a capital gain. If income were overstated, a later capital loss would be relied upon to correct this. Under these conditions the margin of tolerance for reopening returns of stockholders might justifiably be rather wide.

One objection raised against the capital-gains approach may also be brought against this variation of the partnership method. If changes in conditions caused a previously profitable corporation to lose a large part of its earning prospects, a capital loss would occur when stock was transferred, which might, if fully deductible, result in a refund of a large portion of the tax already paid on retained profits. The same thing might take place if the stock were transferred at a time when the stock market was temporarily depressed. As in the case of the capital-gains approach, the result would be equivalent to granting the stockholder a very long period of averaging of income from his stockholdings. This would seem to be appropriate only if other income recipients were given equal opportunities for averaging taxable income.

f. Evaluation

(1) Equity considerations

The partnership method would eliminate any element of double taxation of dividend income in the area to which it was applicable. Stockholders would be taxed according to their personal circumstances at usual individual rates.

However, in some instances stockholders might be embarrassed by taxation of income over which they did not have full control. The fact that the corporation had accumulated undistributed profits would not always give stockholders an immediate increase in resources with which to pay taxes. Even if the value of the individualès shareholdings increased promptly to reflect corporate accumulations, which would not always be the case, he could realize this increment only by disposing of some of his securities and decreasing his proportionate interest in the company. Furthermore, such opportunity at best would be available only in the case of readily marketable stock.

(2)ee Economic considerationsee

The partnership approach would free management of the necessity of taking the corporation tax into account in its decisions. But the individual income tax would have to be taken into account more explicitly than at present, and it might in many cases prove more restrictive than the corporate tax. Since all income flowing from the corporation would be subject only to individual income tax imposed on its recipient, the tax premium on debt financing would be entirely eliminated. Moreover, the likelihood of a direct effort by management to shift the tax on corporate profits to prices or wages would be diminished.

By freeing dividends from taxation at the corporate level, the partnership method might stimulate purchase of stocks by individuals and thus make outside financing of corporate expansion easier. On the other hand, individuals might hesitate to acquire shares in growing corporations likely to wish to retain a considerable part of their profits.

eUnder the partnership method corporations lacking access to nationalee capital markets could retain larger net amounts of profits than under the present tax system. If, however, application of the partnership method increased stockholder pressure for dividend distributions, retention of earnings might become more difficult.

(3) Administrative considerationsee

Administrative difficulties of application of the partnership method to large, publicly held corporations appear virtually insuperable. However, a simplified version of the method seems feasible if restricted to more closely held corporations with relatively simple capital structures.ee

e2. Collection of tax from corporation exactly equivalentee to individual tax if profits distributed

An alternative version of the general approach which determines tax liability on undistributed profits on an individual basis would impose the tax upon the corporation rather than upon individual stockholders. Undistributed profits of each corporation would be allocated among shareholders and individual income tax on the additional imputed income calculated separately for each individual stockholder. The sum of these additional imputed liabilities, which would be exactly equivalent to individual income tax which would have been due had all the corporation's profits been distributed, would then be collected from the corporation. If dividends were later declared from income which had been so taxed, they would not be subject to individual income tax.

a. ttUse in United Kingdom and Australiatt

The United Kingdom and Australia apply this method to "private" corporations which fail to distribute a reasonable portion of their profits. 1/ The procedure is applicable in the United Kingdom to a company under control of not more than five persons and in Australia to atcompany under control of not more than seven persons. In both jurisdictions, a company is deemed to be a "private" company if it is not a subsidiary of a public company or a company in which "the public are substantially interested" -- that is, a company in which common shares carrying 25 percent or more of the voting power are unconditionally held by the public and listed on a stock exchange. The test of reasonable distribution is left in the United Kingdom to be determined by the special commissioners for the Income Tax Acts, within broad statutory limits. In Australia the statute requires distribution of the whole of distributable income of an investment company and for other companies the whole of dividends received from private companies plus two-thirds of other distributable income.

Australia formerly applied this method to all corporations, whether public or private, which failed to make a reasonable distribution of profits. However, a Royal Commission on Taxation which sat in 1933 and 1934, recommended that consideration be given to restricting it to private companies, 2/ and this was later done. 3/

b. ttEvaluationtt

This method would be essentially similar, in conception and operation, to the partnership treatment. It would place the cash drain of meeting tax liabilities attaching to undistributed profits on the corporation rather

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1/ In the United Kingdom the super-tax [surtax] under this provision is "assessed upon . . . [the] member [stockholder] in the name of the company" and, if the stockholder does not elect to pay the tax, it is payable by the company. In Australia it appears that the tax is assessed directly against the company. United Kingdom, Finance Act, 1922, sec. 21; see The Income Tax Act, 1918, and Finance Acts, Years 1919 to 1941 Inclusive, with supplements (London: H. M. Stationery Office, 1941), paragraph 547, pp. 255-259. Commonwealth of Australia, Income Tax Assessment Act of 1936, sec. 103-104; see Income Tax, Explanatory Handbook Showing the Difference Between the Income Tax Assessment Act 1936 and the Income Tax Assessment Act 1922-1934 (Canberra, Commonwealth Govt. Printer, 1936), p. 128 et passim.

2/ Commonwealth of Australia, Royal Commission on Taxation, First Report, 1933 (Canberra: Commonwealth Govt. Printer, 1933), p. 30.

3/ Income Tax Assessment Act of 1936, sec. 103-104, loc. cit.

than on stockholders. From the administrative viewpoint, it might be easier to collect the imputed tax from corporations than from individuals, but the chief administrative burden -- allocating profits and computing individual liabilities -- would be the same as under the partnership method. Moreover, the plan would impose great compliance burdens on corporations, and would make advance planning by corporations extremely difficult.

Economic implications of collecting a given tax from a corporation would differ somewhat from effects of collecting the same tax from stockholders. Investment decisions and price and wage policy of management would be more likely to be affected by collection at the corporate level. Payment of the tax by corporations might restrict investment funds of corporations more than payment by individuals under the partnership method, but this is not certain.

C.oo<u>Adjustment for distributed profits at theoo corporate level -- credit for dividends paidoo</u>

Adjustment for distributed profits at the corporate level would involve reduction of the corporate tax on account of dividend distributions. A tax would be imposed on corporate net income but a deduction from taxable income or a tax credit would be granted the corporation for dividends paid.

The principle of an adjustment in the corporate tax on account of dividend distributions is given a limited recognition by present Federal tax law. Dividends paid by public utility corporations on preferred stock issued prior to October 1, 1942, are credited against surtax net income, and are thus freed of the corporate surtax. 1/

The tax credit or deduction for dividends paid might be such that the corporate tax would apply only to undistributed profits, and distributed profits would be subject only to the individual income tax. Alternatively, some corporate tax on distributed profits could be continued by allowing only a partial deduction or tax credit for dividends paid. Whichever were done, it would probably be advisable to allow a considerable period for carrying forward and/or backward losses and dividends paid in excess of current income. It might be desirable to allow a tax credit for dividends paid in the corporation's own stock or other certificates as well as for

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1/ <u>Internal Revenue Code</u>, sec. 15(a), sec. 26(h); provided by the Revenue Act of 1942, as amended.

dividends paid in cash, provided the non-cash dividends were taxable to the recipient. 1/

The following is an example of a specific version of the dividends-paid-credit approach which would reduce, but not eliminate, the corporate tax on distributed profits. A 40-percent tax might be levied on corporate net income and a tax credit allowed equal to, say, one-fourth of dividends paid from current income. 2/ This particular plan would reduce the corporate tax on distributed profits to 20 percent. The tax on corporate income as a whole would range from 20 percent, if all distributed, to 40 percent, if nothing were distributed. 3/ Any number of variations of this basic approach would be possible with different maximum rates, and tax credits or deductions.

1/ Under the undistributed profits tax of 1936, which was in some respects similar to the dividends-paid-credit plan, a two-year carryforward of dividends paid in excess of available income was allowed, and dividends paid in stock and other property were considered distributions of corporate income so long as the dividends were taxable to recipients. (Sec. 27, Revenue Act of 1936, Public No. 740, 74th Cong., 2nd sess., chap. 690, 49 Stat. 1648.) No carryforward or carryback of operating loss was allowed in the original 1936 act, but a one-year carryforward of net operating loss was added in 1938 for purposes of the remnant of the undistributed profits tax only. (Sec. 26(c), Revenue Act of 1938, Public No. 554, 75th Cong., 3rd sess., chap. 289, 52 Stat. 447.)

2/ The illustrative rates used in the text for this and other plans were developed when the combined corporate normal tax and surtax was 40 percent. The illustrations have not been revised with the reduction of the corporate tax rate to 38 percent in the Revenue Act of 1945, partly because of the convenience of dealing with the even numbers appropriate for a 40 percent over-all corporate rate. The particular rates mentioned at various points in the text are intended solely to illustrate the operations of the plans; they imply no recommendation as to the proper rate structure.

3/ To illustrate, suppose a corporation has profits of $100. The tentative maximum tax of 40 percent would be $40. If no dividends were paid, no tax credit would be allowed, and $40 would be the final corporate tax liability. If, however, the corporation paid $24 of dividends, it would get a tax credit of one-fourth of this amount, or $6. The final corporate tax would be $34 ($40 less $6 tax credit for dividends paid). If the corporation paid $80 of dividends, it would get a tax credit of one-fourth of this amount or $20, which would reduce its final tax to the minimum of $20. The maximum amount of dividends which could be paid from current income and still leave enough to meet the corporation's final tax liability would be $80. Hence the greatest possible tax credit for dividends paid from current income would be $20, and the minimum tax $20, or 20 percent of income.

The operation of a dividends-paid-credit plan and the tax load on corporate profits under such a plan are illustrated in Chart 2. This chart, which is drawn in the same general way as Chart 1, shows the total tax on corporate profits under the particular rate schedule mentioned in the preceding paragraph. The chart shows how the total tax would be made up of: (1)tthe corporate tax, which would vary with the portion of profits paidtt out in dividends by the corporation; and (2) the individual income tax ontt distributed profits, which would depend on the amount of dividends paidtt out to taxable stockholders and the rate of tax to which these dividendstt would be subject in the hands of individual stockholders. The chart shows all possible combinations of these factors and hence the entire range oftt possible total tax load on corporate profits under the illustrative dividends-paid-credit plan.tt

The first (upper left) panel of Chart 2 shows the total tax on the assumption that the corporation retains none of its profits but pays out all its current income in dividends and taxes. The total tax is determined by adding the corporate tax (20 percent in this case) and the individual tax. The chart is so constructed that the total tax corresponding with any given individual tax rate appears on the right-hand scale directly opposite that individual rate in the middle scale.

The second (upper right) panel of the chart is the same as the first except that the corporation is assumed to retain 30 percent of its profits. These retained profits do not currently come within the field of the individual income tax, as is indicated by the shrinkage of the individual rate scale. At the same time, the corporate tax is reduced to 30 percent rather than to 20 percent, which partly compensates for the restriction of the individual tax base.

The third (lower left) panel of the chart generalizes the analysis illustrated in the first two panels. It shows the locus of all possible verticle lines of the type appearing in the first two panels. It is possible to read the total tax on corporate profits for any assumed combination of retained profits and individual tax rates.

tChart 2 brings out the fact that the particular rate schedules usedtt for illustration of this approach would not completely eliminate double or additional taxation of distributed corporate profits. But it would be possible to select rates which would do so.

1.tt <u>Rationale</u>tt

The purpose of granting a tax credit to corporations for dividends paid would be to reduce or eliminate double taxation of distributed profits. Distributed profits would be wholly or partially relieved of the corporate tax, in recognition of the fact that such profits are taxable income in the hands of stockholders. Undistributed profits, which would not be currently subject to tax in the hands of stockholders, would remain subject to the full corporate income tax, in order to reduce possibilities for tax avoidance and postponement and to prevent revenue loss. The credit-for-dividends-paid approach would be less of a departure from the present system than either the partnership or capital-gains approach, which have already been discussed.

2.tt<u>Relief for small corporations</u>tt

Although the credit-for-dividends-paid approach would not be intended as a penalty tax on undistributed profits, it would offer an inducement to distribute corporate earnings. 1/ The current tax load would be lighter on corporations that could conveniently pay out a large portion of their income than on those that needed to retain a considerable part of their profits. 2/ Since many small and medium-sized corporations must rely on retained earnings as their primary source of additional capital, it might be considered desirable to lessen the impact of the tax on such corporations. This could be accomplished by treating some stated amount of retained income as if distributed. A "presumptive" dividends-paid allowance would be granted for tax purposes, and a limited amount of retained profits would be subject to no more tax than distributed profits.

Such a presumptive dividends-paid allowance would result in some inequality of taxation of different parts of retained profits and would permit some postponement of individual taxation. The tax stimulus to distribute dividends would be lessened. The presumptive allowance, however, would be a valuable concession to small, growing companies and would probably somewhat simplify compliance with the plan.

a.tt<u>Added versus vanishing presumptive</u>tt
<u>dividends-paid allowance</u>tt

The presumptive dividends-paid allowance could be an addition to actual dividends paid -- that is, the first $X of retained income could be treated as if distributed, regardless of the amount of income or dividends paid. Alternatively, the presumptive dividends-paid allowance could be restricted to the first $X of income available for dividends, with the

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1/ A penalty tax on undistributed corporate profits has been supported on the basis of a number of considerations. Arguments which have been advanced in favor of such a tax include the following: (1) It would compel corporation managers to submit projected new investments and expansions to the test of the capital market; (2) it would give stockholders an opportunity to dispose of their share of corporate profits as they please, rather than being forced to leave it in the corporation; (3) it would curb excessive saving; (4) it would put a brake on arbitrary power of corporate management; (5) it would check the growth of giant corporations.

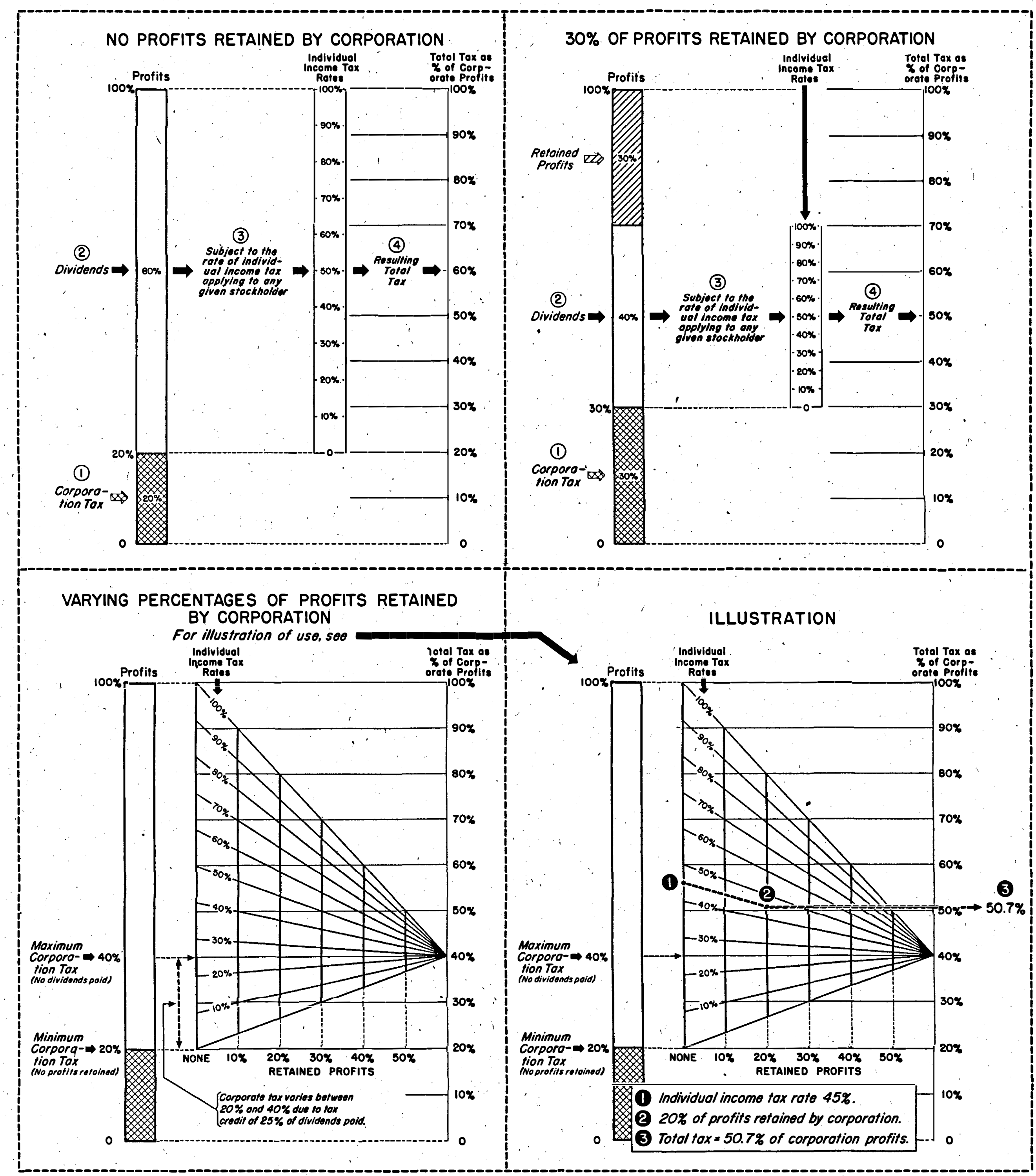
2/ Given complete averaging of corporate income and dividends and stable tax rates, the ultimate tax would be the same on all profits if they were finally distributed as dividends.

Chart 2

TOTAL TAX ON CORPORATE PROFITS UNDER DIVIDENDS-PAID CREDIT PLAN

40% MAXIMUM CORPORATE TAX, WITH 25% TAX CREDIT FOR DIVIDENDS PAID, RESULTING IN 20% MINIMUM CORPORATE TAX.

Aggregate of corporation and individual income tax based on:
A. Varying percentages of profits retained by corporation.
B. Rate of individual income tax applying to any given stockholder.



proviso that the allowance should not exceed $X minus dividends actually paid. The former practice may be termed an added presumption, the latter a vanishing presumption. An added presumption could be supported on the grounds that all firms should be allowed to retain a limited amount of profits on equally favorable terms and that a cushion should be provided for cases in which minor deficiencies in corporate income as originally reported were discovered after the tax return had been filed. A vanishing presumption could be based on the view that a presumption is justifiable chiefly for corporations which cannot afford to distribute their profits and that firms which can distribute dividends do not need special treatment.

The differences between an added and a vanishing presumptive dividends-paid allowance would be most significant for medium-sized corporations. Very small corporations would pay only the minimum tax with either kind of allowance, and very large corporations would probably not be greatly affected by a moderate-sized allowance of either type. Medium-sized corporations would find that their dividend policy would significantly affect their tax bills. 1/

b. Size of presumptive dividends-paid allowance

A presumptive dividends-paid allowance of any fixed size, whether vanishing or additive, would exceed the requirements of many corporations. If unused presumptions were allowed to accumulate, a premium would be placed on acquisition of existing small companies for the sake of their accumulated unused presumptive dividends. The simplest safeguard would be to limit the presumptive allowance to the smaller of (1) some fixed amount or (2) the corporation's net income (minus the basic tax on distributed profits if that were a feature of the plan). Such a limitation would, however, result in some discrimination against firms with widely fluctuating income as compared with firms with stable income.

1/ An added presumptive allowance of, say, $50,000 would offer no tax inducement to pay out the last $50,000 of income available for dividends but would offer a tax inducement to pay any amount of dividends short of that. A vanishing presumptive allowance of $50,000 would offer no tax inducement to pay out the first $50,000 of dividends, but would offer an inducement to pay out all income in excess of $50,000. In the case of a corporation with $100,000 of income available for dividends, a vanishing presumption would mean that the corporation's tax would be the same whether it paid $50,000 in dividends or no dividends, but its tax would be reduced if it paid more than $50,000 in dividends. Under an added allowance, payment of any amount of dividends up to $50,000 would reduce the corporation's tax, but additional dividend payments would not reduce the tax any further. For all corporations that would be likely to pay out more than $50,000 of dividends without any tax inducement, the vanishing presumption would offer a greater incentive to pay additional dividends.

Choice of size of maximum allowable presumption depends on coverage desired. It is estimated that in the prewar year 1940 vanishing or added presumptions of various sizes would have reduced coverage as follows: 1/

Presumption	Exempted a/		
	Percent of firms with net income	Percent of net income	Percent of retained net income
$ 100,000			
Vanishing	96%	17%	25%
Added	98%	25%	35%
$ 50,000			
Vanishing	94%	12%	19%
Added	96%	17%	25%
$ 25,000			
Vanishing	89%	8%	13%
Added	94%	12%	19%

a/ Or subject only to the minimum tax.

One serious problem with a presumptive dividends-paid allowance of any fixed size would be that it would offer a tax incentive to split up existing corporations and to organize new businesses, whenever possible, as a number of small corporations rather than one larger corporation. However, the inducement for "split-ups" would not be much different than under the present graduation of the corporate tax on net incomes of less than $50,000.

3. Dividends paid in excess of available income

If a corporation paid dividends in excess of available income — net income minus the basic tax, if any — these could be treated, in effect, as distributions of past or future income. 2/ Alternatively, the tax could be computed separately for each year without regard to distributions of other years. Failure to carry over excess distributions, however, would make maintenance of a stable dividend policy more difficult.

1/ Estimated from data in Statistics of Income for 1940, Part 2, assuming that dividends paid under the plan would be the same percent of income available for dividends in each net income class as in 1940.

2/ In some cases excess dividend distributions would first be revealed after the end of the tax year in which paid, when the income that a corporation originally reported was later decreased by audit or by a carryback of net operating loss.

The simplest procedure would be to allow distributions in excess of available income to reduce the maximum tax in future years. This could be accomplished technically by carrying forward either excess distributions of dividends or credits in excess of the maximum allowable in the current year. It would be more in accord with the logic of dividend distributions to regard excess dividends as distributions of previously retained net income. Moreover, this treatment would make the tax advantage of distributions certain, since it would not depend on the possibility of future accumulations of profits. A carryback would therefore provide a greater inducement for paying dividends in times of depression than would a carryforward. Nevertheless, a carryback of excess dividends would involve some administrative problems and would require granting of refunds of taxes previously collected. In the early years of the plan a carryback might benefit fewer corporations than a carryforward. The carryback and carryforward procedures might be combined, with excess distributions or credits applied first to prior years and any unexhausted balance carried forward.

The issue between carryforwards and carrybacks would concern mainly large corporations, provided a fairly generous presumptive dividends-paid allowance were a feature of the plan. The presumptive allowance would reduce the tax on small corporations to a minimum, whatever their dividend policy. Either a carryback or carryforward could adequately meet the needs of a firm with profits and dividends fluctuating above and below a reasonably stable level. A steadily declining firm that wished to pay out profits accumulated in earlier, more prosperous years would be benefited only by a carryback.

There would be little reason in principle for limiting the period of carryforward and/or carryback of excess distributions of dividends or credits. However, considerations of administrative expediency would suggest some arbitrary limit of, say, five or six years. The period should be long enough to permit a reasonable degree of balancing of dividends and profits.

4. Treatment of special types of income

a. Intercorporate dividends

If dividends received from other corporations were fully included in corporate income, no problem would arise in connection with credit or deduction for dividends paid from this source. On the other hand, if intercorporate dividends received were wholly or partially excluded from the tax base for determination of maximum corporate tax, 1/ no credit or deduction should be given for dividends distributed from the part of this income excluded from the base.

1/ For purposes of corporate normal tax and surtax, present law allows a credit against taxable income equal to 85 percent of dividends received from domestic corporations subject to income tax, with certain limitations. Internal Revenue Code, sec. 26(b).

One solution would be to include the full amount of dividends received in income for computation of tentative maximum tax and to allow against any minimum tax an appropriate tax credit for dividends received. Alternatively, dividends received could be wholly or partially excluded from the base for the maximum tax and dividends paid eligible for credit reduced by an equal amount. The latter solution would completely or partially exempt intercorporate dividends from tax but would grant no credit for dividends distributed from exempt income. 1/ It would be implicitly assumed that dividends were paid first from non-taxable dividends received and from other income only after non-taxable income was exhausted. The first approach (through use of a tax credit for dividends received) could be adjusted either to free dividends received from all tax if distributed, or to leave a low minimum tax on intercorporate dividends even if not retained by the recipient. Income from intercorporate dividends would presumably be subject to some tax if retained. 2/

Similar problems would be encountered in dealing with other kinds of income not subject to regular taxation, such as partially and wholly tax-exempt interest, and excess of percentage depletion over cost depletion. Since these kinds of income presumably would not have been included in full in the base for the maximum corporate tax, their distribution as dividends should not reduce the maximum tax in the same way as distribution of fully taxable income. Either of the two solutions mentioned for intercorporate dividends could be adopted.

5. Evaluation

a. Equity considerations

Adjustment of the corporation tax for dividends distributed could completely free distributed profits from double taxation. Dividend income could be made taxable in the same way as other income, at rates applicable to individual recipients. Undistributed profits would be subject to taxation at the corporate level so that individual tax postponement or avoidance through the corporate machinery would be reduced. Under this approach, any desired degree of taxation of corporate income as such, without regard to whether it was distributed or retained, could be achieved by varying the credit for dividends paid.

1/ For example, if 85 percent of dividends received were excluded from the base, as under present law, dividends paid subject to credit would be reduced by 85 percent of the amount of dividends received.

2/ For example, assuming a 40-percent maximum tax on corporate income with a 25-percent tax credit for dividends paid, an additional tax credit of 15 percent of intercorporate dividends received would wholly exempt dividends received if paid out by the stockholding corporation but subject them to a 25-percent tax if retained.

The dividends-paid-credit approach would not completely equalize current taxation of distributed and undistributed profits. The corporate tax rate would always be higher or lower on some parts of retained profits than the combined individual and corporate tax would be if the profits were distributed. The extent of current undertaxation or overtaxation, measured by strictly individual standards, would depend on the rate structure adopted. For high-income stockholders there would be a tax advantage from retention of corporate profits, and such stockholders might press for large retentions. Low-income stockholders would suffer from such a policy, since their individual tax liabilities would be less on distributed profits than the corporate tax on their share of undistributed profits. The approach might impose a burden on stockholders in corporations that, because of impaired capital, are prevented by State laws from paying out their current income in dividends.

b. Economic considerations

An adjustment for dividend distributions at the corporate level would reduce taxes on all corporations except those which retained all their earnings. Such a reduction in taxes paid by corporations would make many investment opportunities seem more profitable and might lessen tax restraints on management decisions to invest.

The effect on individual decisions to purchase securities would be less direct, but insofar as the system permitted or stimulated additional dividend payments it would make stock more attractive to many individuals. However, to the extent that the approach made retention of corporate profits less usual, it might lessen the incentive that some high-income individuals now have to buy shares in corporations likely to retain a large portion of their earnings. These individuals would find it harder to take advantage of the opportunity of postponing taxes and perhaps of ultimately realizing the fruits of their investment in the form of a capital gain, with consequent tax advantages under present law.

Retained earnings would still be subject to tax, but this would not necessarily interfere seriously with financing of corporate investment. If a presumptive dividends-paid allowance were granted, small corporations would be free to grow by use of retained earnings. Large corporations could pay necessary dividends at smaller cost. Although retained funds of larger corporations would be lessened as a result of the tax, such concerns can more often resort to the capital market to finance attractive investments. It seems likely, however, that an investment opportunity has to be more attractive to induce investment of funds to be secured from the capital market than to induce a corporation to invest retained earnings and other internal funds. Undoubtedly, there would be corporations that would be unable or unwilling to finance some investment under the dividends-paid-credit plan that they would be able and willing to finance if there were no corporate tax.

Reduction of the tax paid by corporations would be more likely to counteract any disposition of management to try to pass on the corporation tax by raising prices or depressing wages than would an adjustment granted to individual stockholders.

If distributed profits were completely freed of taxation at the corporate level, the tax incentive to debt financing would be eliminated. If some basic tax were continued on all profits, the premium on debt financing would be reduced but not eliminated.

c. Administrative considerations

Although some administrative problems would be met in a plan for coordination involving recognition of distributed profits at the corporate level, these complications do not seem grave enough to be an important factor in evaluating the plan.

D. Adjustment at the individual level for corporate tax on distributed income

1. Withholding tax approach

One approach to coordinating corporate and individual income taxes would be to collect a withholding tax from corporate profits. This withholding might be regarded as a part of the corporate income tax or as merely an advance payment on tax liabilities of stockholders. In either case the withholding rate would apply to both distributed and undistributed profits. When dividends were distributed, individuals would include in their taxable incomes cash dividends received plus the withholding tax paid by the corporation. After computing their individual income tax, stockholders would take credit for the tax on their dividends withheld at the corporate level. The withholding approach to integration is often called the British system. 1/

a. Rationale

The withholding approach would attempt to reduce or eliminate double taxation of distributed profits by applying part or all of the tax paid by the corporation with respect to such profits against the tax liability of stockholders. This approach would be based on the idea that a tax formally paid by a corporation may be regarded as a tax paid by or on behalf of its stockholders. On this reasoning, if a corporation paid a withholding tax on its profits, a stockholder should not be required to pay a tax on his dividends, unless his individual tax liability exceeded the amount already paid by the corporation with respect to the profits from which the

1/ The Research Committee of the Committee for Economic Development has recommended a withholding plan for the United States. (See their report, A Postwar Federal Tax Plan for High Employment, 1944.) Mr. George E. Barnes has proposed a dual corporation tax system composed of (a) a basic franchise tax similar to the present corporation income tax, and (b) an additional withholding tax that would be credited to dividend recipients. (See his article, "A Plan to Simplify Corporation Taxes," Exchange, Vol. V, September, 1944.)

dividends were paid. Similarly, if the amount paid by the corporation exceeded the stockholder's liability, he should get a refund. Since the withholding tax paid by the corporation would be used to meet a portion of stockholders' tax liabilities, this tax should be regarded as a part of stockholders' income. Stockholders would be presumed to have received cash dividends plus the withholding tax attached to them. The withholding tax would apply not only to profits currently distributed but also to undistributed profits, in order to prevent excessive tax avoidance and postponement with respect to undistributed profits.

b. Illustration

The operation of a particular withholding plan and the distribution of the tax load under it are illustrated in Chart 3. This chart is drawn in the same way as Charts 1 and 2, which were used to illustrate the present system and the dividends-paid-credit approach. Chart 3 shows the total tax on corporate profits under a plan that would impose a 20-percent basic corporate tax plus a 20-percent withholding tax, and that would credit the withholding tax to individual stockholders at the rate of $1 for each $3 of cash dividends received. The total tax on a dollar of profits earned on a share of stock owned by any stockholder can be read off the right-hand scale opposite the individual rate applicable to dividend income of the stockholder.

The essence of the withholding approach is illustrated in Chart 3 by the overlapping of the individual rate scale and the withholding part of the corporate scale. This illustrates how part of the tax paid by the corporation would be used to meet the individual stockholder's tax liability and shows that the withholding tax so used would be included in the stockholder's taxable income. Only the withholding relating to dividends paid would be currently credited to stockholders. In the first (upper left) panel of the chart, where no profits are assumed to be retained by the corporation, all of the withholding would be currently credited to stockholders; but in the second panel, where 30 percent of profits are assumed to be retained by the corporation, only half of the total withholding would be currently credited to stockholders. For stockholders not subject to individual income tax or subject to a rate of less than 25 percent, all or part of the withholding related to dividends would be refunded.

The lower half of Chart 3 generalizes the illustration given in the upper half. The slope of the bottom individual-rate line upward to the right illustrates how the amount of withholding credit currently available to stockholders would diminish as the amount of profits retained by the corporation increased. But at the same time, stockholders' tax liabilities would decrease, and the smaller withholding credit would still cover the first 25-percentage points of individual tax liability on dividend income.

c. Rate of withholding

The rate of withholding on corporate income would be important for reasons of equity as well as for protection of the revenues. To prevent any possibility of tax postponement or avoidance by individuals the rate would have to be equal to the highest individual tax bracket. To prevent reduction of tax revenues by retention of corporate profits, the withholding rate would need to be equal to the average individual tax rate applicable to dividend income. The maximum individual tax rate would probably be regarded as too severe. On the other hand, the minimum individual tax rate, which is often suggested, would permit a considerable amount of tax postponement by individuals. Well over half of total dividends received by individuals are likely to be subject to more than the minimum individual tax rate, assuming approximately present exemptions and a $2,000 beginning surtax bracket. 1/ The withholding rate could be applied to all corporate profits or to the balance remaining after application of any corporate tax not considered withholding.

d. Withholding in excess of individual tax

Equity would require that individuals be given tax refunds if the tax withheld on their dividends exceeded their individual tax liability. This would cause an administrative problem, the exact extent of which would depend on the withholding rate in comparison with individual tax rates and exemption. Many individuals would be able to adjust for overwithholding in connection with their estimates and current payments of tax, if the present individual system were continued. Many others would have to depend on cash refunds.

e. Methods of withholding

This section mentions first a simple withholding method that would call for a uniform mark-up of cash dividends to reflect withholding at the corporate level. Then it discusses problems encountered with this method and presents relatively minor modifications of the method designed to meet some of these problems without significant loss of simplicity. Finally, the section outlines an alternative withholding method that would require corporations to allocate exactly the amount withheld to various dividend payments and to report this to dividend recipients.

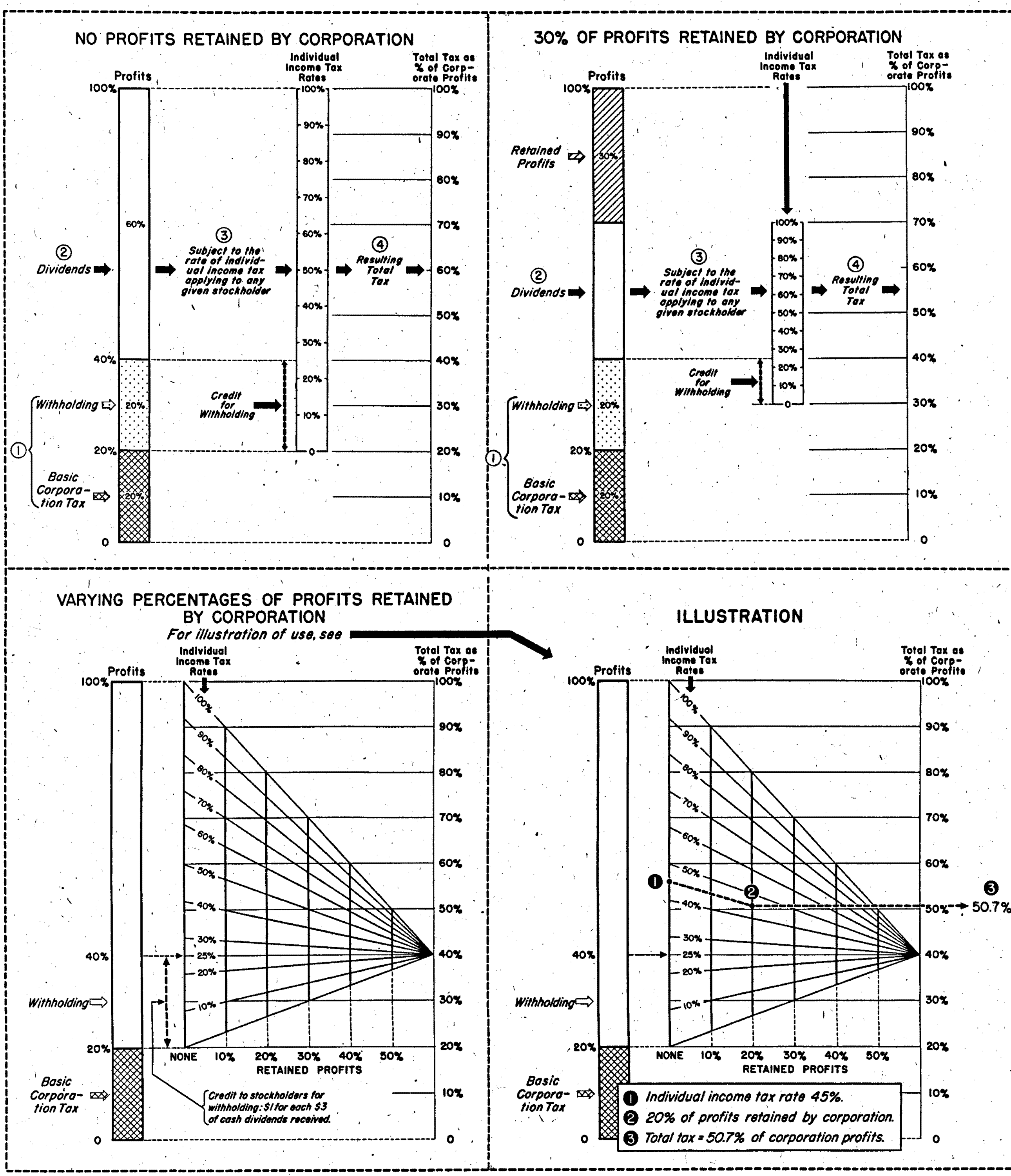
1/ In 1940 and 1941, 55 to 60 percent of dividends paid to individuals (and institutions treated as individuals in national income estimates) were reported on individual tax returns with net income of $5,000 or more, making allowance for the part of income from fiduciaries estimated to be dividends. Most of these individuals presumably had surtax net income in excess of $2,000. Many individuals with net incomes of less than $5,000 also had surtax net income in excess of $2,000.

Chart 3

TOTAL TAX ON CORPORATE PROFITS UNDER WITHHOLDING PLAN

20% BASIC CORPORATE TAX PLUS 20% WITHHOLDING TAX CURRENTLY CREDITED TO STOCKHOLDERS AT RATE OF $1 FOR EACH $3 OF CASH DIVIDENDS.

Aggregate of corporation and individual income tax based on:
A. Varying percentages of profits retained by corporation.
B. Rate of individual income tax applying to any given stockholder.



(1)oo Uniform mark-up of cash dividends to reflect amount withheldoo

The simplest withholding method would require dividend recipients to increase their cash dividends for tax purposes by a uniform fraction to reflect the current rate of withholding at the corporate level. Thus, if a 40-percent corporate tax were regarded exclusively as a withholding tax, individual dividend recipients would include in their taxable income approximately $1.67 for each $1 of cash dividends received. If only half of a 40-percent tax were regarded as a withholding tax, individuals would include approximately $1.33 for each $1 of cash dividends. 1/ After computing their individual income tax liabilities on net income, including full nominal dividends, individuals would apply the difference between nominal and cash dividends as a tax credit, thus reducing their personal liabilities. Stockholders not subject to individual income tax would be allowed to claim a refund for corporate tax withheld on their dividend income.

(a)oo Dividends on preferred stockoo

Unless specifically so provided by legislation, dividends on preferred stock probably would not be reduced by the withholding tax collected from corporations. 2/ If recipients of preferred dividends were given the same tax credit as holders of common stock, they would get a windfall. In effect, preferred stockholders would be credited with, and receive a refund for, taxes actually borne by common stockholders. This could be avoided only if corporations were specifically required to reduce contractual dividends on preferred stock by the amount of the withholding tax. 3/ Mere denial of a withholding credit to preferred stockholders would not meet the problem. Common stockholders, as residual claimants in the corporation, would typically bear the whole corporate tax, including

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1/ This system would be equivalent to a 20-percent tax on all corporate profits and a 25-percent withholding tax on the balance of corporate income after deduction of the basic tax.

2/ This paragraph is written on the assumption that corporate income after taxes would be large enough to cover preferred dividends. While this would not always be the case, the reasoning would be much the same so long as both common and preferred stockholders had a genuine equity in the corporation.

3/ Unless the dividends were paid from earnings and profits accumulated before adoption of the withholding plan. Preferred stockholders would in effect largely escape any basic corporate tax not treated as a withholding tax, just as they are now protected from the present corporate tax.

the withholding tax, and would not be adequately recompensed by the mark-up and credit system described in the preceding paragraph. 1/ Another way of meeting this problem would be to grant corporations a credit for preferred dividends paid in arriving at the withholding tax base. This would combine a general withholding approach with some features of the dividends-paid-credit approach discussed above.

(b)oo <u>Dividends not paid from currentoo fully taxable incomeoo</u>

The simple withholding system described above would be reasonably satisfactory if dividends were paid only from profits that had all beenoo subject to the same rate of withholding tax. Dividends paid from taxableoo income of the current year or a prior year when the withholding rate wasoo the same as the current rate would present no problem. However, dividendsoo would often be paid in whole or in part from profits that had not beenoo fully subject to the current withholding tax or that had borne a higheroo rate. If such dividends were treated like those originating from currentoo taxable income, stockholders would receive credit for more or for less taxoo than had actually been paid on their behalf by the corporation.

(1)oo <u>Earnings and profits accumulatedoo prior to adoption of planoo</u>

Profits retained prior to adoption of the withholding plan would have been subject to a corporate tax but not to withholding. If dividends paid from this source were treated as if they had been subject to withholding, the result would be discrimination in favor of stockholders in corporations that had previously retained earnings as compared with stockholders in corporations that had regularly distributed the major part of profits.

(2)oo <u>Earnings and profits accumulatedoo subsequent to adoption of planoo</u>

If the withholding rate were varied from year to year, many cases of under- or overstatement of true withholding and of proper individual tax credits would arise. 2/ Presumably the withholding rate would be geared to individual income tax rates and would need to be changed whenever

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1/ Assume, for example: corporate profits \$100; withholding tax \$40; preferred dividends \$50; hence, available for common dividends \$10. The withholding tax would have occasioned a \$40 or 80-percent reduction in income available for common dividends, but the 67-percent mark-up would give common stockholders credit for a maximum of \$6.70 of withholding.

2/ If the withholding rate were held constant, the system could be arranged so that the basic corporate tax rate could be varied without complication. This would be possible if the withholding rate were applied to profits remaining after deduction of the basic tax, instead of to total income. This method, of course, would require a higher nominal rate of withholding than a system that would simply impose a corporate tax of X percent and provide that X-Y percentage points of the tax should be considered withholding.

individual tax rates were altered. If rates fluctuated widely, this defect would seem to be serious enough to require some refinement of the simple system already described.

(c) Dividends paid from income partially or wholly tax-exempt

If withholding were regarded as a part of the corporate tax, a problem would arise with respect to dividends paid from corporate income that is partially or wholly tax-exempt, or subject to a lower rate of tax than other kinds of income. This would include partially tax-exempt interest, wholly tax-exempt interest, excess of percentage depletion over cost depletion, and perhaps capital gains and other kinds of income. Unless an adjustment were made, the simple withholding method involving a uniform mark-up would give credit for more than the actual amount withheld on such income. 1/

One solution would be to adjust the withholding rate upward on income not subject to the regular corporate tax rate, so that the simple mark-up treatment could be applied to dividends paid from such income. For example, the excess of percentage depletion over cost depletion might be exempt from the basic corporate tax but subject to a 25-percent withholding tax. This would permit a one-third mark-up of dividends paid from this income, as of other dividends under a plan calling for a 20-percent basic tax and a 20-percent withholding tax. 2/ This solution, however, might not be considered appropriate for dividends paid from wholly tax-exempt interest.

If withholding were regarded as an advance payment of stockholders' tax liabilities rather than a tax on the corporation, it might be possible

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1/ For example, partially tax-exempt interest might be subject to a basic tax of 10 percent and ordinary corporate income to a basic tax of 20 percent, with an additional 20-percent tax on all corporate income, which would be treated as withholding. The corporation would thus pay a 30-percent tax on partially tax-exempt interest. Out of $100 of such income received by a corporation, stockholders might be paid cash dividends of $70. If stockholders applied the regular one-third mark-up, the cash dividends would be increased to $93.33 of taxable income; stockholders would receive credit for $23.33 of withholding ($93.33 taxable dividends minus $70 cash dividends). Yet the amount withheld on this $100 of corporate income would actually have been only $20.

2/ Similarly, in the case of income subject to say one-half the basic corporate rate, a 32.5-percent tax might be imposed, consisting of 10-percent basic tax and 22.5-percent withholding tax. This modification would make a one-third mark-up appropriate -- (100 percent - 32.5 percent)1-1/3 = 90 percent, which is 100 percent of partially tax-exempt income minus the basic corporate tax of 10 percent.

to ignore distinctions among types of corporate income. Withholding might be applied at the same rate to all income from which dividends could be paid, including wholly and partially tax-exempt interest and similar items, as well as ordinary income. At present, wholly tax-exempt interest, for example, is not subject to corporate tax, but dividends paid from such interest are taxable income in the hands of stockholders. 1/ The withholding system would not impose a corporate tax on tax-exempt income, but it would require corporations to withhold in advance a portion of stockholders' presumed taxes on dividends that might be paid out of such income.

This withholding plan would differ from the present method of withholding on salaries and wages in that no account would be taken of dividend recipients' personal exemptions. (However, if withholding exceeded the individual stockholder's tax liability, he would receive a refund from the Treasury.)

(d) Dividends paid from capital

Dividends paid from capital are now not taxable to stockholders and hence must now be segregated from other dividends. Under a withholding system, dividends paid from capital would present no new problems.

(e) Intercorporate dividends

Dividends received from other domestic corporations that had been subject to the withholding tax should be exempt from the withholding requirement in the hands of a stockholding corporation. It might also be considered desirable to exempt intercorporate dividends from any basic corporation tax not treated as a withholding tax. It would probably be necessary to trace intercorporate dividends back through the different corporate layers to determine exactly how much had been withheld on them, so that proper credit could be given to individual stockholders who might receive dividends paid by the stockholding corporation out of the dividends that it had received from other corporations. This tracing would require some arbitrary rule as to the source from which dividends are paid.

(f) Relief for small corporations

If a lower tax were desired for small corporations, the tax rate could be graduated. This would give rise to the same kind of complications at the individual level as would be associated with other kinds of corporate income taxed at less than the standard rate. A uniform percentage mark-up of dividends for tax purposes might give stockholders in small corporations credit for more than the actual amount of withholding. This difficulty could be met in the same way as the similar problem discussed in the preceding section -- by a higher withholding rate. In this case, there might be objection to such a solution because it would put a drain

1/ Regulations 111, sec. 29.115-3.

on the cash resources of small corporations and would result in overwithholding on the dividends of many stockholders in small corporations. Moreover, adherence to the simple mark-up system would greatly restrict the scope of possible graduation of the corporate rate scale. With a one-third mark-up, for example, the beginning corporate rate could not be less than 25 percent, and would have to be higher if some basic corporate tax in addition to withholding were desired for the smallest corporations. 1/

(2) Exact allocation of withholding with reports to stockholders

From the foregoing discussion it appears that some, but not all, of the problems encountered with the simplest version of the withholding approach could be met by relatively minor adjustments. However, there seems to be no satisfactory way of making sure in all cases that a uniform mark-up of cash dividends received by individuals would result in an accurate statement of actual withholding on the profits from which the dividends were paid. The most serious difficulties would arise in connection with dividends paid from earnings and profits accumulated prior to adoption of the plan, from wholly tax-exempt interest, and from profits of prior years when different rates of withholding were in effect.

A more refined method would be to require corporations to report to each stockholder and the Bureau of Internal Revenue the precise amount withheld on any cash dividends paid. Stockholders would use this report rather than a uniform mark-up in filing their returns.

Under this method, corporations would compute tax on their net income in the usual way, or with the adjustments in withholding rates previously mentioned for certain types of income. When dividends were paid they would allocate the withholding tax between distributed and undistributed profits. If dividends exceeded net income of the current year, a last-in-first-out rule or some other convention could be applied to determine the source from which the dividends were paid. Dividends would be applied first against income of the current year and then against retained income of the immediately preceding year and so on back to earlier years.

1/ With a one-third mark-up system the beginning corporate rate might be 25 percent, which would all be withholding. Corporations in the next size group might be subject to a 30-percent rate. In this group a corporation would pay $30 of tax on $100 of profits and might then distribute $70 of cash dividends. The cash dividends would be marked up to $93.33 for tax purposes, and stockholders would get credit for $23.33 of withholding. The remaining $6.67 of tax paid by the corporation would be considered the basic corporation tax. It can be readily seen that such a system would leave little room for variations in the basic tax and withholding tax paid by small corporations.

Either of two rules could be adopted for dividends assumed to be paid from non-taxable income or income subject to less than the standard corporate tax rate. Such income could be prorated between dividends and retained income and each dividend assumed to be composed partly of ordinary income and partly of non-taxable income. Alternatively, it could be assumed that dividends were paid first from non-taxable income of prior years up to the amount of that income and from taxable income of the current year only after non-taxable income of prior years was exhausted.

Having determined the source of dividends paid, the corporation could determine the amount of tax which had been withheld on the dividend. The corporation would report to each stockholder the cash dividend and the withholding tax allocable to it, and the sum of these two items would be the nominal dividend that would be included in the stockholder's taxable income. Apparently these reports would have to be made at the close of the corporation's tax year to all stockholders of record at dividend dates during the year.

One technical difficulty under the method would arise from adjustments of prior-year corporate income due to audit, carrybacks, or court decision. A deficiency in corporate income would require an additional corporate tax and additional withholding. But a reduction in corporate net income originally reported would not necessarily warrant refund of a part of the amount previously withheld. Stockholders might already have received credit for the withholding originally reported. Probably refunds could properly be made to the corporation for excessive withholding only if application of the last-in-first-out or similar rule showed that the income originally reported had not been distributed.

The exact-allocation method would obviate difficulties of the uniform mark-up method related to dividends paid from funds not subject to the full rate of withholding. It would, however, occasion a large amount of paper work both for corporations and individual taxpayers. Difficulties of verifying and auditing individual returns would be greatly increased. The system might induce adoption of once-a-year dividend policies.

f. Relation of withholding to taxation of capital gains and losses realized on stock

It has been suggested that under a withholding plan an adjustment should be made in taxation of capital gains realized on stock, to take account of the fact that undistributed profits that may be responsible for at least a part of the capital gains have been subject to withholding. 1/ The justification for an adjustment would be similar to that under the

1/ Harold M. Groves, Production, Jobs and Taxes (New York, 1944), pp. 46-47. Groves has later reconsidered and withdrawn his earlier recommendation. See his, Postwar Taxation and Economic Progress (New York, 1946), p. x.

partnership method. Under the partnership method retained earnings would be currently taxed to individual stockholders, and the basis of stock would be increased as if stockholders had made an additional investment in the corporation. While the withholding plan would not go so far as the partnership plan, it would collect a tax on retained earnings on behalf of stockholders. A stockholder may realize his share of retained earnings either by selling his stock at a gain or by receiving a dividend. Under the withholding method he would get a tax credit if he received a dividend but no credit if he realized a capital gain. The result would appear to be a discrimination against capital gains.

Closer examination, however, suggests that the discrimination against capital gains might be less extreme than it would appear at first sight. To some extent, stockholders who sold their stock would "cash in" on their share of withholding on retained profits in the form of higher prices for the stock. A share of stock in a corporation that had retained profits would in effect carry with it a tax receipt for withholding on the retained profits. The hypothetical tax receipt would be redeemable when the retained profits were paid out in dividends. The prices at which stock sold would reflect the value of withholding as well as retained profits. If investors expected that the retained profits would be paid out soon, stock prices might include almost the full amount of the withholding. In that event, the stockholder who sold his stock would get his share of withholding on retained profits as a part of his capital gain. The stockholder who realized his share of earnings in the form of a dividend would get a tax credit for his share of withholding, and would include the credit in his taxable income. Full taxation of the seller's capital gain would involve no discrimination against him as compared with the dividend recipient. In other cases, however, the market price of stock would not reflect the full amount of withholding, and sellers would not get the full benefit of withholding. If investors expected that a corporation would postpone paying out its retained earnings for several years, a time discount would attach to the sales price of withholding associated with its retained earnings. If investors anticipated that retained earnings would never be paid out in dividends, the withholding related to them might add little or nothing to the market value of the corporationts stock. 1/ Full taxation of capital gains in the latter two kinds of cases would mean some discrimination.

Any discrimination against capital gains arising out of retained earnings would not be serious so long as capital gains are subject to the present comparatively low tax rate. Such discrimination would become worse, however, if the tax rate on capital gains were to be raised toward that on ordinary income. Some people, who believe that more effective taxation of capital gains is especially important, fear that discrimination against capital gains might be used as an argument for continuing the

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1/ The retained profits would still have a market value, however, if investors thought that the corporation would earn a return on them in the future.

present low tax rate on capital gains. They consider this an objection to a withholding system or any other approach that would put a tax on undistributed corporate profits and not adjust the basis of stock to take account of that tax. 1/

A satisfactory adjustment of the capital gains tax to take account of previous withholding on retained corporate earnings would be very difficult. An arrangement almost as elaborate as the full partnership method would be needed to determine exactly how much undistributed profits and withholding on them accrued on a share of stock while it was owned by any one person. When a stockholder sold his share, presumably he should get credit for withholding related to undistributed profits accumulated while he held the stock. If so, a future holder should not be allowed to claim the same withholding when the retained profits were finally paid out in dividends. Yet a complicated system would be needed to grant withholding credit to the one stockholder and to deny it to the other.

g. Evaluation

(1) Equity considerations

The withholding approach could eliminate every element of double taxation of dividend income. Corporate and individual taxation of distributed profits could be completely integrated by this method. At the same time, undistributed profits would be subject to taxation at the corporate level and individual tax postponement through corporate retention of earnings thereby reduced.

The withholding approach, like a credit for corporations for dividend distributions, could not completely equalize current taxation of distributed and undistributed profits. The withholding rate on undistributed profits would be lower than the marginal tax rate of some stockholders, higher than that of others. The result would be tax postponement in the first case and temporary overpayment in the second case. Unless the withholding rate were higher than the first-bracket individual rate, there would probably be some tax postponement for the majority of retained profits, but not for the majority of dividend recipients.

The withholding approach could be combined with any desired basic tax on corporations themselves by treating only part of the corporate tax as a withholding tax.

The simplest withholding method, which would make no effort to determine the exact source of dividend payments, would often grant too much or

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1/ Only the partnership approach and the so-called capital gains approach would entirely avoid the problem.

too little credit for withholding. A more refined method, which allocated withholding in a rather precise (albeit arbitrary) way to particular dividend payments, would be a great improvement from the standpoint of equity.

(2) Economic considerations

A withholding plan would be the most direct approach to removal of tax impediments to individual investment in stocks. Stockholders would not have to rely on changes in corporate dividend policy for a larger net return. If cash dividends were maintained, any dividend recipient, whether or not subject to personal income tax, would get a larger yield after taxes.

The withholding approach would not eliminate the corporate tax as a factor in management decisions. Corporations would pay as much in taxes as under a corporate tax of the present type imposed at the same rate as the withholding tax. The effects of the tax on management decisions would depend to a great extent on how managers thought of the tax. To the extent that they considered the withholding tax a corporate tax, rather than a tax on stockholders, they presumably would react to it in much the same way as to a corporate tax of the present type. They would consider the withholding tax a factor affecting the profitability of investment and the length of time necessary to recover capital outlays in risky fields. To the extent that managers looked on the withholding tax as something that could be written off their books when dividends were paid, the effect of the tax on investment decisions would be similar to that of a tax under a dividends-paid-credit plan. Looked at from this latter point of view, the withholding system would appear to be composed of two elements -- a tax on undistributed corporate profits and collection at source of individual taxes on dividends.

A withholding tax would restrict the maximum amount of investment funds available to a corporation from internal sources as much as the present type of tax or a tax under a dividends-paid-credit plan. If corporation managers looked forward to the opportunity of writing the withholding tax off their books when they distributed dividends, the withholding tax would offer much the same incentive to pay dividends as a dividends-paid-credit plan. A withholding-tax plan would leave corporations less funds to pay cash dividends than would a dividends-paid-credit plan, but the tax credit to stockholders for withholding together with refunds for overwithholding would probably make stockholders content with smaller cash dividends. The withholding plan would probably make it easier for corporations to obtain new outside equity capital, but it seems likely that profit prospects must be better to induce corporations to raise and invest such new funds than to induce them to invest internal funds.

If management consciously tries to mark up prices and hold down wages to recoup the corporation income tax, adoption of a withholding plan would be less likely to change this than a reduction of the present corporation income tax or adoption of a dividends-paid-credit plan.

(3) Administrative considerationsee

The withholding method in its simplest form would present no grave administrative difficulties. Admittedly, the plan would somewhat complicate the individual tax return, and refunds for overwithholding might be a problem. A more refined and more equitable withholding method would result in rather serious administrative problems attributable mainly to efforts to trace various kinds of income through the corporation in order to determine how much withholding tax should be credited on particular dividend payments.

2.ee Dividends-received-credit approachee

Another variation of the general approach to coordination of corporate and individual taxes through an adjustment at the individual level would be to allow stockholders a credit or exemption for dividends received. Dividends received would be exempt from normal tax or from the first bracket of the individual tax; or stockholders would be granted a tax credit equal to the amount of dividends received multiplied by the normal or first-bracket tax rate. Dividends would be subject to individual surtax rates or rates in excess of the first-bracket rate. Advocates of this approach usually contemplate a corporate tax rate equal to the individual normal tax or first-bracket rate, but it would be possible to have a higher corporate tax rate. The dividends-received-credit approach is similar to the plan used in the United States prior to 1936. 1/

Chart 4 illustrates a particular dividends-received-credit plan, under which a 40-percent corporate tax would be imposed and dividends received by individual stockholders would be exempt from the first 20-percentage points of individual income tax. Like the charts illustrating the plans already discussed, Chart 4 shows how the corporate and individual taxes combine to give the total tax on corporate profits for any given stockholder and any dividend policy. The effect of exempting dividends received from the first 20-percentage points of the individual tax is shown in the chart by the dropping of the individual rate scale. For stockholders subject to more than a 20-percent tax rate on ordinary income, the personal income tax on dividends is always 20-percentage points less than the tax on other kinds of income. But the total tax on corporate profits is never less than 40 percent, since the exemption means nothing to stockholders who would not be taxable in any case.

a.ee Rationaleee

The dividends-received-credit approach resembles in some respects the withholding approach, but it differs from that approach in certain other important respects. Advocates of the dividends-received-credit approach would justify reducing the individual tax on dividend income on the

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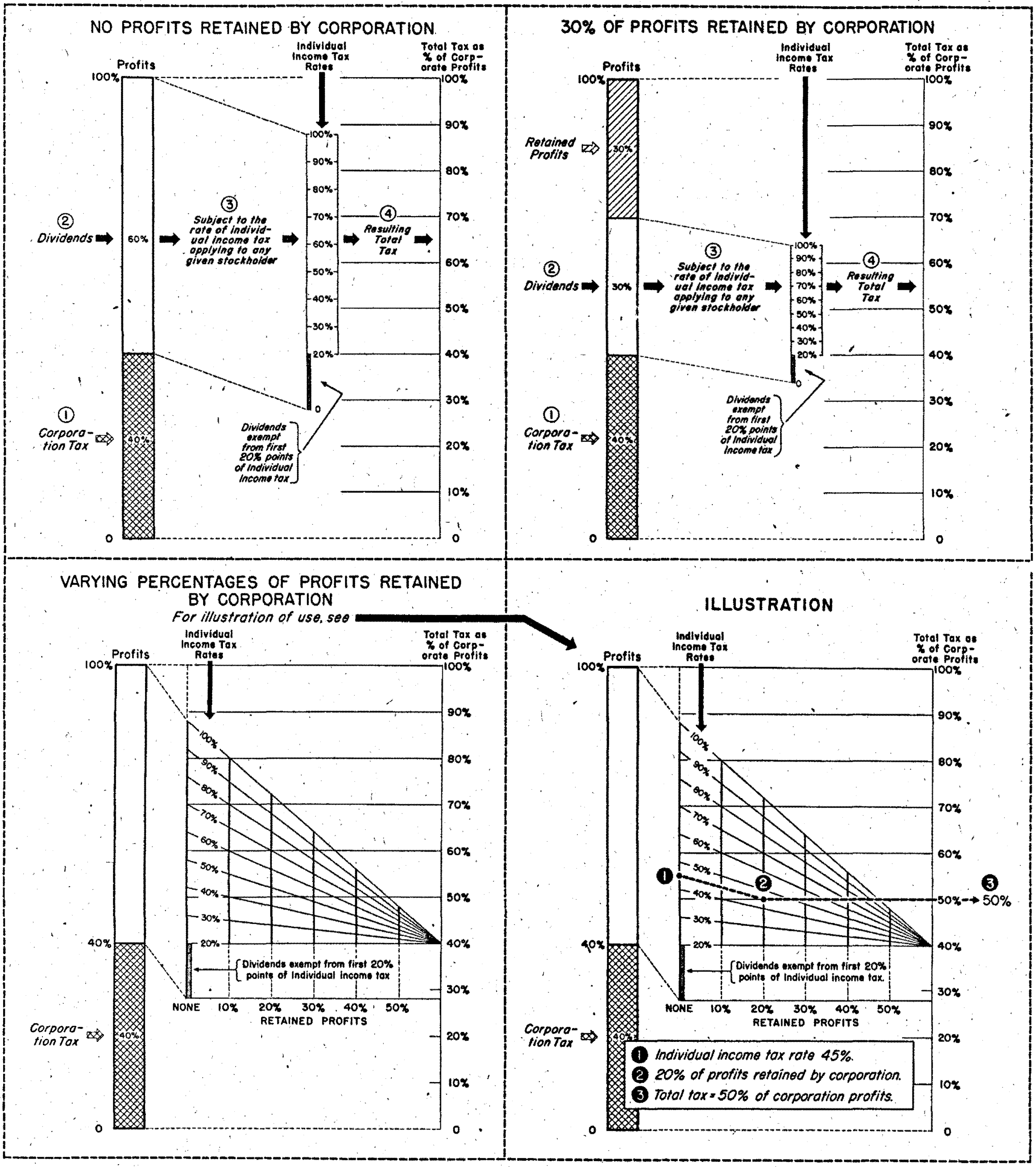
1/ The dividends-received-credit approach has been recommended by a Committee on Postwar Tax Policy, under the chairmanship of Mr. Roswell Magill. See the report of the Committee, A Tax Program for a Solvent America (1945), pp. 98-103.

Chart 4

TOTAL TAX ON CORPORATE PROFITS UNDER DIVIDENDS-RECEIVED CREDIT PLAN

40% CORPORATE TAX; DIVIDENDS EXEMPT FROM FIRST 20% POINTS OF INDIVIDUAL TAX.

Aggregate of corporation and individual income tax based on:
A. Varying percentages of profits retained by corporation.
B. Rate of individual income tax applying to any given stockholder.



grounds that the corporate tax should be considered a partial payment of the tax liability of dividend recipients. However, the dividends-received-credit approach would not follow this logic to its conclusion. Like the withholding approach, it would in effect apply part or all of the corporate tax to the liabilities of individual stockholders, but, unlike the withholding approach, it would not include the corporate tax in the taxable income of dividend recipients. For discharge of personal tax liability, the dividends-received-credit approach would operate as if stockholders had actually paid the corporate tax from their own income; but in assessing personal tax liability, the corporate tax would not be considered a part of stockholders' income. Moreover, the dividends-received-credit approach would make no adjustment for corporate tax on dividends paid to stockholders not subject to individual income tax. To be sure, there is only one tax in the case of dividends paid to non-taxable recipients, but the real significance of the double-taxation criticism of the present corporate tax system is not that there are two different taxes but that dividends are taxed more heavily than other kinds of income.

b. Implicit rate structure

The net result of the dividends-received-credit approach would be vastly different tax benefits for persons at different income levels. Under this approach, the total tax on profits earned for stockholders with incomes too small to be subject to individual income tax would remain as high as under the present system. At the other extreme, the total tax on corporate profits earned for high-income stockholders would be less than the tax on other kinds of income. If no profits were retained by the corporation, the total tax in the case of high-income stockholders would be less under the dividends-received-credit approach than if no corporate tax were imposed and dividends were subject only to the regular individual income tax. If, as is often proposed, the corporate tax rate and the individual normal tax or first-bracket rate were equal, the dividends-received-credit plan would result in combined corporate and individual taxes lower than the regular individual tax alone in the case of all profits distributed to stockholders subject to more than the minimum individual tax rate. By its nature, the dividends-received-credit approach would not benefit low-income stockholders, but it would offer substantial advantages to stockholders with high incomes.

The implicit rate structure under a particular dividends-received-credit plan is illustrated in the following table. The table also shows for comparison the total tax under a superficially similar withholding approach. The table shows the total tax on corporate profits for stockholders subject to different individual tax rates, on the assumption that the corporation retains none of the profits. Alternatively, the figures may be regarded as the total tax on the distributed portion of profits, including in distributed profits the corporate tax relating to dividends paid.

Stockholder's regular individual tax rate	Total tax a/	
	Dividends-received-credit plan (40% corporate tax; dividends exempt from first 20-percentage points of individual tax)	Withholding system (20% basic corporate tax plus 20% withholding tax)
0%	40%	20%
20	40	36
40	52	52
60	64	68
80	76	84

a/ This comparison assumes that under the withholding system refunds would be made to individuals whose tax was lower than the withholding rate and that cash dividends plus the amount withheld would be included in individual taxable income.

The foregoing table brings out the characteristics of the dividends-received-credit approach. As compared with the withholding plan, the dividends-received-credit plan would impose a much higher tax in the case of low-income stockholders (who are subject to the lower individual tax rates); but in the case of high-income stockholders (who are subject to high individual tax rates), the total tax would be less under the dividends-received-credit plan. As the table shows, the total tax would be less in the case of upper-bracket stockholders than the individual tax alone, without any corporate tax at all. Under the particular version of the dividends-received-credit approach illustrated in the table, this last-mentioned peculiarity becomes evident only for very high individual tax rates, but under other versions of the approach it would be evident over a much wider range of individual tax rates. 1/

1/ The breaking point would be where the following equation was satisfied:

$$R_{si}\ (1 - R_c) + R_c = R_{ni} + R_{si},$$

where R_{si} is the average rate of individual surtax on dividend income; R_c is the corporate tax rate; and R_{ni} is the individual normal or first-bracket tax rate.

With a 40-percent corporate rate and a 20-percent individual normal or first-bracket tax rate, the breaking point would be at a 50-percent average individual surtax rate (70-percent aggregate regular individual rate) on dividend income. For higher individual rates, the combined tax on distributed profits would be lower than the individual tax alone. For lower surtax rates, the combined tax would be greater. With equal corporate and individual normal tax rates ($R_c = R_{ni}$), the combined corporate and individual taxes would always be lower than the individual tax alone, if the stockholder were subject to surtax.

c. Possible modifications of the dividends-received-credit system

Some of the anomalies of the dividends-received-credit system would be eliminated if individuals were required to include the full value of dividends (before deducting the corporate tax) in their surtax income. With a 20-percent corporate tax and dividends exempt from an individual normal tax of 20 percent, stockholders would report for surtax purposes their cash dividends increased by one-third. This modification would transform the system into a withholding tax approach, but without refunds for individuals not subject to personal income tax.

Another possible modification of the dividends-received-credit approach that would eliminate the discrimination in favor of dividend income inherent in the unmodified plan would be to allow all taxpayers to deduct the normal tax from taxable income in computing the surtax. With respect to all taxable income except cash dividends and partially tax-exempt interest, the taxpayer would be entitled to a deduction for the normal tax paid, but on items of income on which no normal tax was imposed there would be no deduction. This method would have the undesirable effect of making tax rates seem higher than they actually were. To raise any given amount of revenue, higher nominal surtax rates would be required than under the present system. For example, a normal tax rate of 20 percent plus a surtax rate of 50 percent would add up to a 60-percent combined rate rather than 70 percent. Moreover, this modification of the dividends-received-credit approach would still give no benefit to the stockholder with income too small to be subject to the individual income tax.

d. Evaluation

(1) Equity considerations

The inequitable character of the implicit rate structure of the dividends-received-credit system would be its most serious disadvantage. The system would discriminate against low-income dividend recipients and in favor of high-income dividend recipients.

The system would not completely eliminate double taxation of distributed profits but it would reduce the degree of double taxation. In the highest income bracket dividends might be taxed at lower rates than other kinds of income. In lower brackets distributed profits would still bear a higher tax than other income.

(2) Economic considerations

In common with other adjustments at the individual level, the dividends-received-credit system would leave the corporate tax as a possible factor in management decisions as to investment and price and wage policies. It would reduce, but not wholly eliminate, tax discrimination against equity financing. It would make investment in stock especially attractive to wealthy individuals.

(3) Administrative considerations

The dividends-received-credit system would be easier to administer than the other methods of coordination that have been discussed in this report. Administrative simplicity would be the chief advantage of the dividends-received-credit approach.

3. Partial exclusion of dividends received from individual taxable income

Still another adjustment at the individual level, somewhat related to the dividends-received-credit approach, would be to exclude a part of dividends received from individual taxable income. For example, a 40-percent corporation income tax might be imposed and individual stockholders allowed to exclude from taxable income some stated fraction of dividends received. 1/

Chart 5 shows the total tax on corporate profits under a particular dividend-exclusion plan, which would provide for a 40-percent corporate tax and exclusion from individual taxable income of 40 percent of dividends received. This chart is drawn in the same way as the preceding ones. Under the plan illustrated the corporate tax would always be 40 percent, but the individual tax would be influenced both by the dividend exclusion and the portion of profits retained by the corporation. The dividend exclusion, represented in the upper half of the chart by the shaded bar and in the lower half by the shaded area above the top individual-rate line, causes the individual rate scale to contract. This, of course, greatly lessens the tax load on dividends under any given individual rate schedule.

a. Rationale

The intent of the dividend-exclusion approach apparently would be to reduce the individual tax on dividends in recognition of the fact that corporate profits have been subject to a corporate tax. Exclusion of a portion of dividends received from taxable income would reduce the individual tax on them, but the reduction would bear little relation to the amount of tax already paid by the corporation. The reduction in individual tax would depend on the tax value of the exclusion from taxable income, which in turn would be governed by the top rate applicable to the stockholder's income. Although all corporate profits would have borne the same rate of corporate tax, the individual adjustment to take account of this

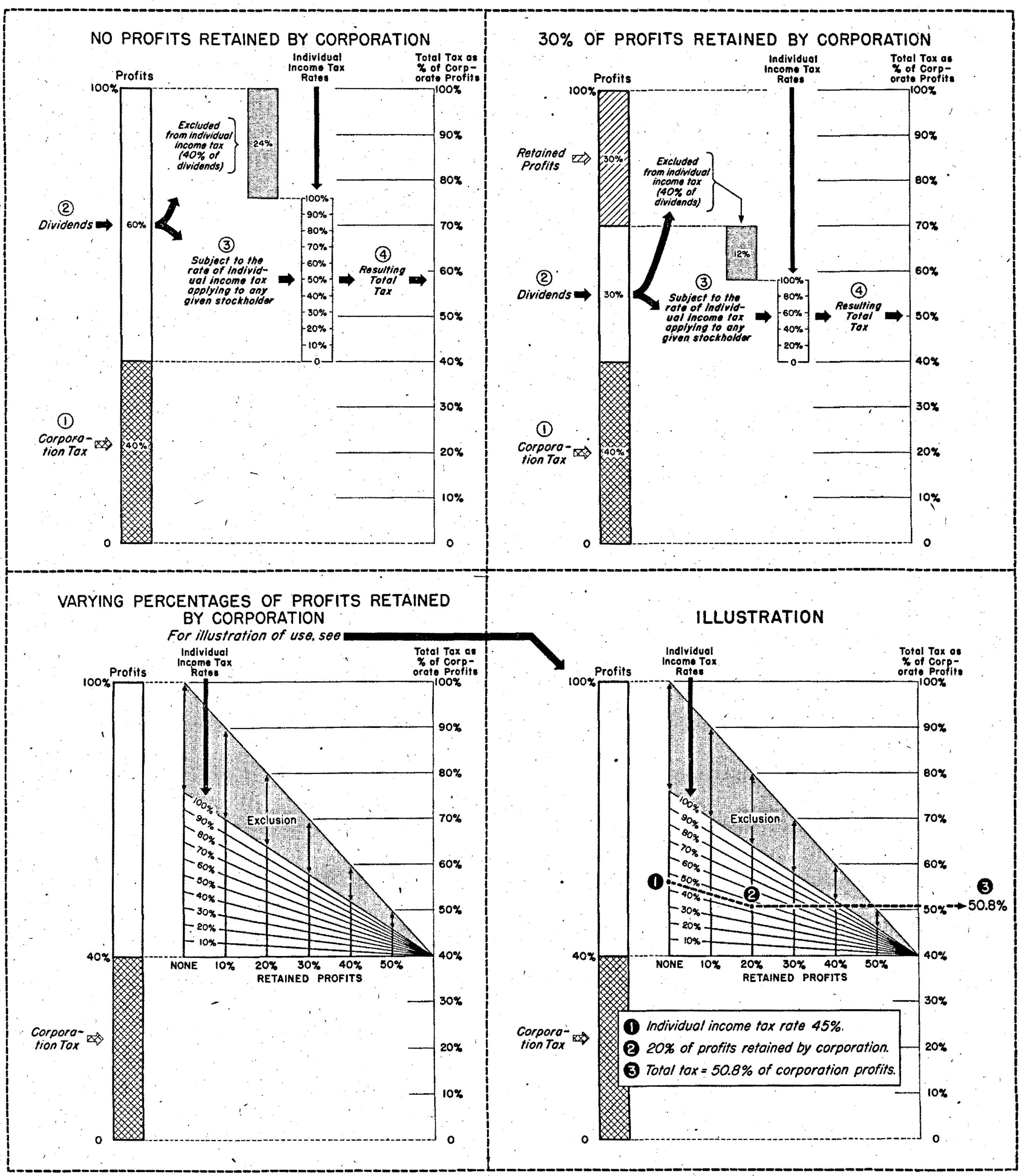
1/ A specific plan proposed by a group of Minnesota businessmen called for a 40-percent corporate tax and exclusion of 40 percent of dividends received. See, Twin Cities Research Bureau, Inc., Postwar Taxes, The Twin Cities Plan, Saint Paul, Minnesota (1944).

Chart 5

TOTAL TAX ON CORPORATE PROFITS UNDER DIVIDENDS EXCLUSION PLAN

40% CORPORATE TAX; INDIVIDUALS EXCLUDE 40% OF DIVIDENDS RECEIVED FROM TAXABLE INCOME.

Aggregate of corporation and individual income tax based on:
A. Varying percentages of profits retained by corporation.
B. Rate of individual income tax applying to any given stockholder.



tax would differ greatly among dividend recipients. Exclusion of 40 percent of dividends received from individual taxable income would not make a 40-percent corporate tax in any sense equivalent to a withholding tax, nor would the plan be equivalent to a dividends-received-credit plan.

b. Implicit rate structure

The dividend-exclusion approach would reduce the weight of taxation on corporate profits distributed to stockholders subject to personal income tax. The extent of this reduction would depend on the rate of taxation to which particular stockholders were subject. Stockholders not liable for individual income tax would receive no benefit; those subject to a high tax rate would receive a large benefit. The tax value of the dividend exclusion would increase uniformly with the progression of the individual income tax.

With a 40-percent corporate tax and 40-percent dividend exclusion, the combined individual and corporate taxes on distributed profits would never fall below 40 percent and would always increase as the rate of tax on individual dividend recipients rose. However, in all cases where dividends, if distributed to individuals, would have been subject to a tax rate above 62.5 percent, this particular scheme would yield a smaller combined tax on distributed profits than would the individual income tax alone. 1/

The effect of the dividend-exclusion plan discussed above is illustrated in the following table:

Stockholder's individual tax rate	Reduction in individual tax rate on dividends (percentage points)	Total tax on distributed profits
0%	0%	40%
20	8	47
40	16	54
60	24	62
80	32	69

1/ The breaking point would be where the following equation was satisfied:

$$R_i \,[(1 - D_i)\ (1 - R_c)] + R_c = R_i,$$

where R_i is the average rate of individual income tax on dividend income; D_i is the percent of dividends received excluded from individual taxable income; and R_c the corporate tax rate.

c. Evaluation

With regard to equity, economic effects, and administrative considerations, the dividend-exclusion approach would resemble the dividends-received-credit approach. Both approaches would favor high-income stockholders as compared with those with low incomes, but the dividend-exclusion plan would go further in this direction. For this reason, the dividend-exclusion approach would probably make stock even more attractive to wealthy investors than would the dividends-received-credit plan.

E. Summary comparison of methods of coordination and estimates of revenue yield of illustrative plans

The objective of plans for coordinating corporate and individual taxes is to reduce inequalities between total taxes on corporate profits and on other kinds of income. The problem of achieving equality of taxation has two sides. One side is elimination or reduction of "double taxation," that is, keeping corporate profits from being taxed more heavily than other kinds of income. The other side is prevention or limitation of tax postponement and avoidance, that is, keeping corporate profits from being taxed less than other kinds of income.

The only way to assure complete equality of taxation of all corporate profits and other kinds of income is to eliminate the corporate tax and to tax stockholders on their full share of corporate profits, without regard to whether the profits are distributed or retained by the corporation. This may be called the partnership approach, since it disregards the corporate entity for tax purposes and treats stockholders as partners. The partnership approach achieves complete equality of taxation by looking through the corporate entity and taxing profits retained by the corporation in the same way as profits distributed to stockholders. No other approach to coordination does this. Since corporations do not distribute all of their profits, all other approaches must fall short of complete equality of taxation of corporate profits and other income.

The distributed part of corporate profits could be taxed at exactly the same rates as other kinds of income under any of the four basic approaches to coordination discussed in this memorandum. These basic approaches are: (1) the partnership approach, which would disregard the corporate entity for tax purposes and currently tax stockholders on their full share of corporate profits, whether distributed or retained; (2) the capital-gains approach, which would eliminate the corporate tax and tax stockholders on realized capital gains at regular individual rates; (3) the approach that would reduce the corporate tax when profits were distributed as dividends; (4) the approach that would adjust stockholders' taxes to take account of the fact that corporations have paid taxes on profits from which dividends are distributed.

The part of corporate profits retained by corporations could be taxed at exactly the same rates as other kinds of income only under the partnership approach. Under the three other basic approaches, total taxes on corporate profits would be affected by the amount of profits retained by the corporation. Under some conditions undistributed profits would be taxed less heavily than other kinds of income. Under other conditions undistributed profits would be taxed more heavily than other kinds of income. Some stockholders would gain at least a temporary tax advantage by having their share of profits retained in the corporation. Under the two approaches that would require collection of a tax from corporations, other taxpayers would suffer at least a temporary tax disadvantage by having their share of taxes retained in the corporation. One important problem in coordinating taxes on corporate profits is how to minimize differences in taxation of corporate profits and other kinds of income attributable to the fact that corporations retain part of their profits.

All approaches except the partnership of necessity fall short of complete equality of taxation of retained profits and other kinds of income. Moreover, specific versions of approaches that would levy a tax on the corporation may also depart from complete equality of taxation of distributed profits and other kinds of income, but such departures are a matter of deliberate choice. Advocates of these plans may wish to stop short of complete elimination of additional taxes on corporate profits because of their appraisal of revenue needs and their doubts about the complete validity of the case against the present corporate tax system. Among the specific plans presented for illustrative purposes in this memorandum, the dividends-paid-credit plan, withholding plan, dividends-received-credit plan, and dividend-exclusion plan, all retain some corporate tax on distributed profits. Under these plans, distributed profits, as well as retained profits, would be taxed differently from other kinds of income.

Chart 6 compares, as methods of coordination, some of the specific plans discussed in this memorandum. To that end, the chart compares the total tax on corporate profits under specific versions of the present corporate tax system and four other plans with the total tax under the partnership method. The partnership method is used as the standard of complete coordination. The chart is intended to convey only a general impression of the distribution of total taxes on corporate profits under the various plans. Emphasis is on differences in treatment of profits earned for high- and low-income stockholders. Chart 6 is drawn on the assumption that the corporation retains none of its profits. Alternatively, the chart may be thought of as relating to the part of profits that is distributed by any corporation (including in distributed profits the corporate tax relating to that part of profits). Differences among the plans shown in the chart relate only to distributed profits. Each of the five specific plans shown would impose a 40-percent tax on retained corporate profits.

The top panels of Chart 6 are intended to explain the relation between the graphic methods used in this chart and in the first five charts. In the top-right and following panels, the broken diagonal line represents the total tax on corporate profits under the partnership method, which is merely the individual tax alone. The solid diagonal line in each case is the total tax (corporate and individual) under the particular plan being compared with the partnership method. The shaded area between the two diagonals is the difference between the individual tax under the partnership plan and the total tax under the particular plan under consideration. This difference is attributable entirely to the corporate tax. Where the solid line is above the broken line, the chart indicates that the plan under consideration would tax distributed corporate profits more heavily than other kinds of income. Where the solid line falls below the dotted line in the two bottom panels, the plan would tax distributed corporate profits less heavily than other kinds of income. By the standard of complete coordination, the former is overtaxation or, broadly speaking, "double" taxation; the latter, undertaxation.

It can be quickly seen from the chart that the additional tax under all five plans is highest on profits earned for low-income stockholders, who are subject to the low individual tax rates shown toward the left end of the top scale in each panel. The gap between the two diagonal lines is widest here. Under the present system, the dividends-paid-credit plan, and the withholding plan, the gap between the diagonals gradually narrows at higher individual tax rates, and completely closes at the illustrative 100-percent individual tax rate at the extreme right. This means that the corporate tax adds less to the total tax on profits earned for high-income stockholders than on profits earned for low-income stockholders. The reason is simple. High-income stockholders, who are subject to high personal tax rates, would pay a high tax on their share of corporate profits even under the partnership method. In large part, profits taken by the corporate tax would otherwise have been taken by the individual tax. Under both the dividends-paid-credit plan and the withholding plan, the net corporate tax, depicted by the shaded area, is only half that under the present system. These two plans would go half way toward eliminating "double taxation" of distributed profits.

Under the dividends-received-credit plan and the dividend-exclusion plan, the total tax on corporate profits would be less for high-income stockholders than the individual tax alone under the partnership treatment. This is shown in Chart 6 by allowing the solid line to fall below the dotted line toward the right. These two plans would go beyond complete elimination of double taxation. They would put dividend income of wealthy stockholders in a preferred position.

Chart 6 is satisfactory for comparing the general distribution of the tax load under the plans illustrated. It brings out clearly differences in the relative treatment of high- and low-income stockholders. However, the illustrative plans are not strictly comparable, because they would yield different amounts of revenue. For this reason, the exact total tax

Chart 6

TOTAL TAX ON CORPORATE PROFITS UNDER FIVE PLANS COMPARED WITH PARTNERSHIP TREATMENT

Assuming no Profits Retained by Corporation

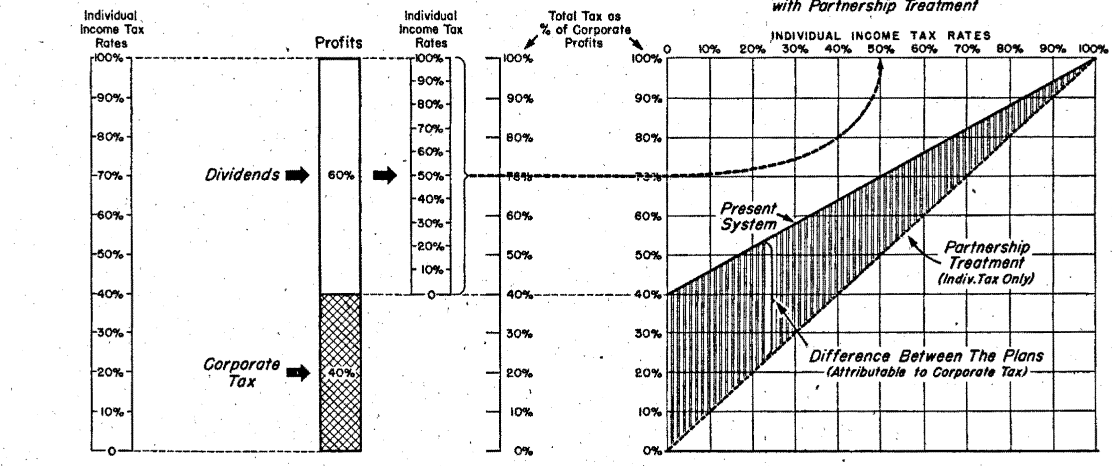
PARTNERSHIP TREATMENT

Total Tax = Individual Tax

PRESENT SYSTEM - 40% CORPORATE TAX

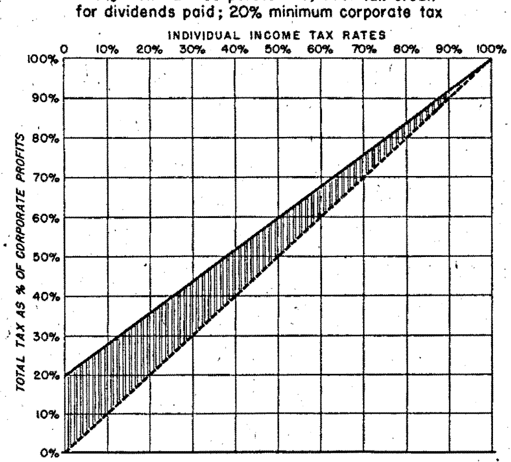
Total Tax = Corporate Tax + Individual Tax

① As shown in Chart I. → ② As shown for better comparison with Partnership Treatment



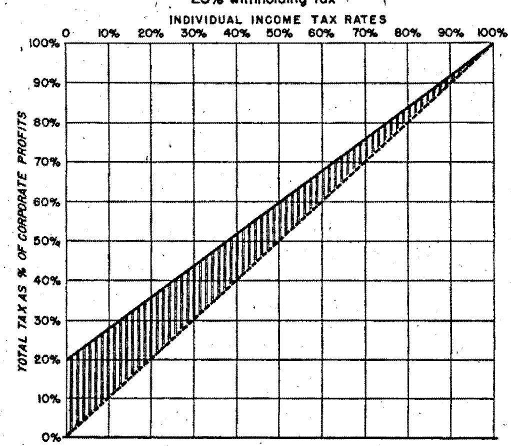
DIVIDENDS-PAID CREDIT PLAN

40% Maximum corporate tax; 25% tax credit for dividends paid; 20% minimum corporate tax



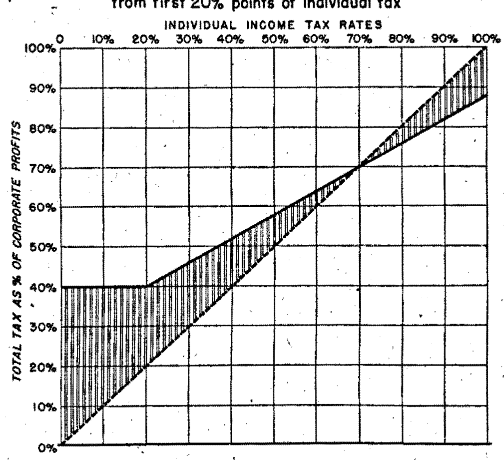
WITHHOLDING PLAN

20% Basic corporate tax plus 20% withholding tax



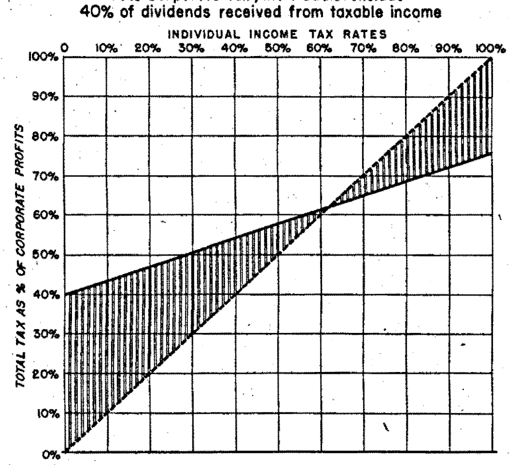
DIVIDENDS-RECEIVED CREDIT PLAN

40% Corporate tax; dividends exempt from first 20% points of individual tax



DIVIDENDS EXCLUSION PLAN

40% Corporate tax; individuals exclude 40% of dividends received from taxable income



shown for any particular stockholder is not of great significance. The total tax shown for the present system, for example, is higher for most stockholders than under other plans, partly because the present type of plan shown in the chart would yield more revenue. Although this does not affect the reliability of the general impression conveyed by the chart, the differences in revenue should be taken into account.

Since revenue yield is an important consideration in appraising a tax plan, it is desirable to have some impression of the effect of the different plans on revenues. The following table gives estimates of the yield of plans illustrated in Chart 6. 1/ The table shows separately the estimated corporate tax liability, the net individual tax on dividend income, and the resulting total yield of each of the plans. In estimating the individual tax liability on dividend income, the rates and exemptions of the Revenue Act of 1945 were used, and dividends were treated as the last increment in individual income. All the estimates are based on assumed economic conditions consistent with national income payments of about $150 billion.

In making the revenue estimates, it has been assumed that net dividends paid by all domestic corporations, as a group, would be the same percentage of corporate income available for dividends under all of the plans. Under each of the plans except the dividends-paid-credit plan, income available for dividends would be net corporate income minus the corporate tax liability. Under the dividends-paid-credit plan, income available for dividends was taken to mean net corporate income minus the minimum corporate tax, rather than net income after the actual final corporate tax liability. Under this plan, corporations could reduce their taxes to the 20-percent minimum by paying out all of their current income. Hence, all corporate income above the minimum tax liability may be said to be available for dividends.

The assumption as to dividend policy implies larger cash dividends under the dividends-paid-credit plan than under the other plans. The amount of dividends taxable to stockholders, however, would be roughly the same under the withholding plan and the dividends-paid-credit plan. The smaller cash dividends paid under the withholding plan would be marked up for purposes of the individual income tax. The assumption of dividend payments equal to a uniform percentage of available income was selected as unambiguous, although arbitrary. Some more or less arbitrary assumption

1/ The version of the dividends-received-credit plan used in the table differs slightly from that illustrated in Chart 6. In the plan shown in the table, dividends would be exempt from the first 19-percentage points of individual tax, rather than the first 20-percentage points as shown in the chart. This modification was made because the beginning rate of individual tax under the Revenue Act of 1945 is 19 percent (combined normal tax and surtax, after deduction of the 5-percent tax reduction provided by the Act).

Revenue Yield of Five Corporate Tax Plans 1/

(Billions of dollars)

Plan	Income tax liability net of credits and refunds: Total 2/	Corporate tax	Individual tax on dividends 3/
Present system (40% corporate tax 4/)	10.5	8.6	2.0
Dividends-paid-credit plan (40% maximum corporate tax; 25% tax credit for net dividends paid 5/; 20% minimum corporate tax 6/)	9.1	6.4	2.7
Withholding plan (20% basic corporate tax plus 20% withholding tax 5/)	9.1	8.6	0.6 7/
Dividends-received-credit plan (40% corporate tax 4/; dividends exempt from first 19 percentage points of individual tax)	9.6	8.6	1.0
Dividend-exclusion plan (40% corporate tax 4/; individuals exclude 40% of dividends received from taxable income)	9.7	8.6	1.1

Source: Treasury Department, Division of Research and Statistics

1/ National income payments assumed to be approximately $150 billion. Dividends paid under all plans assumed to be the same fraction of income available for dividends. (See text.)

2/ The two following columns do not add to this total in some cases because of rounding.

3/ Viewing dividends as the last increment in individual income; rates enacted by Revenue Act of 1945, with modifications of individual tax indicated in connection with each plan.

4/ Corporate tax credit equal to 20 percent of partially tax-exempt interest also allowed.

5/ Corporate tax credit equal to 15 percent of partially tax-exempt interest also allowed.

6/ Based on corporate net income excluding partially tax-exempt interest.

7/ After deducting $0.4 billion of refunds to stockholders for overwithholding.

was necessary because there is no experience on which to base refined estimates. The particular assumption used may well understate the amount of dividends that would be paid under the alternative plans, as compared with the present system. Reduction of the degree of "double taxation" of distributed profits might make wealthy stockholders less inclined to retain profits in the corporation to avoid individual surtax. The dividends-paid-credit plan and the withholding plan would be likely to stimulate more dividend payments than the other plans. It seems likely that the psychological effect of the dividends-paid-credit plan would make that plan the most effective in stimulating dividend payments.

If corporations would pay out the same fraction of income available for dividends under the dividends-paid-credit plan and under a comparable withholding plan, both plans would always yield the same total revenue. The yield would be divided differently between corporate and individual taxes, but the total would be the same. Under the withholding approach a tax credit relating to dividends would be given to stockholders. Under the dividends-paid-credit approach an equivalent tax credit would be given to corporations for distributing their profits. The total revenue would be the same, not only for the particular illustrative rate structures used in this memorandum, but also for any other rate structures that bore the same relationship to each other.

All of the plans for coordination of the corporate and individual income taxes would yield smaller revenues than the present system. The withholding plan and the dividends-paid-credit plan would yield less than the other illustrative plans, because they would go furtherest toward elimination of "double taxation" of distributed profits. The smaller revenue loss under the dividends-received-credit plan and the dividend-exclusion plan would be attributable mainly to the higher tax on dividends received by low-income stockholders.

APPENDIX A

Collections from Corporation Income and Excess-Profits Taxes, Individual Income Taxes, and Total Internal Revenue, Fiscal Years 1925-1945

(Money amounts in millions)

Fiscal year	Corporation income and excess-profits taxes 1/	Individual income taxes	Total internal revenue 2/	Corporation income and excess-profits taxes as a percent of total internal revenue (percent)
1925	$ 916	$ 845	$ 2,584	35.4
1926	1,095	879	2,836	38.6
1927	1,308	912	2,866	45.6
1928	1,292	883	2,791	46.3
1929	1,236	1,096	2,939	42.1
1930	1,263	1,147	3,040	41.5
1931	1,026	834	2,428	42.3
1932	630	427	1,558	40.4
1933	394	353	1,620	24.3
1934	400	420	2,672	15.0
1935	579	527	3,282	17.6
1936	753	674	3,494	21.6
1937	1,088	1,092	4,634	23.5
1938	1,343	1,286	5,644	23.8
1939	1,156	1,029	5,162	22.4
1940	1,148	982	5,323	21.6
1941	2,053	1,418	7,352	27.9
1942	4,744 3/	3,263	13,030	36.4
1943	9,669 3/	6,630	22,369	43.2
1944	14,767 3/	18,261	40,120	36.8
1945	16,027 3/	19,034	43,800	36.6

Source: Annual Report of the Secretary of the Treasury for 1945, pp. 483-487.

1/ Includes unjust enrichment tax, 1937-1945.

2/ Includes income tax on Alaska Railways except in fiscal years 1935, 1936, and 1937, during which time these receipts were considered trust fund receipts.

3/ Includes amounts refundable as postwar credit against excess-profits tax, and refunds attributable to carrybacks of unused excess-profits credits and net operating losses, etc.

APPENDIX B

Progressivity of a Flat-rate Corporate Income Tax on Distributed Profits

1. Determinants of progressivity

This discussion of the progressivity of the corporate income tax relates to its effects on individual incomes. It is concerned with statistical aggregates or averages rather than with particular cases. In these terms, the over-all progressivity of a flat-rate corporate income tax depends on: (1) the distribution of dividends by individual income classes in relation to the distribution of total income and (2) individual income tax rates on dividends paid to stockholders.

2. Estimates of tax load on various individual income classes attributable to corporate tax on distributed profits

The following table shows what may be called the "net corporate tax" on distributed profits, taking into account the two factors mentioned above. The table uses the 1942 distribution of income and dividends by individual income classes and a hypothetical set of individual income tax rates. The table relates to distributed corporate profits, including in distributed profits the portion of the corporate tax allocable to dividends actually paid. The table deals only with profits distributed to stockholders subject to individual income tax, under the 1942 exemptions. It does not include profits distributed to non-taxable individuals, foreigners, and institutions.

Column 2 of the table shows the increasing importance of dividends as a source of individual income in successively higher income classes. The figures in this and other columns relate to aggregate income of all individuals in the various income classes, not merely to dividend recipients. 1/ Column 3 shows the impact on aggregate individual income of a 40-percent corporate tax on distributed profits -- without allowance for the fact that a part of the profits taken by the corporate tax would have been taken by the regular individual tax. Columns 2 and 3 suggest that a flat-rate corporate tax may have, in the aggregate, a markedly progressive effect on

1/ Statistics of Income for 1942, Part 1, does not show the number of returns reporting various kinds of income in each income class. It is reasonable to assume, however, that in 1942, as in prior years, the increasing importance of dividends as income rises is attributable to two factors: (1) a larger proportion of individuals receiving dividends in high-income classes than in low-income classes and (2) dividends constituting a larger fraction of the total income of dividend recipients in high brackets than in low.

"Net Corporate Tax" on Distributed Profits
40-Percent Corporate Tax on Distributed Profits Stated as a Percent of Aggregate Individual Income in Different Income Classes

(1) Individual net income classes (thousands)	(2) Adjusted dividends as percent of adjusted individual net income 1/	(3) 40-percent corporate tax on distributed profits as percent of adjusted individual net income (40% of col. 2)	(4) Marginal individual income tax rate (hypothetical)	(5) "Net corporate tax" as percent of adjusted individual net income 2/
0 - $ 4	2.4%	0.96%	16%	0.80%
$ 4 - 6	8.0	3.2	21	2.5
6 - 8	13.9	5.6	25	4.2
8 - 10	17.1	6.8	29	4.9
10 - 14	20.2	8.1	33	5.4
14 - 15	22.5	9.0	37	5.7
15 - 20	24.2	9.7	41	5.7
20 - 25	26.7	10.7	45	5.9
25 - 30	28.9	11.6	48	6.0
30 - 40	31.5	12.6	51	6.2
40 - 50	34.6	13.8	54	6.4
50 - 60	36.1	14.5	57	6.2
60 - 80	38.3	15.3	60	6.1
80 - 100	41.2	16.5	62	6.3
100 - 200	45.2	18.1	64	6.5
200 and over	53.8	21.5	65	7.5

1/ Aggregate dividends (including dividends estimated to be paid to individuals through fiduciaries) and aggregate net income of individuals from Statistics of Income for 1942, increased by the 40-percent corporate tax on distributed corporate profits. Dividends received by individuals filing Form 1040A estimated on the basis of the ratio of dividends to "other income" reported by individuals in the same income class filing Form 1040.

2/ The 40-percent corporate tax on distributed profits as a percent of individual net income, reduced by the individual income tax that would have been due had the corporate tax on distributed profits been added to dividends paid to individuals. This is: (column 3) X (100 percent - column 4). May not check exactly, due to rounding.

individual incomes. But the analysis cannot be left here. Column 3 does not reflect the effect of the second major determinant of the progressivity of the corporate tax, the individual income tax rates on dividends. The figures in Column 3 may be thought of as showing the "gross corporate tax" on distributed profits, in contrast with the "net corporate tax," which is shown in Column 5.

Column 5 of the table shows the "net corporate tax" on distributed profits, taking into account the effect of both major determinants of the progressivity of the tax. The figures in Column 5 are called the "net corporate tax" because they show the "gross corporate tax" (Column 3) reduced by the individual income tax that stockholders would have had to pay if their dividends had been increased by the amount of the corporate tax on distributed profits. This adjustment must be made to get a true picture of the net tax load attributable to the corporate tax. Comparison of Columns 3 and 5 reveals that the net effect of the corporate tax is much less progressive than one would suppose merely from inspection of figures on the distribution of dividends among individual income classes. But the "net corporate tax" on distributed profits is broadly progressive in the sense that, in the aggregate and on the average, it is a greater percentage of high incomes than of low incomes.

a. Technical reservations regarding estimates

Some reservations of both a technical and a conceptual nature apply to interpretation of the table. The technical reservations concern mainly the crudity of the computations. All income recipients in a given net income class are assumed to be subject to the same marginal tax rates. Actually, these rates would vary considerably, depending on such factors as the number of personal exemptions and the portion of the income represented by long-term capital gains. The former factor is probably especially important in the lower brackets, the latter in the upper brackets. Despite these limitations, the figures are believed to give a picture which is reasonably accurate in the large, if not in specific details.

b. Conceptual problems

On the conceptual level, the most obvious point to be mentioned is the fact that the table assumes that the corporate income tax on distributed profits rests entirely on dividend recipients. It is tacitly assumed that any reduction in that tax would be fully reflected in additional dividend payments, distributed in the same manner as dividends actually paid in 1942.

Another basis for differences in interpretation of the estimates relating to the distribution of the corporate income tax concerns the definition of tax progression.

3. <u>Note on the definition of progressionee</u>

In a strictly formal sense a progressive tax usually has been definedee as one the rate of which increases as the base increases, and a regressive tax, one for which the rate decreases as the base increases. However, general usage relates the effective rate of any tax to the income of persons assumed to bear it. Thus an excise tax, which is nominally proportional, is ordinarily said to be regressive in effect.

Even by the income standard the concept of progression is somewhat vague. Comparisons of the degree of progression of different tax schedules are even less exact. Apparently the most usual approach is to measure progression by the ratio of effective tax rates on net income before taxes of high-income groups to effective rates on low-income groups. A ratio greater than one indicates that a tax is progressive, and presumably the higher the ratio the greater the degree of progression.

But another logical definition is to say that a progressive tax is one that reduces the inequality of individual incomes -- after taxes. This approach measures progressivity by the ratio of income after taxes in high-income groups to income in low-income groups.

These two definitions may conflict when different degrees of progression are compared. For example, suppose the effective income tax rate is 10 percent on a $1,000 income and 50 percent on a $50,000 income. The tax is progreesive by either definition. The upper bracket rate is 5 times the lower, and the higher income is 50 times the lower before tax but only 27.8 times the lower after tax.

Now suppose that an additional 10 percentage points are added to the rate schedule in each bracket, making the rates 20 percent and 60 percent. Does the addition increase or decrease the progressivity of the income tax? The top rate is now only three times the lower, and by the first standard progression has decreased. But the additional 10 percentage points of tax takes 1/9 of the lower income remaining after the original tax and 1/5 of the upper. The spread between incomes after tax has been reduced. The higher income after tax is now 25.0 times the lower, as compared with 27.8 times the lower under the previous schedule.

On the assumption that the corporate tax is not shifted, it appears to beebroadlyeprogressive according to both definitions. However, it is more progressive on the second definition (reduction ineinequality of incomes after taxes) than on the first and more usual definition. In the first definition the corporate tax, even though itself mildly progressive, may decrease the progressivity of the whole tax system. According to the second definition, it clearly increases progressivity of the whole system.

Formal progression is, of course, only one aspect of the equity and economic effects of a tax or a tax system. The weight of taxation and the absolute amount of income left after taxes in both high- and low-income groups must also be taken into account.

4. <u>Recovery of revenue attributable to corporate tax on distributed profits</u>

The "net corporate tax" shown in Column 5 of the preceding table is roughly equivalent to the following increases in individual surtax rates:

Surtax net income (thousands)	Percentage points increase in individual surtax
0 - $2	2
$2 - 4	4
4 - 6	5
6 - 8	6
8 and over	7

This means, subject to the assumptions and limitations already mentioned, that the part of the corporate tax imposed on profits distributed to stockholders subject to individual income tax could be approximately recovered from the same individual income groups by the foregoing increases of individual surtax rates. 1/ The revenue would be recovered from the same individual income classes estimated to have borne the corporate tax on distributed profits in 1942, but not in the same amount from every individual within each class. The increased surtax would apply to all individuals with taxable income in the various brackets, not to dividend recipients alone.

1/ Assuming, among other things, the 1942 distribution of dividends and previously existing individual tax rates as shown in Column 4 of the previous table.

APPENDIX C

New Domestic Corporate Security Issues by Types, 1/ 1921-1945

(Money amounts in millions)

Year	Total, all types of issues	Short-term bonds and notes	Total, long-term issues	Long-term bonds and notes	Preferred stock	Common stock	Total stock	Total stock as percent of total long-term issues (percent)
				Total (new capital and refunding)				
1921	$ 2,269	$ 213	$ 2,056	$ 1,781	$ 75	$ 200	$ 275	13.4
1922	2,947	134	2,813	2,192	333	288	621	22.1
1923	3,166	181	2,985	2,249	407	329	736	24.7
1924	3,522	336	3,186	2,320	346	520	866	27.2
1925	4,222	308	3,914	2,667	637	610	1,247	31.9
1926	4,575	295	4,280	3,059	544	677	1,221	28.5
1927	6,508	303	6,205	4,466	1,055	684	1,739	28.0
1928	6,930	265	6,665	3,174	1,397	2,094	3,491	52.4
1929	9,377	251	9,126	2,369	1,695	5,062	6,757	74.0
1930	4,957	620	4,337	2,810	422	1,105	1,527	35.2
1931	2,371	400	1,971	1,628	148	195	343	17.4
1932	644	214	430	406	11	13	24	5.6
1933	380	89	291	139	15	137	152	52.2
1934	489	168	321	287	3	31	34	10.6
1935	2,268	51	2,217	2,066	124	27	151	6.8
1936	4,579	63	4,516	3,963	271	282	553	12.2
1937	2,434	95	2,339	1,579	468	292	760	32.5
1938	2,141	11	2,130	2,032	79	19	98	4.6
1939	2,117	79	2,038	1,804	161	73	234	11.5
1940	2,763	39	2,724	2,396	246	82	328	12.0
1941	2,619	43	2,576	2,277	219	80	299	11.6
1942	1,042	5	1,037	908	110	19	129	12.4
1943	1,061	38	1,023	849	131	43	174	17.0
1944	3,118	14	3,104	2,592	411	101	512	16.5
1945	6,166	46	6,120	4,811	1,031	278	1,309	21.4

For footnotes see p. 78

New Domestic Corporate Security Issues by Types, 1/ 1921-1945 (continued)

(Money amounts in millions)

Year	Total, all types of issues	Short-term bonds and notes	Total, long-term issues	Long-term bonds and notes	Preferred stock	Common stock	Total stock	Total stock as percent of total long-term issues (percent)
				New capital				
1921	1,702	161	1,541	1,276	71	194	265	17.2
1922	2,211	104	2,107	1,537	293	277	570	27.1
1923	2,635	143	2,492	1,833	335	324	659	26.4
1924	3,029	276	2,753	1,924	318	511	829	30.1
1925	3,604	221	3,383	2,231	594	558	1,152	34.1
1926	3,754	249	3,505	2,418	509	578	1,087	31.0
1927	4,657	221	4,436	2,962	874	600	1,474	33.2
1928	5,347	211	5,136	2,175	1,149	1,812	2,961	57.7
1929	8,003	205	7,798	1,874	1,517	4,407	5,924	76.0
1930	4,483	520	3,693	2,460	412	1,091	1,503	40.7
1931	1,551	289	1,262	951	116	195	311	24.6
1932	326	34	292	271	11	10	21	7.2
1933	161	17	144	24	15	105	120	83.3
1934	178	32	146	112	3	31	34	23.3
1935	404	11	393	323	55	15	70	17.8
1936	1,193	23	1,170	817	90	263	353	30.2
1937	1,226	48	1,178	769	205	204	409	34.7
1938	874	4	870	803	48	19	67	7.7
1939	384	5	379	282	26	71	97	25.6
1940	736	12	724	589	61	74	135	18.6
1941	1,062	24	1,038	865	94	79	173	16.7
1942	625	3	622	503	103	16	119	19.1
1943	376	23	353	261	55	37	92	26.1
1944	651	2	649	425	133	91	224	34.5
1945	1,256	2	1,254	600	429	225	654	52.2

For footnotes see p. 78

New Domestic Corporate Security Issues by Types, 1/ 1921-1945 (concluded)

(Money amounts in millions)

Year	Total, all types of issues	Short-term bonds and notes	Total, long-term issues	Long-term bonds and notes	Preferred stock	Common stock	Total stock	Total stock as percent of total long-term issues (percent)
				Refunding				
1921	568	52	516	506	4	6	10	1.9
1922	735	29	706	655	40	11	51	7.2
1923	530	37	493	416	72	5	77	15.6
1924	492	60	432	396	28	8	36	8.3
1925	618	87	531	436	43	52	95	17.9
1926	819	45	774	641	34	99	133	17.2
1927	1,851	82	1,769	1,504	181	84	265	15.0
1928	1,584	54	1,530	999	248	283	531	34.7
1929	1,375	46	1,329	496	178	655	833	62.7
1930	474	100	374	351	9	14	23	6.1
1931	820	111	709	677	32	--	32	4.5
1932	318	180	138	135	2/	3	3	2.2
1933	219	72	147	115	--	32	32	21.8
1934	312	137	175	175	--	--	--	--
1935	1,863	39	1,824	1,743	69	12	81	4.4
1936	3,388	40	3,348	3,147	181	20	201	6.0
1937	1,210	47	1,163	810	264	89	353	30.4
1938	1,268	7	1,261	1,229	31	1	32	2.5
1939	1,733	74	1,659	1,522	135	2	137	8.3
1940	2,027	27	2,000	1,807	185	8	193	9.7
1941	1,557	19	1,538	1,412	125	1	126	8.2
1942	418	2	416	405	8	3	11	2.6
1943	685	16	669	587	76	6	82	12.3
1944	2,466	12	2,454	2,166	278	10	288	11.7
1945	4,912	45	4,867	4,212	602	53	655	13.5

Source: Commercial and Financial Chronicle series: 1941-1945, Commercial and Financial Chronicle, Vol. 163, No. 4459 (January 28, 1946), p. 507; prior years, Statistical Abstract of the United States, annual volumes.

1/ Preferred stocks of no par value and all common stocks are taken at their offering price, other issues at par.
2/ Less than $0.5 million.

APPENDIX D

Net Savings of Corporations and Individuals, 1/ 1929-1945

(Billions of dollars)

Calendar year	National income	Net savings of corporations 2/	Net savings of individuals including unincorporated businesses 2/
1929	83.3	1.2	8.8
1930	68.9	- 3.9	5.8
1931	54.5	- 5.8	5.4
1932	40.0	- 6.4	2.6
1933	42.3	- 2.8	2.1
1934	49.5	- 2.1	3.3
1935	55.7	- 1.3	4.1
1936	64.9	- 0.9	6.1
1937	71.5	- 0.8	6.7
1938	64.2	- 1.5	4.4
1939	70.8	0.4	6.0
1940	77.6	1.8	7.5
1941	96.9	4.0	14.2
1942	122.2	4.4	28.6
1943	149.4	5.5	33.3
1944	160.7	5.4	38.9
1945	161.0	4.5	34.9

Source: Estimates of the Department of Commerce, Survey of Current Business, May, 1942; March, 1943; and February, 1946.

1/ These estimates are derived from figures used in national income estimates, and must be interpreted in that light. The national-income estimate of corporate profits, for example, excludes capital items, such as capital gains and losses and inventory revaluations. Therefore, the estimate of net corporate savings given here differs from the figure that can be derived from Statistics of Income.

2/ The definition of net savings for corporations differs somewhat from that of net savings for individuals. For corporations, allowances for depreciation, depletion, and other business reserves are deducted before arriving at the net savings figure. For individuals, similar business reserves are deducted for unincorporated businesses, but such items as depreciation on owner-occupied houses and other consumers' durable goods are not deducted.