The Substantive Tax Reform Project: Preliminary Findings on the Corporate Tax

Charles O. Galvin

THE SUBSTANTIVE TAX REFORM PROJECT: PRELIMINARY FINDINGS ON THE CORPORATE TAX*

by

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I. History of the Project

EVEN before the sixteenth amendment, the Corporation Excise Tax of 1909 had provided for an excise tax on all corporations measured by a percentage of income.[1] In the beginning rates on corporate and individual incomes were modest. The corporate rate under the 1909 Act was one per cent on incomes over $5,000. During subsequent years rates progressed steadily upward, so that by the time of the Revenue Act of 1951 a normal tax of thirty per cent was imposed on all income and an additional twenty-two per cent on income over $25,000. The Revenue Act of 1964 reduced the normal tax to twenty-two per cent and increased the surtax on incomes over $25,000 to twenty-six per cent. In addition to the corporate income tax, excess profits taxes were imposed during World War I, World War II, and the Korean War.

With respect to individual incomes, a normal tax of one per cent and a surtax rate of one per cent progressing to six per cent were imposed under the 1913 Act. In World War I the surtax rate progressed to sixty-five per cent at the top. Normal tax and surtax rates were reduced in the Twenties, the surtax rate at the highest bracket being twenty per cent for the years 1925 to 1931. Both normal and surtax rates were increased in the Thirties to finance the social and economic legislation of the New Deal Era and increased further in the Forties to finance World War II, with a normal tax of three per cent and a top surtax rate of ninety-one per cent.[2] Some re-

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[1] The constitutionality of this tax was sustained in Flint v. Stone Tracy Co., 220 U.S. 107 (1911). The court refused to follow Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895) which had declared the income tax imposed by the Wilson Tariff Act of 1894 unconstitutional:

> Within the category of indirect taxation, as we shall have further occasion to show, is embraced a tax upon business done in a corporate capacity, which is the subject-matter of the tax imposed in the act under consideration. The *Pollock Case* construed the tax there levied as direct, because it was imposed upon property simply because of its ownership. In the present case the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax, measured by the standard prescribed. The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way.

220 U.S. at 150.

[2] Historically, there have been two income taxes: a normal tax and a surtax. The normal tax was generally a flat rate, and the surtax, a progressive rate, relatively much higher than the normal tax. In 1954 Congress combined the two into a single rate table but interest on certain obligations of the United States was exempted from normal tax. Therefore Int. Rev. Code of 1954, § 1(c) provides for a calculation of the tax in these cases by eliminating the 3% normal tax.

ductions were made for the years 1946 to 1950, but higher rates were restored to finance the Korean War; rates thereafter remained substantially high until the reductions effected in 1964.

Until the Forties, individual and corporate rates were not high enough to cause any profound concern about the income tax. Following World War II, however, individuals and business organizations evinced greater concern about the tax. Although economists had been writing about different kinds of taxes for a number of years, it was not until the post-World War II period that legal scholars began to give any significant attention to the subject. Indeed, prior to World War II, only a few law schools offered a separate course in federal taxation, and the offering of multiple courses in taxation in the curricula of law schools did not emerge generally until the late Forties and early Fifties. The two disciplines, law and economics, went their separate ways. Economists wrote on the shifting and incidence of taxes, the effect of different kinds of taxes on allocation of resources, and the development of economic models in which the tax factor was significant. Legal scholars were largely concerned with technical analysis of tax rules and critiques of the tax impact on various business and investment patterns. The emphasis in economic writing was on macro-economic analysis; in legal writing the emphasis was on the application of the law to particular transactional patterns. In the Fifties the Joint Committee on the Economic Report and the House Committee on Ways and Means inaugurated multidisciplinary discussions on tax policy for the future.[3] These efforts constituted the first major broad scale consideration of tax reform.

It was against this background that the Section of Taxation of the American Bar Association undertook a major effort in substantive tax reform in 1962. A Special Committee on Substantive Tax Reform was organized to consider fundamental changes in federal tax policy. This was the first time that a group of private practitioners had undertaken such a project.[4] By early 1964, the committee had delineated nineteen items for particular study and requested the Treasury Department to supply certain statistical data with respect to them.[5] The committee was aware that these items were only a beginning, but it believed that the data would provide important insights into the general problem and suggest further areas of exploration. As a trial run the committee proposed an individual income tax rate schedule of ten to forty per cent and a corporate rate of forty per cent.

After extensive work in the development of analyses on various assump-

[3] *See, e.g., Hearings on General Revenue Revision Before the Comm. on Ways and Means*, 85th Cong., 2d Sess. (1958); HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM (3 vols.) (Comm. Print 1960); HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., PANEL DISCUSSIONS ON INCOME TAX REVISION (Comm. Print 1960); JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY (Comm. Print 1956).

[4] *See Report of the Board of Governors*, 88 ABA REP. 468-70 (1963); *Resolutions on Substantive Tax Reform*, 16 ABA TAX SECTION ANN. REP. 4-5 (1963). *See also* Galvin, *Tax Reform—What? Again?*, 17 SW. L.J. 203 (1963).

[5] *Report of the Special Comm. on Substantive Tax Reform*, 17 ABA TAX SECTION ANN. REP. 277, 282 (1964).

tions, the committee concluded that a group of lawyers working as volunteers on a professional project could not hope to gather all the relevant data and make the necessary detailed research without a full-time staff.[6] Accordingly, appropriate recommendations were made through the Section of Taxation to the Board of Governors of the American Bar Association, and, as a result, a special committee was organized to present the project to the American Bar Foundation under the directorship of Arthur B. Willis, Esq., of the Los Angeles Bar.[7] The Foundation in early 1967 agreed to sponsor a pilot, or demonstration, project.

Dr. Benjamin Okner, formerly associate professor of economics at Ohio State University, served during the summer of 1967 as principal investigator and then accepted a position on the staff of The Brookings Institution.[8] Thereafter, the American Bar Foundation, in cooperation with Southern Methodist University, continued the project under Mr. Willis's direction with Doctors David J. and Attiat Ott of the Department of Economics of Southern Methodist University, as principal investigators. Also contributing to the project were Professor Robert A. Bernstein and this author of the School of Law of Southern Methodist University, and Messrs. Gary A. Robbins, Robert W. Tinney, and J. Scott Turner, graduate student assistants to the Doctors Ott. A comprehensive report of the project will appear in the American Bar Foundation-Southern Methodist University publication: *Studies in Substantive Tax Reform.* The Foundation's declination to give further support to the project is regrettable in view of the excellent working team which Mr. Willis had assembled. However, the comprehensive report may induce others to continue this most necessary research, the results of which affect the economic welfare of the entire nation.

II. Summary of Principal Findings

Economists frequently allude to a concept of income consistent with what is known as the Haig-Simons definition; that is, between two points of time, income consists of net accretions to wealth, or power of consumption, plus the value of transfers of wealth and the market value of rights exercised in consumption.[9] In developing two models of a broadened tax base (BTB_1 and BTB_2) the Otts applied the Haig-Simons definition using

[6] The Committee emphasized that it took no position with respect to any area of inquiry. Nevertheless, various groups objected strenuously to the work of the Committee. *See* Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Galvin, *Progress in Substantive Tax Reform; Work of the American Bar Association; Treasury Studies; What Tax Practitioners Can Do*, U. SO. CAL. 1965 TAX INST. 1; Willis, *A New Approach to Substantive Tax Reform: A Lawyer's Views*, U. SO. CAL. 1968 TAX INST. 845; *Report of the Special Committee on Substantive Tax Reform*, 21 ABA TAX. SECTION ANN. REP. 734 (1968).

[7] *Report of the Special Comm. on Substantive Tax Reform*, 90 ABA REP. 555 (1965).

[8] For Okner's economic and statistical analysis of proposals for changes in the income tax, see B. OKNER, INCOME DISTRIBUTION AND THE FEDERAL INCOME TAX 77-81 (1966).

[9] H. SIMONS, PERSONAL INCOME TAXATION 61-62, 206 (1938); Haig, *The Concept of Income —Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921). The principle of the Haig-Simons definition has been adopted by the Canadian Royal Commission on Taxation. 3 REPORT OF THE ROYAL COMM'N ON TAXATION (CANADA) 39 (1966).

such data as could be analyzed and programmed on the computer within the limits of time and resources available. Their major findings are summarized in Table 1.

TABLE 1

SUMMARY OF EFFECTS OF BASE BROADENING ON THE TAX BASE; A COMPARISON OF THE ALTERNATIVE TAX BASES (BTB_1 AND BTB_2)

Item	BTB_1	BTB_2
1. Old Tax Base (billions of dollars)	230.4	230.4
2. New Tax Base (billions of dollars)	481.6	501.3
3. Change in Tax Base (billions of dollars)	251.2	270.9*
a. State and local bonds interest	1.1	1.1
b. Interest on life insurance	1.7	1.7
c. Employer's contribution to and interest on profit sharing and pension plans	7.0	7.0
d. 1. Partnership treatment of corporate profits	44.1	—
2. Dividends plus capital gains (realized and unrealized) on corporate stock	—	58.6
e. Deductions and exemptions	179.5	179.5
f. Realized capital gains as ordinary income	11.2	—
g. Old Age Insurance benefits	3.6	3.6
h. Social Security survivors' benefits	.2	.2
i. Imputed rent	—	28.7
j. Unemployment compensation	2.2	2.2
k. Sick pay	.6	.6

* The sum of items a. through k. equals $283.2 billion under BTB_2. Items e. and i. were calculated separately and, in each calculation, mortgage interest on homes ($6.4 billion) and real estate taxes on homes ($5.9 billion) were treated as nondeductible items. Therefore, the total of $12.3 billion must be eliminated from either item e. or item i. The resultant addition to base is $270.9 billion ($283.2-12.3 billion).

The major differences in BTB_1 and BTB_2 are that BTB_1 excludes imputed rent and attributes corporate profits to the shareholders as partnership income, whereas BTB_2 includes imputed rent on owner-occupied dwellings, "grosses up" dividends as if there were no corporate tax, and includes the full amount of capital gains, realized and unrealized, on corporate stock.[10] The Otts used 1965 tax rates on 1964 revenues as obtained from the Tax File, a carefully selected group of 100,000 individual income tax returns for 1964.[11]

[10] Assume that a taxpayer owns a share of stock in which his cost, or basis is $100, that this share of the corporate earnings before corporate taxes with respect to this stock is $200, that the corporate tax is 50%, and that the corporate dividend distribution attributable to this share is $50. Under the calculations for BTB_2, the shareholder's dividend is "grossed up" as if there were no corporate tax, that is, by an additional $50 and the increase in the share value is also added to the shareholder's income. Thus, this method has approximately the same effect as the partnership treatment because it eliminates the tax at the corporate level and taxes the shareholder on dividends received on a gross-up basis plus the change in value of his stock.

[11] Four tapes have been prepared for the years 1960, 1962, 1964, and 1966. The Otts used the 1964 tape as the 1966 tape has become available only recently. The 100,000 returns were selected out of 65 million filed. Some information which does not appear on the returns had to be gleaned from other sources and programmed with the information appearing on the tape.

Table 2 reflects that a flat, or proportional, rate of 14.4 per cent on BTB_1 and 13.9 per cent on BTB_2 would produce the same revenue collected in 1964 under the progressive rate structure then in effect.[12] These results

TABLE 2

COMPARISON OF THE TAX REVENUE EFFECTS OF ALTERNATIVE BROAD TAX BASES

Item	BTB_1	BTB_2
1. Estimated Tax Revenue From Application of 1965 Tax Rates to 1964 Brookings Tax File (Before Tax Revision), plus Actual 1964 Tax Revenue From the Corporate Income Tax (billions of dollars)	69.7	69.7
2. Tax Revenue From BTB at 1965 Tax Rates (after revision) (billions of dollars)	113.3	126.4
3. Flat Tax Rate Needed to Raise Amount in 1[13]	14.4%	13.9%

become even more dramatic when one realizes that there are several major base-broadening items not taken into account in the Otts' calculations. Thus, in a major continuing project the base would be further broadened by the addition of (1) gifts, devises, and inheritances,[14] (2) gains on exchanges not recognized under present rules such as like-kind and reorganization exchanges, (3) unrealized appreciation in all property values,[15] (4) conversion of LIFO inventories to FIFO, (5) imputed rent on taxpayer occupancy or use of properties other than dwellings, (6) unreported income,[16] and so on. Without the recognition of these items, both BTB_1 and BTB_2 tend to have a bias against service-related income. What is significant from the Otts' preliminary findings is that a rate of twelve to fourteen per cent is possible under one of the broadest possible bases. A rate so low would provide opportunities for simplification, equity, and ease of administration and thereby eliminate much of the social cost incurred under the present system.

III. TAXATION OF THE CORPORATE INCOME STREAM

The Otts proceeded on the assumption that the choice of organizational form should not be influenced by a more onerous tax burden on one form

[12] The 14.4% rate is the result of using the tax base of $481.6 billion of BTB_1 and dividing into the actual individual and corporate income tax revenue of $69.7 billion. The 13.9% rate is determined by dividing BTB_2 of $501.3 billion into $69.7 billion.

[13] *See* note 12 *supra*.

[14] Bittker estimates that transfers of wealth by death in 1953 amounted to $23.3 billion. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 945 (1967).

[15] It has been estimated that the inclusion of appreciation on publicly held stock (not all stock or all assets) as ordinary income would have increased the individual income tax yield in 1965 by at least $15 to $26 billion. Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 631-32 (1967). The Otts have calculated that in 1964 the addition to taxable base by including unrealized appreciation would be about $35 billion. They did not break this figure out separately to obtain the effect on revenue in AGI classes.

[16] In 1959 Surrey noted that unreported income might be as high as $26.5 billion. Surrey, *The Federal Income Tax Base for Individuals*, in HOUSE COMMITTEE ON WAYS AND MEANS, 86TH CONG., 1ST SESS., 1 TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1, 11 (Comm. Print 1959).

as compared with others. It is contended that those who pool their capital to operate a business should have the same after-tax effect on the business profits irrespective of whether they operate in general partnership, limited partnership, pool, syndicate, corporation, or some other form of business association. A contrary argument is that the limited-liability feature of corporate operation permits the amassing of capital to form the industrial giants of modern American business, and, therefore, this feature is properly susceptible to some surcharge.[17] The study proceeded on the assumption that if the double taxation of the corporate income stream should be eliminated, several desirable mechanisms could be used: (1) The entire corporate income could be attributed to the shareholders on a partnership basis similar to the pattern of present Subchapter S. (2) The corporate income could be subject to tax at a rate equal to, say, the highest individual income tax-rate; and as income is distributed, the shareholder would "gross up" his dividend receipt by the amount of tax paid at the corporate level on his share of corporate earnings and claim a credit for the tax thus withheld. This technique is similar to that now applied in the case of withholding on wages and salaries and foreign taxes paid at the source on corporate distributions.[18] (3) The corporation could claim a deduction for dividends paid. (4) The dividends, once taxed at the corporate level, would be excluded from the shareholder's gross income, a technique presently recognized to a limited extent in the case of the $100 dividend exclusion. Taking into account the revenue costs resulting from these methods and the argument, alluded to above, that some differential in tax cost may be justified for the corporate operation, the Otts then explored one modification—the constrained credit—a device which does not eliminate all the double tax on the corporate income stream.[19]

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[17] *See* R. GOODE, THE CORPORATION INCOME TAX 24-40 (1951).

[18] The gross-up-and-credit method is explained in Willis, *Comments and Observations by the Project Director*, in STUDIES IN SUBSTANTIVE TAX REFORM (1968):

> Under the full credit concept, individuals receiving dividends whose marginal tax rate was less than the corporate tax rate would receive a refund. Thus, assuming an individual whose marginal tax rate on his dividend income was 20 per cent and assuming a corporate tax rate of 48 per cent, he would receive a refund (or a credit against income tax owed on other income) of 28 per cent of his grossed-up dividend income. On $520 of actual dividend income, he would receive a refund (or its equivalent) of $280, computed as follows:
>
> | | |
> |---|---|
> | Actual dividend income | $520 |
> | Dividend income after gross-up for 48% corporate tax | $1,000 |
> | Tax payable on $1,000 of grossed-up dividend income (marginal rate of 20%) | $200 |
> | Credit for corporate tax (at 48%) | $480 |
> | Net tax or (refund) | $(280) |
>
> Thus, the low bracket taxpayer in this example really would receive $800 ($520 plus $280) of tax free income. What capital gain treatment can possibly be that good!

[19] The constrained credit would limit the credit allowed for the corporate tax by the taxpayer-recipient's actual tax computed at his marginal tax rate on his grossed-up dividend income. Thus, in the example given in note 10 *supra*, the constrained credit would be $200, computed as follows:

Actual dividend income	$520
Dividend income after gross-up for 48% corporate tax	$1,000
Tax payable on $1,000 of grossed-up dividend income, assuming the marginal rate to be 20%	$200
Credit for corporate tax, limited to tax paid on dividend	$200
Refund	-0-

TABLE 3

PARTNERSHIP TREATMENT OF CORPORATE INCOME

(millions of dollars)

Adjusted Gross Income Class	*Amount Imputed*		*Change in Tax Revenue from Imputation*		*Change in Tax Revenue after Removing Imputation from BTB*
0- 600	208		50		59
600- 1500	509		81		96
1500- 3000	1,598	23%	285	12%	342
3000- 5000	2,495		533		641
5000- 7000	2,168	50%	539	33%	627
7000- 10000	3,557		1,008		1,161
10000- 15000	4,931		1,586		1,814
15000- 20000	3,917		1,503		1,708
20000- 25000	2,423		1,025		1,160
25000- 50000	7,809		4,049		4,379
50000-100000	6,193		3,847		4,025
100000-500000	5,985		4,122		4,178
50000-over	2,341		1,638		1,639
Total	44,134		20,265		21,830

Table 3 is an analysis of the partnership treatment of corporate income.[20] Under the partnership treatment approximately twenty-three per cent of the imputed income occurs in brackets from $0-10,000 and these brackets account for approximately twelve per cent of the added revenue. Similarly, approximately fifty per cent of the imputed income occurs in brackets from $0-25,000 and these brackets account for approximately thirty-three per cent of the added revenue. These figures belie the contention that the partnership treatment would soak the rich.

Professor Bernstein in his comments on the Otts' findings has considered the partnership treatment as "probably unworkable, and possibly unconstitutional, as applied to large publicly-held corporations."[21] The administrative problems are formidable. The stockholder of a large corporation would have to account for his aliquot share of corporate income, and unless the corporation distributed sufficient cash, he would have the problem of seeking funds from other sources to meet the tax liability. Other problems would include the determination of the date the share of earnings would be allocated, the burden of record-keeping imposed on the stockholder, the handling of adjustments to corporate income of prior years, the calculation of the allocable share of income in cases in which there are several classes of stock with varying rights in corporate earnings, and the

[20] Table 3 is typical of many similar tables relating to the analysis of base broadening items. The Otts devised an ingenious method of presenting as to each base broadening item the tax revenue by AGI classes as if the particular item were the *only* item added to the base and the difference in tax revenue if *all* base broadening items were considered and the particular item was "peeled off."

[21] Bernstein, *Some Legal Consideration in Substantive Tax Reform Proposals*, in STUDIES IN SUBSTANTIVE TAX REFORM (1968).

treatment of shareholder recipients who under present rules are tax-exempt.[22]

Table 4 reflects the results of the "gross-up-and-credit" method, pursuant to which the tax withheld at the corporate level would be added to the recipient-shareholder's income and credited to his tax liability. It is as-

TABLE 4

REVENUE EFFECTS OF GROSS-UP AND FULL CREDIT OF DIVIDENDS, 1964

(millions of dollars)
(zero shifting)
(no change in dividends)

Adjusted Gross Income Class	*Change in Tax Revenue*
0- 600	- 41.0
600- 1500	- 102.0
1500- 3000	- 327.3
3000- 5000	- 504.0
5000- 7000	- 418.2
7000- 10000	- 660.0
10000- 15000	- 877.7
15000- 20000	- 666.0
20000- 25000	- 392.1
25000- 50000	-1,091.4
50000-100000	- 682.3
100000-500000	- 512.3
500000-over	- 185.8
Total	-6,460.1

sumed that (1) the corporate tax is not shifted, and that (2) dividend distributions remain unaffected. With respect to these two qualifiers, some comment should be made. In an economy of monopolistic competition the corporate managers may shift the tax to the consumers in price or to one of the production factors—labor, land, capital—in reduction of cost. If the corporate tax is susceptible of 100 per cent shifting, the effect on shareholders is the same as if there were no tax.[23] The shifting effect may be illustrated by the following example. Assume a selling price of $200, costs of $100, a net income of $100, and a corporate tax of fifty per cent which is not shifted, shifted fifty per cent, and shifted one hundred per cent.

	Col. 1 No tax	*Col. 2 No shifting*	*Col. 3 50% shifting*	*Col. 4 100% shifting*
Price	$200	$200	$233.3	$300
Cost	100	100	100	100
Pre-tax net income	100	100	133.3	200
Corporate tax	-	50	66.6	100
After-tax net income distributed	100	50	66.6	100
Gross-up	100	100	100	100
Credit	-	50	33.3	-

[22] *Id.*

[23] R. GOODE, THE CORPORATION INCOME TAX 44 (1951).

In column 1 it is assumed that there is no corporate tax and all profits are distributed. In column 2, if no part of the tax is shifted, or stated otherwise, if the shareholders bear all the corporate tax, then the shareholders are entitled to a full gross-up and credit to place themselves in the same position as if no corporate tax were imposed. In column 3 it is assumed that the corporate managers are able to make a price adjustment to shift the tax to the consumer. In such case, only half the corporate tax is borne by the shareholders; therefore, the gross-up and credit equals half the tax.[24] In column 4, there is complete shifting of the tax through price adjustment; therefore, no gross-up and credit is applied.

Table 5 reflects the effect of changes in dividend policy assuming the gross-up and credit would impel an increase in dividends. Even with a

TABLE 5

REVENUE EFFECTS OF GROSS-UP AND FULL CREDIT OF DIVIDENDS, 1964

(millions of dollars)

(zero shifting)

Adjusted Gross Income Class	*No Change in Dividends*	*50% Rise in Dividends*	*100% Rise in Dividends*
0- 600	- 41.0	- 54.1	- 65.1
600- 1500	- 102.0	- 144.1	- 184.8
1500- 3000	- 327.3	- 455.0	- 576.1
3000- 5000	- 504.0	- 685.2	- 847.6
5000- 7000	- 418.2	- 555.5	- 672.2
7000- 10000	- 660.0	- 849.5	-1,003.6
10000- 15000	- 877.7	-1,089.3	-1,251.3
15000- 20000	- 666.0	- 773.9	- 834.5
20000- 25000	- 392.1	- 432.6	- 445.4
25000- 50000	-1,091.4	-1,015.5	- 858.9
50000-100000	- 682.3	- 443.8	- 164.3
100000-500000	- 512.3	- 165.7	187.9
500000-over	- 185.8	- 44.4	97.1
Total	-6,460.1	-6,708.5	-6,618.7

fifty per cent and one hundred per cent increase in dividends, the revenue effects are not significantly different.[25] This is an important revelation, for

[24] The Otts used the formula $P = \frac{P^1}{1-St}$ where P is the pre-tax corporate net income, P^1 is the corporate net income if there were no tax, t is the tax, and S is the shifting parameter. M. KRZYZANIAK & R. MUSGRAVE, THE SHIFTING OF THE CORPORATE INCOME TAX: AN EMPIRICAL STUDY OF ITS SHORT-RUN EFFECTS UPON THE RATE OF RETURNS 11-12 (1963). As an example, suppose that the corporate tax rate, t, is equal to 50%, the corporate net income if there were no tax, P^1, is $100, and the corporation can shift 50% of the tax. Assume that all corporate income after taxes is distributed. Then $P = \frac{100}{1-.50x.50}$, or P = $133. Thus, the corporate managers will make a price adjustment or reduce costs to increase pre-tax net income by $33. This is illustrated in col. 3.

[25] In the lower adjusted gross income groups the increase in dividends causes an increase in the tax revenue loss because the tax credit is greater than the marginal tax rate which the individual pays on dividend income. The trend changes in the $15-20,000 group because the marginal tax rate is approximately equal to the corporate rate; increases in tax revenue in these brackets are almost

if a change in corporate tax policy which would induce larger dividend distributions should have a serious effect either for or against the fisc, such change in policy would have to be approached warily.[26] This, however, seems not to be the case from the Otts' findings. In the long run, of course, the gross-up-and-credit method tends to approach, but never reaches, the same result as the partnership method; that is, if all corporate earnings were distributed, then, assuming no shifting, all taxes would be grossed up and credited at the shareholder level.[27]

As has been mentioned above, the revenue implications of a full gross-up and credit suggested some compromise proposal. Assuming that dividends received were grossed up by the amount of the tax paid at the corporate level, the Otts then determined the revenue implications of constraining, or restricting, the credit so that a taxpayer would claim the credit against his tax but could not claim a refund. The constrained credit may be critized as working haphazardly on individuals and thereby producing inequities. Thus, two individuals, each with the same salary, and each with the same dividend income, but one having an unexpected loss in some extraneous transaction, would have different tax consequences as to dividends. One would receive the full credit; the other, after deducting his loss, might produce a much reduced tax liability which would limit the

TABLE 6

REVENUE EFFECT OF GROSS-UP AND CONSTRAINED CREDIT OF DIVIDENDS, 1964

(millions of dollars)
(zero shifting)
(no changes in dividends)

Adjusted Gross Income Class	*Change in Tax Revenue*
0- 600	- 8.2
600- 1500	- 14.3
1500- 3000	- 52.6
3000- 5000	- 89.8
5000- 7000	- 77.1
7000- 10000	- 131.6
10000- 15000	- 193.2
15000- 20000	- 185.2
20000- 25000	- 122.8
25000- 50000	- 498.3
50000-100000	- 521.1
100000-500000	- 506.5
500000-over	- 185.7
Total	-2,586.5

entirely offset by the tax credit. In the highest brackets, the increases in dividends are not entirely offset by the credit, and as the dividend income is doubled in these brackets, the credit factor becomes a smaller percentage of the tax on the dividend.

This offsetting of the effect on the lower income groups against that experienced in the higher income groups also explains why the revenue loss, assuming a 50% rise in dividends, is about the same as the revenue loss, assuming a 100% rise in dividends.

[26] Brittain notes that if 1929 income tax rates had been in effect in 1947 the payout ratio would have been 40 percentage points higher and dividends would have been 112% higher than they were in 1947. J. BRITTAIN, CORPORATE DIVIDEND POLICY 205 (1966).

[27] If the dividend-profits ratio were 1, then all corporate profits would be taxed at the stockholder-recipients' respective tax rates.

dividends-received credit. Table 6 is the result of this study. Note that the revenue loss under the constrained credit is $2.586 billion as contrasted with $6.460 billion under the full credit. Table 7 is the result of the constrained credit assuming a fifty per cent and a one hundred per cent rise in dividends respectively.

TABLE 7

REVENUE EFFECT OF GROSS-UP AND CONSTRAINED CREDIT OF DIVIDENDS, 1964

(millions of dollars)
(zero shifting)

Adjusted Gross Income Class	*No Change in Dividends*	*50% Rise in Dividends*	*100% Rise in Dividends*
0- 600	- 8.2	- 9.5	- 10.3
600- 1500	- 14.3	- 15.0	- 15.5
1500- 3000	- 52.6	- 54.4	- 56.1
3000- 5000	- 89.8	- 91.4	- 92.8
5000- 7000	- 77.1	- 74.1	- 71.0
7000- 10000	- 131.6	- 123.1	-114.3
10000- 15000	- 193.2	- 171.4	-148.8
15000- 20000	- 185.2	- 163.6	-137.3
20000- 25000	- 122.8	- 102.2	- 70.7
25000- 50000	- 498.3	- 368.3	-184.3
50000-100000	- 521.1	- 309.8	- 45.5
100000-500000	- 506.5	- 162.5	190.1
500000-over	- 185.7	- 44.4	97.1
Total	-2,586.5	-1,689.5	-659.6

TABLE 8

REVENUE EFFECTS OF ALTERNATIVE TAX TREATMENTS OF DIVIDENDS: GROSS-UP AND FULL CREDIT, GROSS-UP AND CONSTRAINED CREDIT, AND 100% DIVIDEND EXCLUSION

(millions of dollars)
(zero shifting)
(no changes in dividends)

Adjusted Gross Income Class	*Gross-Up and Full Credit*		*Gross-Up and Constrained Credit*		*100% Dividend Exclusion*	
0- 600	- 41.0	15%	- 8.2	6.4%	0.0	1.7%
600- 1500	- 102.0		- 14.3		- .3	
1500- 3000	- 327.3		- 52.6		- 6.7	
3000- 5000	- 504.0		- 89.8		- 34.8	
5000- 7000	- 418.2		- 77.1		- 56.9	
7000- 10000	- 660.0		- 131.6		- 95.8	
10000- 15000	- 877.7		- 193.2		- 179.5	
15000- 20000	- 666.0		- 185.2		- 176.6	
20000- 25000	- 392.1	38%	- 122.8	66%	- 136.3	73%
25000- 50000	-1,091.4		- 498.3		- 513.1	
50000-100000	- 682.3		- 521.1		- 573.6	
100000-500000	- 512.3		- 506.5		- 531.8	
500000-over	- 185.8		- 185.7		- 131.4	
Total	-6,460.1		-2,586.5		-2,436.8	

Table 8 compares the two methods—gross-up and full credit and gross-up and constrained credit—with a complete exclusion of dividend income from the taxable base of individuals. In adjusted gross income (AGI) classes $0-5000 the "full credit" accounts for fifteen per cent of the revenue loss, the constrained credit for 6.4 per cent of the revenue loss, and the dividend exclusion, 1.7 per cent of the revenue loss.[28] The AGI brackets of $25,000 and above would account for thirty-eight per cent of the revenue loss under the full credit, sixty-six per cent under the constrained credit, and seventy-three per cent under the dividend exclusion. Allowing a deduction to the corporation for dividends distributed, the revenue loss is the same as the gross-up and full credit. These significantly different allocations of effect among AGI classes require a more intensive analysis in order to provide the basis for policy choices.

As was noted earlier, BTB_2 also assumes that sales of corporate stock and unrealized appreciation in stock at the end of the year would be included in full as part of the taxable base. Thus, the $58.6 billion of added base consists of $35 billion in net unrealized increments in stock value, $11.2 billion of previously nonincluded capital gains on stock sales, and $12.4 billion of grossed up dividends.

IV. Influence on Corporate Managers and Shareholders

All the tabulations previously described relate to first-order effects; thus, in each case the assumption has been that the actions of corporate managers in the money market remain the same. Any major study in substantive tax reform would have to consider second-order and third-order effects in response to fundamental changes in corporate tax policy.[29] All of the methods described would probably have the effect of impelling greater distributions of corporate earnings than at present. Growth companies would tend to distribute earnings and then resort to the money market for new capital. If dividends were nontaxable, or if the shareholder could look forward to credits for taxes paid at the corporate level, he would probably withdraw funds from interest-bearing securities in favor of stock investments. Thus, there would be a tendency to cause a flight from savings and loan and similar accounts. On the other hand, the treatment of realized and unrealized capital gains as part of the taxable base would have countervailing effects on the attractiveness of the stock market investments. The reallocation of resources against the background of such fundamental changes in tax policy would have to be carefully analyzed in a long range project.

Of special significance would be the effect on closely held corporations.

[28] The gross-up-and-full-credit will produce refunds in the lower brackets, because the taxpayers' marginal rates are less than the corporate tax rate. When the credit is constrained, the refunds in the lower brackets are eliminated so that these brackets do not contribute as much to the overall loss in revenue as is the case with the full credit. In the case of the 100% dividend exclusion there is neither a grossing-up factor nor a refund or credit factor in the lower brackets so that the contribution to the overall revenue loss from these brackets is relatively smaller than in either of the other two methods.

[29] For a recent analysis of second-order and third-order effects of present tax policy, see R. Barlow, H. Brazier & J. Morgan, Economic Behavior of the Affluent 151-71 (1966).

At present, these corporations tend to pay as large salaries as possible to officer-stockholders and little or no dividends. The threat of section 531[30] taxes often impels the owners to sell to or exchange stock with larger, listed, companies in order to bail out accumulated earnings at capital gains and to achieve estate liquidity. Under the various mechanisms described herein, the complex statutory provisions, regulations, rulings, and problems of administration and compliance relating to unreasonable accumulations of earnings,[31] personal holding companies,[32] collapsible corporations,[33] redemptions of stock,[34] and the like, could be reduced to a minimum or eliminated altogether.

All of the foregoing considerations relating to effects on corporate managers and shareholders must be considered in light of substantial reduction in rates. If substantive tax reform means anything, it must mean drastic reduction in rates. Whether it be a flat rate of, say, ten to fifteen per cent, or a graduated rate from, say, five to thirty-five per cent, one cannot speculate on effects as the tax law *is* but as it *may come to be*. In making critical judgments about proposals, one finds it difficult not to look at them in the perspective of the present law, whereas personal motivations, interactions in the economy, and choices of business and investment activity would be quite different under a system of lower rates and a substantially broadened base.

V. The Report of the Royal Commission on Taxation

No discussion of the subject of substantive tax reform would be complete without reference to the recently published major study of the Canadian tax system (the Carter report).[35] There, much of the same rhetoric is employed to urge basic reform in tax policy. A broadened tax base conforming to the Haig-Simons definition, lower rates, and elimination of the double tax on corporate income, are included in the multi-volume report. With respect to the corporate tax, a so-called full-integration system was proposed as follows:

1. The income of Canadian corporations should be subject to a flat rate of tax of approximately 50 per cent.
2. Individuals and families should be subject to progressive rates of tax with a top marginal rate of 50 per cent.
3. The tax base of the resident shareholder should include the corporate income paid or allocated to him, 'grossed-up' for the corporation tax paid.
4. The resident shareholder should receive credit against his personal income tax liabilities for the full amount of the corporation tax paid in respect of the after-tax corporate income paid or allocated to him, with a refund if the credit exceeded the liability.
5. Realized gains or losses on corporate shares should be included in income and taxed at full progressive rates.

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[30] Int. Rev. Code of 1954, § 531.
[31] *Id.*
[32] *Id.* § 541.
[33] *Id.* § 341.
[34] *Id.* §§ 302, 337, 346.
[35] Report of the Royal Comm'n on Taxation (Canada) (6 vols.) (1966).

6. The corporation should be allowed to allocate after-tax corporate income to shareholders without having to pay cash dividends.
7. The cost basis of shares should be increased when the corporation allocated retained corporate earnings to shareholders, so that share gains resulting from the retention of earnings that had been taxed to the shareholder would not be taxed again to the shareholder when realized.[86]

It should be noted that the above proposals combine a gross-up-and-credit mechanism with an optional Subchapter S treatment; that is, after the gross-up and credit is applied to dividends received, the board of directors might allocate *retained* earnings on the partnership basis.

VI. Conclusion

The Substantive Tax Reform Project is a demonstration of the kind of research that must and ultimately will be carried forward by someone. It is my hope, of course, that lawyers will assume the leadership in this work as they have in other areas where efficiency and effectiveness of the laws were at stake. Lawyers have the skill and training to assemble and analyze facts, drawing upon the skills of other disciplines. Nor is this the kind of project that can be done by half-measures. The Canadians spent millions on the Carter report and certainly this country could do no less. The computer provides an invaluable new component in inter-disciplinary research. Data can be arranged in numerous patterns using a variety of assumptions and sub-assumptions not heretofore feasible or practicable.

In no area of inquiry is the need for careful critical analysis more important than that of the corporate tax. Whatever choice of policy is made as to the corporate tax will have profound significance on American industry and the incentives to the formation of capital in this country.

[86] 4 Report of the Royal Comm'n on Taxation (Canada) 7 (1966).