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ELIMINATING THE CAPITAL GAINS PREFERENCE. PART II: THE PROBLEM OF CORPORATE TAXATION*

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Although many different policies are reflected in regard to corporate taxation, two principal policies of the present tax system are evident. First, ordinary income is differentiated from capital gains. Second, the stockholder is distinguished from the corporation as a taxable entity. Both of these policies must be vigorously pursued if two separate systems of taxation—one for capital gains and another for ordinary income—are to be maintained. The present system, however, is inequitable and complex. Much of the complexity and many of the inequities could be eliminated by reforming the system. In particular, the preferential treatment of capital gains should be eliminated. To the extent that the separation of the stockholder and the corporation is premised on the distinction between ordinary income and capital gains, that separation should fall with the demise of capital gains.¹

Preferential treatment of capital gains under the present system results in substantial revenue loss to the government. It provides a "loophole" substantially and disproportionately benefitting high income persons. Moreover, it is a major source of complexity in the tax system. The capital gains preference has been justified as a remedy for a variety of problems such as inflation, bunching, lock-in, and double

¹This is the second of two parts of this article. For the first part, see Waggoner, Eliminating the Capital Gains Preference. Part I: The Problems of Inflation, Bunching, and Lock-In, 48 U. COLO. L. REV. 313 (1977).

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¹For other discussions of integrating the personal and corporate income taxes see Break, Integration of the Personal and Corporate Income Taxes, 22 NAT. TAX. J. 39 (1969); Hall, Integrating Corporate and Individual Income Taxes, in FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 682 (Joint Econ. Comm., Tax Policy Subcomm. 1955); McClure, Integration of the Personal and Corporate Income Taxes, 88 HARV. L. REV. 532 (1975); Symposium, The Taxation of Income from Corporate Shareholding, 28 NAT. TAX J. 255 (1975).

In a series of thoughtful articles Professor Blum proposed substantial revisions in corporate taxation short of integrating the personal and corporate income taxes. See Blum, Corporate Acquisitions Under the Income Tax: Another Approach, 50 TAXES 85 (1972); Blum, Taxing Transfers of Incorporated Businesses: A Proposal for Improvement, 52 TAXES 516 (1974); Blum, The Earnings & Profits Limitation on Dividend Income: A Reappraisal, 53 TAXES 68 (1975); Blum, Taxing the Corporate Shareholder—Some Old Problems Reconsidered, 53 TAXES 217 (1975); Blum, Drawing the Line Between Dividends and Investment Adjustments: A Proposal for More Consistency, 53 TAXES 30 (1977).
taxation of corporate earnings. Preferential treatment of capital gains, however, fails to respond adequately to these problems. Sometimes it provides too little relief, other times too much. If the tax laws presented a system of mechanisms more finely tuned to afford relief from these problems, the capital gains preference could be eliminated.

Part I of this article analyzed the present treatment of capital gains and the resulting problems. The article proposed mechanisms to relieve the problems of inflation, bunching, and lock-in. Part II provides an analysis of a number of different proposals designed to end the double taxation of corporate earnings. The first section outlines the complex mechanics of the present system of taxing corporations and shareholders, then discusses the adverse effects of that system. The next three sections discuss three alternative solutions to the problem of the double taxation of corporate earnings.

One solution to this problem would be partial integration. Under partial integration, dividends would be taxed only once but retained earnings would still be doubly taxed. Under one version of partial integration, the corporation would be allowed a deduction for dividends paid. Under the other version, the shareholder would be allowed a credit for taxes paid by the corporation on dividends he received. Although partial integration could be fairly easily implemented, it should be rejected because it would not solve the problem of double taxation of retained earnings and therefore would probably require retention of many of the complexities of the present system.

An alternative solution would tax shareholders on the benefits of stock ownership—stock appreciation (whether realized or not) and dividends—and repeal the corporate income tax. Although corporate earnings would no longer be doubly taxed, problems would arise in applying dividend and appreciation taxation to closely held corporations. Moreover, unless unrealized appreciation were generally recognized for tax purposes, taxing unrealized appreciation in regularly traded stock could distort investment decisions. Accordingly, this solution is not viable.

The recommended solution is full integration of the personal and corporate income taxes. Under full integration, the corporate income tax would be eliminated. Corporate earnings, whether or not distributed, would be currently taxed to shareholders. The shareholder’s basis of his stock would be increased as the corporation accumulated

4. See id. at 375-86.
earnings and reduced as those earnings were distributed. Although full integration would involve substantial administrative complexities, those social costs would be less than the social costs of the inequity, inefficiency and complexity of the present system of taxing corporations and shareholders.

The Current System

Its Operation

The present system of taxing corporations and shareholders is very intricate and therefore not widely understood. Because this article is intended for those unfamiliar with tax, as well as specialists, the basic system of taxing corporations and shareholders and its inconsistencies will be discussed first. The discussion will then turn to the complicated system created by taxpayers' attempts to exploit these inconsistencies and the government's response.

A corporation is a taxable entity. It computes its taxable income much as an individual would, adding together all of its items of gross income and then subtracting various allowable deductions. Thus a corporation's gross income might include gain on sales of some of its productive assets or investment property, the excess of gross receipts from sales of inventory property over the cost of goods sold, payment received for services, receipts of rent or interest, etc.; deductions might include losses on sales of property, depreciation, payment of rent or salary or interest, etc. Dividends paid to shareholders, however, are not deductible by the corporation in computing its taxable income.

5. Dividends would be taxable after the shareholder's basis in his stock had been recovered.
6. This discussion will focus on normal business corporations. Corporations of certain types such as banks, savings and loan companies, insurance companies, mutual funds, etc. are subject to special rules. See generally Clark, Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603 (1975); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 1.06 (3d ed. 1971) [hereinafter cited as Bittker & Eustice].
7. This statement is a simplification. For example, a corporation's deduction for charitable contributions is limited to 5% of its (modified) taxable income, whereas for an individual the deduction is limited to 50% or 20% of his (modified) adjusted gross income (compare I.R.C. § 170(b)(2) with I.R.C. § 170(b)(1)), and only individuals are allowed a deduction for personal exemptions (I.R.C. § 151). Unless otherwise indicated, all sections referred to are from the Internal Revenue Code of 1954, as amended, Title 26 of the United States Code, and will be cited in the form "Section XXXX." On the other hand, corporations are treated more generously than individuals in regard to the investment tax credit when they are lessors of property (Section 46(e)(3)), in regard to losses (Section 165(c)), and in regard to bad debts (Section 166(d)).
8. The Internal Revenue Code does not expressly disallow deduction of dividends paid. Rather, the Code provides that virtually anything may be includable in gross income under Section 61 unless otherwise provided, but an item is deductible only if authorized by some specific provision such as Section 162 (trade or business expenses) or Section 212 (expenses of investments). No provision generally authorizes a deduction for dividends paid by a corporation.
in contrast to interest payments which are deductible.\(^9\) Thus the amounts from which a corporation pays dividends have already been subjected to the federal income tax at the corporate level.\(^10\)

A shareholder is not taxed on undistributed corporate earnings or changes in the value of stock he continues to hold.\(^11\) The shareholder will be taxed only when the corporation pays dividends or when he sells or otherwise disposes of his stock. Dividends paid in cash or other property\(^12\) will usually be taxed to the shareholder at ordinary income rates if the corporation has "earnings and profits"\(^13\) for either the current year or past years. The shareholder will normally be taxed on stock sales at capital gains rates—half that of ordinary income—if the amount realized exceeds his adjusted basis.\(^14\) Similarly, amounts received on liquidation of a corporation will be treated as though received as payment in exchange for the stock, at capital gains rates.\(^15\)

Normally, then, corporate earnings are taxed once at the corporate level and again as ordinary income at the shareholder level, but the plan contains inconsistencies. These inconsistencies are apparent in the treatment of earnings and profits as well as distributions of appreciated property. If a corporation has undistributed earnings, the shareholder may not be taxed at ordinary income rates. If a shareholder sells his stock before the earnings and profits are distributed, he may be taxed at capital gains rates to the extent those earnings and profits have increased the price of the stock. The purchaser of the stock, however, will be taxed on a dividend of those earnings and profits at ordinary income rates even though the corporation had no

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9. Section 163.
10. Income tax rates are generally lower for corporations than for individuals. For corporations the rate is 20% on the first $25,000 of taxable income, 22% on the next $25,000, and 48% on the remainder. Section 11. For individuals filing a joint return, the rates are 0% to 32% on the first $25,000, 32% to 50% on the next $25,000, and 50% to 70% on the remainder. Section 1(a). Section 1348 limits the maximum rate on personal services taxable income to 50%.
11. Section 61(3) requires inclusion in income of "gains derived from dealings in property," and Section 1001 requires recognition of gain only if there has been a "sale or exchange," or a "sale or other disposition." Thus by negative inference, unrealized gains are not recognized for tax purposes. Eisner v. Macomber, 252 U.S. 189 (1920), held that unrealized gains and undistributed corporate earnings are not "income" within the meaning of the sixteenth amendment. Although as indicated in Part I, supra note 2, at 375-78, that decision's constitutional basis seems to have been eroded, it is still a valid statement of a principle generally followed under the present federal income tax.
12. A corporation's distribution of shares of its own stock normally is not taxable to the shareholders. Section 305.
13. Sections 301(c)(1), 316(a). The determination of "earnings and profits" is a complex matter beyond the scope of this article. See generally Bittker & Eustace, supra note 6, at § 7.03. For present purposes, "earnings and profits" may be considered to be after-tax corporate earnings, reduced by prior dividends.
15. Section 331.
earnings and profits while he held the stock.\textsuperscript{16} If the corporation is liquidated, no one will be taxed at ordinary income rates for those earnings and profits.\textsuperscript{17} The system is also inconsistent at the corporate level. For instance, a corporation is not taxed on the amount of appreciation for property distributed as a dividend or upon liquidation.\textsuperscript{18} Thus, the present system offers some relief from the harshness of double taxation but does so on a sporadic and inefficient basis.

Taxpayers have been ingenious in devising their own means of relief from the effects of double taxation. As a result, a very complex body of law has developed to resist these attempts to exploit various aspects of the system of taxing corporations and shareholders. This body of law deserves further discussion because its complexity demonstrates the necessity of reform.

One method of avoiding the double taxation of corporate earnings is to avoid the corporate-level tax. A popular scheme has been to disguise dividends in the form of deductible payments. A great deal of litigation has arisen over the characterization of payments as interest or salaries rather than dividends. Corporate payments cast as rentals, royalties, and fees for guaranteeing corporate obligations also reflect potential for disguising dividends. The characterization of these payments has largely been left for determination on a case-by-case basis with relatively little guidance from legislation or tax regulations.\textsuperscript{19}

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\textsuperscript{16} In contrast, only interest accrued while a taxpayer held an obligation is taxable to him. To the extent of past accrued interest, gain to the seller will be interest income; payment of interest accrued before a taxpayer acquired an obligation will not be interest income but will reduce basis. Treas. Reg. § 1.61-7(c)-7(d) (1957).

An example might make this inconsistency clear. Suppose A owns a vending machine. When the coin box is full, A sells the machine to B. A should have income as the coins go into the box, and B should not have income when he removes the coins that were in the box when he purchased the machine because he is merely recovering a part of the price he paid for the machine and the coins it contained. This is how the transaction would be taxed if the machine were a bond. But if the machine were a share of stock, B would be taxed as the coins were removed.

It may be that the market will compensate here. Just as the value of stock may increase to reflect retained earnings, it may decrease to reflect the tax consequences of receiving those earnings. See United States v. Phellis, 257 U.S. 156, 171-72 (1921).

\textsuperscript{17} Under Section 333, in liquidating a corporation, shareholders may elect to be taxed on earnings and profits as a dividend and on the difference between the value of property received and their basis in their stock as capital gain only to the extent that money and securities received exceed each’s ratable share of earnings and profits. This election is advantageous where the corporation has little earnings and profits but has property worth much more than its shareholders’ bases in their stock.

\textsuperscript{18} Sections 311(a), 336. Section 311(d) requires a corporation to recognize gain in certain cases when it distributes appreciated property in redemption of stock.

\textsuperscript{19} For instance, Congress in 1969 authorized the Treasury Department to issue regulations differentiating stock from indebtedness, and thus dividends
The lack of clear guidance in this area may result in unequal treatment of taxpayers. Because of the difficulty in drawing clear lines in this area of ambiguous payments, some degree of uncertainty may be unavoidable as long as corporations and shareholders are treated as separate taxable entities.\(^2\)

Another method of avoiding the corporate-level tax is to distribute appreciated property. Because of Sections 311 and 336, the corporation normally will not be taxed on the appreciation. Whether the receipt of the appreciated property is taxed as a dividend or as a liquidation, the shareholder will normally have a basis in the property equal to its fair market value when distributed. In many cases the shareholders will immediately sell the distributed property, recognizing little or no gain. When the distributed assets consist of one or a few pieces of property, particularly when there are numerous shareholders, the corporation may seek potential buyers prior to the distribution. The corporation rather than the shareholder, however, may be treated as if it had sold the property, resulting in additional tax at the corporate level.\(^2\)

The uncertainty of determining the permissible level of corporate activity under these circumstances led to the enactment of Section 337. Under this section a corporation may avoid recognizing gain or loss on sales of its qualifying property after adopting a plan to liquidate within twelve months. These sales are treated as if the property had been distributed and then independently sold by the shareholders. One might question whether this narrow exception to the double taxation of corporate earnings is appropriate. Perhaps a more satisfactory solution would be to consider a corporate distribution of appreciated property as an appropriate time for the recognition of gain.\(^2\)

from interest. It was to consider factors such as whether there was an unconditional promise to pay at a fixed rate of interest for adequate consideration, whether the “debt” was subordinated, the debt/equity ratio, convertibility, and the relationship between debt and stock holdings. Section 385. Those regulations have not yet been issued. For an excellent discussion of tax and institutional issues involved in this area, see Note, Toward New Modes of Tax Decision Making—The Debt-Equity Imbroglio and Dislocations in Tax Lawmaking Responsibility, 83 Harv. L. Rev. 1695 (1970).

Section 162(a)(1) and Treas. Reg. § 1.162-7 (1958) provide general guidance in determining under what circumstances “salary” payments will be deductible. A case may turn on a determination that the father-employee dominated the shareholder-son. Harolds Club v. Commissioner, 340 F.2d 861 (9th Cir. 1965).

20. Others have suggested that the need for drawing a line might be reduced by eliminating the corporate interest deduction. See, e.g., Warren, The Corporate Interest Deduction: A Policy Evaluation, 83 Yale L.J. 1585 (1974). Under this approach it would, of course, still be necessary to distinguish dividends from salary, rent, etc.


22. Blum, Taxing Transfers of Incorporated Businesses: A Proposal for Improvement, 52 Taxes 516, 521-22 (1974), suggests that Section 337 be
Through the manipulation of the two principles that a corporation does not generally recognize gain on the distribution of appreciated property and that a shareholder may obtain capital gains treatment when a corporation is liquidated, the corporate level tax might be avoided and ordinary income converted to capital gains. For example, a corporation might be organized for the purpose of completing a project such as the construction of an apartment building or the production of a motion picture. Upon completion of the project, the corporation could be liquidated, producing no tax at the corporate level and only a capital gains tax at the shareholder level. Normally, these corporate profits would be taxed as ordinary income at both the corporate and shareholder level. Because of Section 341, a liquidation or the sale of the stock of such a “collapsible corporation” will usually produce ordinary income rather than capital gain. The application of Section 341, however, is very complex (it is notorious for containing a 600-word sentence, perhaps the longest in the Internal Revenue Code) and does not restrict the avoidance of the corporate level tax. Thus, Section 341 is an inadequate solution to the problem of “collapsible corporations.”

The corporation may also soften the effects of the double taxation of corporate earnings at the shareholder level by not paying dividends. The shareholder may be taxed later at capital gains rates or may not be taxed at all due to the step-up in basis at death under Sections 1014 and 1023.23 This approach may be particularly attractive when the shareholder’s marginal tax rate exceeds the corporation’s. A variety of barriers, however, restrict this form of tax avoidance.

eliminated, so that the corporation would be taxed on sales of its productive assets. The shareholder would then be given a credit to be applied against his tax liability when the corporation is liquidated for taxes paid by the corporation on such sales in the two prior years.

A few problems remain under Section 337. Corporations have been permitted to “straddle” the date of adoption of a Section 337 plan of liquidation by selling property at a loss before adopting the plan, thus recognizing the loss. The corporation then adopts a plan and thereafter sells other property at a gain which will not be recognized. See, e.g., City Bank of Washington v. Commissioner, 38 T.C. 713 (1962); Virginia Ice & Freezing Corp. v. Commissioner, 30 T.C. 1251 (1958). Also, when a corporation’s principal asset is involuntarily converted, the conversion will be treated as a sale. That sale normally will be treated as having occurred when the involuntary conversion occurred, without the corporation having had an opportunity to adopt a Section 337 plan. Central Tablet Mfg. Co. v. United States, 417 U.S. 673 (1974). Although that result seems to be required under a literal reading of the statute, those involved in a corporation whose principal assets are involuntarily converted, and who might as a business matter choose to liquidate the corporation, would seem to deserve the benefits of the plan, too. Under Section 1033 the corporation whose principal assets or other productive properties are involuntarily converted may elect to avoid recognizing gain by reinvesting the proceeds in productive assets “similar or related in service or use” or, under Section 1033(g), in “like kind” property.

23. These sections are discussed in Part I, supra note 2, at 372-74.
Penalty taxes are a significant deterrent to accumulating corporate earnings. Sections 531-537 may impose an accumulated earnings tax of up to 38% on a corporation which unreasonably accumulates its earnings rather than distributing them. 24 Sections 541-547 impose a 70% tax on undistributed personal holding company income of certain closely-held corporations with specified kinds and amounts of income from investments or from the performance of personal services. Application of the accumulated earnings tax and the personal holding company provisions is often complex; the taxes imposed are severe and may constitute a trap for the unwary. 25

Even if the penalty taxes are not imposed, there are practical and tax barriers to converting the retained earnings to cash. A shareholder might sell his stock to third parties. If the corporation is closely-held, however, outsiders may be unwilling to buy stock and the shareholders may be equally unwilling to welcome outside investors. If not for a number of specific provisions in the tax law, shareholders might be able to convert retained earnings to cash without resorting to dividend payments. For instance, each shareholder might sell some of his stock back to the corporation to obtain cash without changing control of the corporation. Although a sale of stock normally produces capital gains, because of Sections 302, 304 and 318, a stock redemption will frequently be taxed as a dividend even though the sale is made indirectly through other family members, related corporations, or certain other entities. 26 Alternatively, the corporation might distribute preferred stock to holders of its common stock. This is not usually a taxable event. The holders of common stock could then sell the preferred to outsiders, realizing capital gains, without jeopardizing the original stockholders' control of the corporation. To improve the market for the preferred, it could be promptly redeemable. If suc-

24. The tax has been held not to apply to publicly held corporations. Golconda Mining Corp. v. Commissioner, 507 F.2d 594 (9th Cir. 1974). The decision has been criticized. See, e.g., Farkas, Golconda Mining Corporation v. Commissioner and I.R.C. Section 531: Lucky Strike for Publicly Held Corporations, 47 U. Colo. L. Rev. 325 (1976).

25. Under Section 547 a corporation may declare a deficiency dividend after the IRS or a court has finally determined it to be liable for the personal holding company tax. This dividend will reduce the tax owed, but not interest or penalties. Under Section 565 a shareholder may consent to be taxed as though he had received a dividend, thus reducing the amount subject to penalty taxes. This relief is limited, however, because the consent must be filed not later than the due date for the corporation's income tax return. Treas. Reg. § 1.565-1(h)(3) (1960). At that time it may not be known whether the corporation is subject to the penalty tax or how large a dividend would be necessary to avoid imposition of the tax.

26. Such sales will not be treated as dividends if they satisfy the requirements of Section 302(b); for example, they terminate the shareholder's interest, they are substantially disproportionate, or they are otherwise not equivalent to a dividend. See also Section 346 which deals with partial liquidations.
cessful, the transaction would permit cash to be obtained from the corporation as capital gains rather than as ordinary income. Under Section 306, however, sale of stock received in a tax-free distribution may produce ordinary income.

Another means of extracting retained earnings from the corporation without paying ordinary income rates would be to break the corporation in two. The control and ownership of the business could be continued in one corporation with the surplus assets placed in the second corporation. Stock in the second corporation could be distributed tax-free to stockholders of the original corporation. Those stockholders could either liquidate the second corporation or sell it to outsiders, thereby obtaining capital gains rates. The purchasers could then liquidate the second corporation at little or no tax cost, recognizing gain only to the extent the value of the assets exceeded their basis in the stock. Because of Sections 355 and 356, however, the distribution of stock in the second corporation will be taxed as a dividend unless each corporation has been engaged in the active conduct of a trade or business for at least five years.

A final scheme for obtaining capital gains rates would be to liquidate a corporation with substantial retained earnings and then continue the business in another form. Because of the liquidation-reincorporation doctrine, if the business is reincarnated as a corporation, the purported liquidation will be taxed as a dividend.

Many of the provisions discussed above, as well as others not included in this survey, are intricate and imprecise. The complexity imposes a variety of social costs. They produce a system where corporate earnings are only sometimes doubly taxed. The result is an inequitable and inefficient tax system.

Equity and Economics

The complexity of the present system of taxing corporations and shareholders makes it difficult to analyze the system's effects. The system in general provides for double taxation of corporate earnings once at the corporate level and again at the shareholder level so that

27. See, e.g., Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954). The redemption would not be taxed as a dividend to the outsider, because it would terminate his interest in the corporation. Section 302(b)(3).

28. It should be noted that these restrictions, while perhaps necessary to prevent easy conversion of ordinary income into capital gains, make it difficult to divide a corporation into separate entities. This encourages the concentration of control over the economy in relatively fewer corporations. Concentration is further encouraged by other provisions listed in Section 368(a)(1) which in many cases will make it possible to combine corporations without incurring tax liability.

29. See, e.g., Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).

30. See Part I, supra note 2, at 331-35.
income from stock ownership may be more heavily taxed than other income. But for shareholders in high tax brackets, the combination of a corporate tax rate below the highest individual tax rate and the tax advantages to shareholders of deferral and capital gains for corporate earnings not currently distributed may result in relative undertaxation of income from stock ownership. Moreover, the corporate income tax may not be borne by shareholders but may instead be shifted to others, such as the corporation’s customers or suppliers, or owners of capital other than corporate stock. To the extent the corporate income tax is shifted, the tax burden on income from stock ownership is reduced. Before discussing the effects of this system of double taxation as mitigated by deferral, capital gains, and the shifting of the corporate income tax, two premises should be disclosed and justified. The first premise is that the corporate income tax should be analyzed in terms of its effects on individuals, and not simply accepted as a tax on corporations as such. The second premise is that for tax purposes, the income of a corporation should be considered the income of its shareholders.

A tax should be analyzed in terms of the individuals who bear it. That is, the analysis should determine who has less private wealth or income than he otherwise would have because of the tax. The following discussion will consider the taxation of corporations and their shareholders in this context. The alternative, treating the corporate income tax as an excise tax or service charge for the privileges and benefits of operating in a corporate form, is unjustifiable. Most of the benefits of the corporate form are conferred by state law, so these benefits do not justify a federal tax on corporate earnings. A tax on corporate income is a poor measure of those benefits. While the corporate income tax is proportional to income, limited liability, the principal benefit of the corporate form, probably is not. Rather, limited liability would seem more important to shareholders of a corporation with little income or even losses. It is equally doubtful whether the corporate tax system reflects the true costs that a corporation may impose on society. A tax based on sales, payroll, or capital would be more appropriate than one based on income. Moreover, these costs are imposed not only by corporations but also by other businesses and even non-profit organizations. Finally, even if these rationales for the corporate income tax were accepted, one would still want to know as a matter of tax policy who bears the tax.

32. Cf. General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965) (for purposes of state income tax, the income of a multi-state corporation may be allocated on the basis of either a corporation’s sources of income or the social costs which it generates).
The premise of the following discussion, that the income of a corporation should be considered the income of its shareholders, is not self-evident. Corporate earnings may not produce any apparent immediate benefit unless they are distributed. Undistributed corporate income does not give the shareholder any additional cash. Moreover, if the stock does not appreciate, the shareholder could not obtain the benefit of retained earnings by mortgaging or selling his stock. Nevertheless, for tax purposes, corporate income should be treated as shareholders' income. Because shareholders have some indirect control over the payment of dividends since they elect directors, it is not unreasonable to subject shareholders to tax even when dividends are not paid.\(^3\) If the price of the stock does not reflect retained earnings, the shareholder may be considered to have made a bad investment of the corporation's earnings.\(^4\) Thus it seems fair to treat corporate income, even though neither distributed nor reflected in the price of the stock, as the shareholders' income.

The effects of deferral and capital gains on double taxation can best be understood by proceeding as if the corporate income tax were borne solely by shareholders.

In general, promptly paid dividends will be overtaxed at all income levels, the degree of overtaxation decreasing as the shareholder's tax bracket increases. This pattern of taxation violates the principles of horizontal and vertical equity. Horizontal equity assumes that persons with similar incomes should pay similar taxes. Yet if two individuals have the same total income, the one receiving dividends will be more heavily taxed.\(^5\) Similarly, vertical equity assumes that taxation should bear some principled relationship to income.\(^6\) Yet a small income composed solely of dividends will be taxed at a higher rate than a larger income not including dividends, even though gen-


34. If the shareholder had received those earnings and invested them, he would not be entitled to a deduction for the decline in value of his investment until that decline was realized. This assumes that the tax system will continue not to recognize unrealized appreciation, contrary to the suggestion in Part I, supra note 2, at 375-86.

35. See, e.g., Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309, 316-17 (1972). When this article refers to income as being undertaxed or overtaxed, it is not making a statement about desired general levels of taxation, but it is only comparing the tax treatment of two types of income.

36. Taxes may be regressive (taking a larger percentage of low incomes), proportional, or progressive (taking a larger percentage of high incomes). The present system of corporate and shareholder tax, compared to the tax on non-corporate incomes, is not consistent with any of these approaches. The federal income tax uses a progressive rate structure. The value judgment in favor of progression is accepted for the purposes of this article. It should be remembered that the federal income tax is much less progressive in practice than in theory. See Part I, supra note 2, at 314, 315 n.2.
eral tax rates rise with income. Moreover, the overtaxation of corporate earnings discourages ownership of corporate stock.

The pattern becomes more complex if all the corporation's after tax earnings are not immediately distributed. Because of deferral and the capital gains preference, shareholders in low tax brackets are still overtaxed but to a lesser extent. Shareholders in higher tax brackets, however, are undertaxed.\(^7\) Thus, the principles of horizontal and vertical equity are violated. Although stock ownership is still discouraged for most persons, it is encouraged for high income persons. Thus the present pattern of taxing corporations and their shareholders may tend to concentrate ownership of stock among the wealthy.

Determining the effects of the present tax system is further complicated because the corporate income tax may be shifted from shareholders to others.\(^8\) Those who own or manage corporations may view the corporate income tax as another cost to be recovered. Thus, the tax may be shifted forward to consumers. A corporation's ability to pass on this tax may be significant because its competitors face a similar tax.\(^9\) If the tax is shifted forward, it in effect becomes a regressive national sales tax. The ultimate price increase paid by

\[\begin{array}{|c|c|c|c|c|c|}
\hline
\text{Shareholder Tax Bracket} & \text{Immediate} & \text{Delayed} \\
\hline
 & \text{Dividend} & \text{Capital Gain} & \text{Dividend} & \text{Capital Gain} \\
\hline
20\% & (10.4) 58.4 & (5.2) 53.2 & (5.2) 53.2 & (2.6) 50.6 \\
50\% & (26) 74 & (13) 61 & (13) 61 & (6.5) 54.5 \\
70\% & (36.4) 84.4 & (18.2) 66.2 & (18.2) 66.2 & (9.1) 57.1 \\
\hline
\end{array}\]

In the "delayed" columns, it is assumed that the shareholder obtains imme-
diate benefit from the retained earnings because they may be invested by the corporation to produce additional earnings. The effective burden of the tax is reduced, however, because payment is delayed. In the table, the delay is such that an amount invested with the interest compounded would double or, put another way, the tax is in effect halved. For example, at a compound interest rate of 9% an amount invested will double in eight years. See Part I, supra note 2, at 326-27.

If the shareholder's basis is stepped-up by Sections 1014 or 1023, the capital gains tax will be eliminated but the dividend tax will not be changed.

37. Assume a corporation earns $100 and pays $48 in tax. The table shows the additional effective tax (in parentheses) and the total tax for shareholders in the 20%, 50% and 70% tax brackets if the shareholder immediately or after a delay receives a dividend or realizes a capital gain equal to the corporation's after-tax income.

38. For studies of shifting see Part I, supra note 2, at 327 n.22.

39. One may generalize that in our society most economic activity takes place through corporations whose taxable income exceeds $50,000, so that each has a marginal tax rate of 48%. Passing on the tax would be more difficult if competitors had different marginal tax rates. See Hamovitch, Sales Taxation: An Analysis of the Effects of Rate Increases in Two Contrasting Cases, 19 Nat. Tax. J. 411, 417 (1966) (1% increase in sales tax caused 6% loss in sales when surrounding jurisdictions had no sales tax but no loss of sales when surrounding jurisdictions had sales taxes). The parallel between sales and income taxes is imperfect. While competitors will face the same sales tax, income tax liability per product sold will vary with profit margin.
consumers may exceed the tax paid by the corporation because of pyramiding. That is, normally a product passes through several stages with a mark-up applied to each stage. Thus a tax imposed early in the process may have been multiplied by several markups before the product reaches the ultimate consumer.  

The tax may be shifted backward if the corporation attempts to recover the cost of the corporate income tax by reducing the prices it pays to its suppliers. To the extent the costs reduced are wages of employees of either the corporation or its suppliers, the corporate income tax becomes another regressive employment tax.

The tax may also be shifted horizontally to capital other than corporate stock, such as corporate or government debt, sole proprietorships or partnerships. In a tax-free world corporate stock and other capital would probably have similar rates of return after allowing for risk and liquidity. Imposing a corporate income tax will decrease the expected return on corporate stock relative to the expected return from other capital. This corporate income tax, however, will not be borne wholly by shareholders. Initially, invested capital would shift from corporate stock to other capital. As the demand for other capital increased, its rate of return would fall, while the rate of return for corporate stock would increase. Eventually a new equilibrium would be reached where the after-tax rate of return on corporate stock would equal the rate of return on other capital. This new rate of return would be lower than that in a tax-free world. Thus, ultimately, the corporate income tax would be borne by owners of all capital.

The extent to which the corporate income tax is shifted is unclear. Forward and backward shifting may be restricted by competitive pressures and elasticities of supply and demand. Any shifting that does occur may be pyramided as a product is marked up at successive stages of the production and distribution process. Horizontal shifting occurs only to the extent that income from corporate stock is overtaxed.

41. This statement applies to the extent the corporate income tax is not shifted forward or backward.
42. For example, if rates of return on corporate stock and other capital were initially 12%, imposing a 50% corporate income tax would reduce the rate of return on corporate stock to 6%. As investment shifted from corporate stock to other capital, the pre-tax return on stock would increase and would decrease on other capital. A new equilibrium might be an 18% return on corporate stock, halved to 9% by the corporate income tax, and a 9% return on other capital. Although the corporation would be paying a tax of 50%, in this hypothetical its after-tax rate of return would be only 25% lower than in a tax-free world. Thus only half the tax would be borne by the shareholders, the remainder being shifted horizontally to owners of other capital. Although the owners of other capital do not have any direct liability for the corporate income tax, they nonetheless would bear a portion of that tax, because their return on investment would be reduced to 9% from the 12% they earned before there was a corporate income tax.
Overtaxation may not exist because the corporate income tax may be shifted forward or backward and the shareholder may benefit from tax advantages such as deferral and the capital gains. Also other investments may have particular tax benefits or burdens.43

Because the degree of shifting is not known, the effects of different assumptions regarding shifting on taxpayer equity and the economy must be considered. If the tax is not shifted, immediately distributed corporate earnings will be overtaxed at all shareholder tax brackets. The overtaxation of immediately distributed corporate earnings would be eliminated only if all of the corporate income tax were shifted. As more of the tax is shifted the corporation which retains earnings potentially becomes a tax shelter for shareholders at lower and lower tax brackets because of deferral and capital gains. In addition, the market response may increase or decrease any resulting tax advantage.44

The present system adversely effects the economy. Whether or not the tax is shifted, dividend payments are likely to be reduced because corporate managers may seek to obtain the benefits of deferral and capital gains. Stock ownership, compared to other investments, is likely to be more attractive to those in high tax brackets than to those in lower tax brackets, further accentuating the concentration of stock ownership among the wealthy. Forward or backward shifting reduces the disincentive for stock ownership, but at a cost of imposing a regressive sales or wage tax. Horizontal shifting tends to discourage investment reducing the productivity of our economy. The complexity of the present system and its likely undesirable results make it appropriate to consider alternative systems of taxing corporations and shareholders.

If the problem of corporate taxation were merely one of double taxation, the problem could be solved by eliminating one of the taxes: repeal the corporate income tax or exclude dividends from an individual's taxable income. These simple solutions, however, would not solve other problems in the current system and might aggravate them.

43. For example, it has been suggested that real estate investments would not need present tax subsidies, such as accelerated depreciation, if tax subsidies for rival investments, such as the oil depletion allowance and the investment tax credit, were eliminated. General Tax Reform: Panel Discussions Before the Comm. on Ways and Means, 93d Cong., 1st Sess. 602 (1973) (statement of Jerome Kurtz).

44. For example, high income persons may have bid up the price of stock in order to obtain tax shelter benefits. Alternatively, it may be that the demand for equity investment by corporate managers is great enough that the high income individuals do not clear the market. The price of stock drops, reflecting the adverse tax consequences of stock ownership for lower income investors. Thus, if lower income persons affect the market, the advantages of stock ownership to those in higher brackets would increase.
FEDERAL INCOME TAX REFORM

If the solution were limited to repealing the corporate income tax, currently distributed corporate earnings would be taxed like other income with no problems of vertical or horizontal equity. Retained earnings, however, would be exempt from tax until distributed, accentuating the problems of deferral and converting ordinary income into capital gains. These tax effects on shareholders would encourage corporations from paying dividends.

If the solution were limited to excluding dividends from the personal income tax, problems of vertical and horizontal equity would remain. If the corporate income tax were not shifted, all shareholders would be taxed at 48%, overtaxing those in lower brackets and undertaxing those in higher brackets. To the extent the corporate income tax was shifted, the point of undertaxation would be lowered. Moreover, with dividends tax-free but realized gains taxed, the pressure on corporations to distribute all earnings would increase, thus reducing retained corporate earnings, a major source of capital formation in this country. Thus neither eliminating the corporate income tax nor exempting dividends from tax would be sufficient to solve the problems posed by the present system of taxing corporations and shareholders. The next three sections discuss more sophisticated solutions.

PARTIAL INTEGRATION

Partial integration would require only a relatively minor and easily implemented change in our present system. The corporate and personal income taxes would be integrated as to dividends but not as to retained earnings. Under one form of partial integration, the only change from the present system would be that corporations would be allowed a deduction for dividends paid. Under the other form, the shareholder would be allowed a credit against his own tax liability for taxes paid by the corporation on the amounts distributed as dividends.

45. See note 37 supra.

46. To the extent that retained earnings cause the stock price to increase, those selling their stock at the end of the year would be taxed at approximately half their normal rates due to capital gains, a tax cut of 7% for those in the bottom bracket and 35% for those in the top bracket (45% if the 25% Section 1201 alternative tax were used). If the stock were held for 9 years and the interest rate were 8%, taxes would again effectively be halved, cutting taxes an additional 3% in the bottom bracket and 17% in the top bracket (12% if the alternative tax were used). If the stock were not sold before the shareholder's death, appreciation in the stock attributable to pre-1977 earnings would not be taxed at all, cutting taxes an additional 3% in the bottom bracket and 17% in the top bracket (12% if the alternative tax were used). See note 37 supra. Each of the reductions—conversion, deferral, step-up in basis—is more valuable to those in high tax brackets.

47. See text accompanying notes 107-11 infra.
Corporate Dividend Deduction

With a corporate dividend deduction, dividends paid would be subtracted from the corporation's gross income much like other deductions. A dividend deduction would result in dividends being taxed only at the shareholder level. The shareholder would be taxed much as he is under the current system. The corporate income tax then would become a tax only on retained earnings.

A number of problems remain to be resolved under a system of corporate dividend deduction. For instance, it must be decided if the full benefits of this reform should be extended to tax-exempt shareholders. Extending the benefits to these shareholders would result in substantial revenue loss. To deny them the benefits, and thus reduce revenue loss, would require imposing a withholding tax on their dividends equal to the corporate tax rate.

A corporate dividend deduction may frustrate the use of tax subsidies. Even though most tax subsidies should be eliminated, some tax subsidies may be necessary. With a dividend deduction, tax subsidies would be effective only to the extent of the corporation's retained earnings.

Another issue that must be resolved is whether a corporation should be allowed a carryover of its dividend deduction to other years. For example, a corporation might pay dividends in excess of its earnings in a particular year. If a carryover were permitted, that excess could be carried back to a prior year when earnings exceeded dividends, entitling the corporation to a refund of that prior year's taxes. Alternatively, the excess could be carried forward, permitting the corporation to retain earnings free of tax. A carryover might be


49. See Part I, supra note 2, at 344.

50. For example, under normal accounting principles a corporation might have income of $100 and, assuming a 50% tax rate, a tax liability of $50. However, its taxable income, computed by using accelerated depreciation, might be only $50, or it might qualify for an investment tax credit of $25. In either case, to the extent its dividends-paid deduction exceeded $50, the benefit of the tax subsidy would be lost.

Under present law dividends are taxable to the shareholder if the corporation has current or historic earnings and profits. Section 312(a). As indicated in note 13 supra, earnings and profits generally mean taxable corporate income as reduced by corporate income taxes and dividends. However, earnings and profits are computed without allowance for various tax subsidies, such as the percentage depletion of minerals, Treas. Reg. § 1.312-6(c) (1960), the investment tax credit, Rev. Rule 63-63, 1963-1 C. B. 10, and, since 1972, accelerated depreciation. Section 312(k). Because under present law dividends may be taxable without regard to tax subsidies, loss of the benefits of the tax subsidy at the corporate level results in loss of all the benefits. Under a system of partial integration, the definition of earnings and profits might be changed to permit allowance of tax subsidies so that their benefits would not be completely lost. For further discussion see text accompanying note 114 infra.
justified as providing more complete relief from the double taxation of corporate earnings. Earnings taxed to shareholders would be relieved of corporate income tax, even though the corporate tax was paid in a different year. A carryover would also permit integration of the personal and corporate income taxes for liquidations, if the liquidation were treated as a dividend to the extent of the corporation's retained earnings. A carryover, however, would not necessarily promote more complete integration of the personal and corporate income taxes because the advantages of deferral would still be present. A carryback of dividends in excess of earnings would eliminate double taxation, but at the expense of granting shareholders in tax brackets above the corporate income tax rate the benefit of deferral between the year in which the corporation earned the income and the year in which the income was distributed. A carryforward would permit a corporation to retain future earnings, shielding these future earnings from the individual income tax. Moreover, stock is likely to have changed hands between the year of excess dividends and the year to which the excess is carried. The owners of stock who benefit from the carryover may not be the owners who were burdened when the corporation retained earnings and thus incurred tax liability.

Limiting the deduction to promptly-paid dividends might increase current distribution of earnings, resulting in more complete integration. Discouraging retention of earnings, however, may endanger necessary capital formation. The conflicting goals of full integration and promotion of capital formation may be balanced by allowing only a limited carryback, such as three years.

To satisfactorily evaluate the corporate dividend deduction, it must be compared with the shareholder dividend credit.

Shareholder Dividend Credit

With a shareholder dividend credit, the corporation would compute its taxes much as it does now with no deduction for dividends. Unlike the present system, however, this form of partial integration would entitle the shareholder to a credit against his own tax liability for the tax paid by the corporation on the amount distributed.

A major problem with the shareholder dividend credit is that it is premised on the questionable assumption that the corporate income tax is not shifted but rather is borne wholly by the shareholders. To

51. For further discussion see text accompanying notes 67-69 infra.
52. Dividends paid shortly after the end of the corporation's taxable year might be considered current. Such a grace period would permit a corporation to determine its taxable income for the year before deciding how large a dividend to pay. See Section 267(a)(2).
53. See text accompanying notes 38-43 supra.
the extent the corporate income tax is shifted, a shareholder credit would result in undertaxation of dividends. Because dividends would be taxed at the corporate level, the problem of shifting would be more severe with dividend credits than with dividend deductions. A partial credit might provide a crude adjustment for possible shifting.

In providing a shareholder credit for dividends received, the dividend must be "grossed up" to reflect the tax paid by the corporation on that amount. For example, if a corporation were subject to a tax rate of 50% it would have to earn $200 to pay a $100 dividend from its after-tax income. The shareholder may be viewed as entitled to a $200 dividend with $100 paid to the IRS as a withholding tax. The shareholder's position is like that of an employee who receives only $8,000 of his $10,000 salary, the remainder being withheld and paid to the IRS. For both the shareholder and the wage earner, both cash received and amounts withheld must be included in income. Amounts withheld may then be claimed as a credit against the tax liability on the income so determined. Thus assuming a 50% corporate income tax rate, a shareholder receiving a $100 dividend would have $200 "grossed up" income and a $100 tax credit.

To prevent overtaxing shareholders in lower brackets, the credit would have to be refundable if it exceeded the shareholder's tax liability. If the credit were not refundable only those shareholders in tax brackets as high as the corporate tax rate or those with other taxable

54. To the extent double taxation under the present system causes shifting of the corporate income tax, partial integration would make shifting less likely. The question, however, is not whether shifting would occur, but rather how fast any present shifting would be undone.

55. If the corporate income tax is shifted, the amount shifted should be treated as a business expense to be deducted in determining income, and not as income tax. In the example in note 42 supra, the tax-free rate of return on stock and other capital was 12%. The new equilibrium rate of return after the imposition of a 50% corporate income tax was 18% on stock, halved to 9% by the tax, and 9% on other capital. In such a case, only two-thirds of apparent corporate earnings are real, the remainder being the mechanism of shifting. The burden of the corporate income tax on shareholders is only 25% of these real earnings. Accordingly, corporate income should be reduced one-third, and only 25% of this reduced amount should be used to compute the shareholder credit.

56. Withholding on wages is covered by Sections 3401-3404.

57. Failure to gross-up would understate shareholder income in proportion to the corporate tax rate. The shareholder would realize a benefit both from the amount distributed and from the corporate tax paid in regard to that amount. The amount distributed would be cash in hand, and the tax might be used as a credit against the shareholder's tax liability. It has long been established that one's payment of another's tax liability may be income to that other person. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). Taxing the shareholder on the benefit received in cash but not on the benefit received as a credit would in effect tax the shareholder only on the corporation's after-tax earnings even though he received benefits from all the earnings. This could produce the anomaly that capitalists might lobby for a 100% corporate tax rate while socialists might lobby to repeal the tax.
income could take full advantage of the credit. Other shareholders would still be overtaxed and thus discouraged from investing in stock.\footnote{58}

How to determine the proper rate of credit presents problems. The theoretical 48% corporate income tax rate may not be appropriate because corporations often are taxed at lower rates. The surtax exemption limits the tax on the first $25,000 of income to 20% and on the next $25,000 to 22%.\footnote{59} Tax subsidies such as accelerated depreciation and the investment tax credit result in corporations paying less than the statutory rate on income as defined under normal accounting principles.\footnote{60}

Eliminating the surtax exemption would solve the first problem.\footnote{61} If the exemption survives, however, and if a corporation distributes less than all of its earnings, there are three ways to determine how much the distributed earnings were taxed and thus the amount of the shareholder's credit. The dividend could be deemed paid first from earnings under the surtax exemption, or last from those earnings, or from all earnings subject to the average tax paid by the corporation.\footnote{62} The first approach would eliminate the benefits of the exemption to the extent dividends are paid, the second would preserve those benefits to the extent earnings are retained, and the third would elim-

\footnote{58. For example, a corporation might pay a $100 per share dividend. Assuming a 50% corporate tax rate, the holder of one share would have $200 income and a $100 tax credit. A shareholder in a 50% or higher tax bracket would fully use the credit against his tax liability on the dividend. A shareholder in the 40% tax bracket, who would need only $80 for his $100 credit to cover his tax liability on the dividend, might use the remaining $20 of his credit against his tax liability on other income such as interest or salary. But a shareholder in a tax bracket below the corporate rate who had little other income—such as a retired person whose income consists of tax-exempt social security and dividends—could not fully use the credit unless it was refundable.}

\footnote{59. Section 11.}

\footnote{60. See Tax Notes, Tax Analysts & Advocates, at 26-33 (Nov. 17, 1975) (typical tax rates are 20%-40%, not the theoretical 48%); G. Breck & J. Pechman, Federal Tax Reform 91 (1975).}

\footnote{61. The surtax exemption is hard to justify. A subsidy to the middle class should be based on individual income. The surtax exemption is not determined on an individual basis, however, since there may be little correlation between a corporation's income and its owner's tax brackets: small corporations may be owned by the wealthy, and large corporations may have many shareholders in low tax brackets. Furthermore, a subsidy to small business should apply to all businesses, not only to corporations. See Bucovetsky & Bird, Tax Reform in Canada: A Progress Report, 23 Nat. Tax J. 15, 34 (1972).}

\footnote{62. For a corporation which earned $100,000 and distributed $20,000, the three methods would entitle shareholders to credits of $5,000, $18,461.54, and $10,534.35 respectively. These figures are obtained by solving the equation, Credit = \left(\frac{1}{1-\text{Tax Rate}}-1\right)\text{Dividend, using tax rates of 20%, 48%, and 34.5%}. The computations would be simplified with a 50% corporate income tax and no surtax exemption.}
inate the benefits in proportion to the percentage of earning distributed.63

Tax subsidies such as accelerated depreciation and the investment tax credit may result in a corporation having less taxable income or lower tax liability than it would under normal accounting principles. A shareholder dividend credit, like the present system, requires computation of a corporation's income in order to determine the extent to which a dividend is taxable to the shareholder because only distributions of earnings are included in shareholder income. Unlike the present system, however, computing the corporation's tax liability would be necessary under a shareholder dividend credit in order to determine what credit the shareholder would be allowed. The problem is whether to use tax accounting or normal accounting to measure the corporation's income and tax liability. The present system uses normal accounting to compute a corporation's income for purposes of determining whether a dividend is taxable.64 Using this approach and basing the credit on the taxes in fact paid by the corporation would tend to eliminate the benefit of the tax subsidy, in effect converting it into a mere reduction in the withholding rate on dividends, while leaving dividends fully taxable. A second possibility is to base the credit on the statutory rate applied to income determined under normal accounting. This approach, however, would substantially increase the cost of tax subsidies because shareholders would receive refunds of taxes never paid by the corporation. A more satisfactory approach is to base the taxability of dividends on the corporation's income as computed for tax purposes and base the shareholder credit on the corporation's tax liability on that income. To the extent the corporation's tax payments were reduced by non-refundable credits like those for investment and foreign taxes, the shareholder credit would be nonrefundable. Shareholders would receive tax-free cash when a corporation's distribution exceeded its taxable income, just as present tax subsidies produce tax-free cash from unincorporated businesses. This result is consistent with the purpose of integration because it taxes income from corporations and other businesses similarly.

63. Under each of the three possibilities, the corporation would have paid taxes reduced in the same amount by the surtax exemption. But the effect of the surtax exemption is best measured by the total taxes paid by both corporation and shareholder. Under the first possibility, the shareholder's credit is only 20% to 22%; thus his additional tax liability will be larger, or his refund smaller, than under the second possibility where the shareholder's credit may be up to 48%. The third possibility falls between the first two, depending on the corporation's income and the amount of the dividend.

This question of ordering arises only if the corporation has more than $25,000 of income and becomes significant only if its income exceeds $50,000 and not all of its earnings are distributed.

64. See note 50 supra, for a discussion of the treatment of tax subsidies in determining earnings and profits.
A corporation's distribution of a prior year's earnings presents deferral problems when the shareholder's tax liability on the distribution does not equal his credit, because of the delay between the year in which the income was earned and the year in which the shareholder pays any additional tax or receives a refund. By adding interest payments to the shareholder's tax or refund, these deferral problems could be reduced. Computation would be easier if dividends were considered as paid first from the current year's earnings, working backwards as necessary.

The shareholder dividend credit as usually proposed integrates the personal and corporate income tax only for dividends, not for retained earnings. Integration could be extended to retained earnings by treating a sale of stock or a liquidation as a dividend of those earnings. The shareholder would increase his amount realized upon sale or liquidation by the amount of tax paid by the corporation on his share of the retained earnings, obtaining a credit for that amount. A purchaser of stock in a corporation with retained earnings would be taxed only on distributions of corporate income earned while he held the stock.

Because a shareholder's tax liability under a dividend credit system would be dependent on the corporation's tax liability, a change in the corporation's taxes because of a refund claim or an audit might affect the shareholder's taxes. Adjusting the returns of the many individual shareholders in a large corporation could create substantial administrative problems. These problems would arise, however,

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65. The shareholder would compute his tax liability on all his income, and subtract from this his tax liability on his income other than dividends from old retained earnings. Cf. Section 1348(a). If this amount exceeded his credit in regard to those dividends, he would pay that amount with interest between the year of the dividend and the year the corporation earned the amounts not distributed. If the credit were greater, he would be paid interest. If the distribution included earnings from more than one year, separate computations would be required for each year. See Part I, supra note 2, at 396.

66. Dividends paid from pre-effective date earnings should not entitle the shareholder to a credit.

67. For example, the Ford administration proposed a system of partial integration limited to dividends. See Hearings Before the House Comm. on Ways and Means, 94th Cong., 1st Sess. (July 31, 1975) (statement of Treasury Secretary William E. Simon). It would allow a corporate deduction for one-half of dividends paid, and a shareholder credit for one-half of dividends received. The final tax reform proposal from the Ford administration included a system of full integration, while still commending partial integration as a first step. Dep't of the Treasury, Blueprints for Basic Tax Reform (January 17, 1977).

68. The interest charge proposed in text accompanying notes 65-66 supra, would reduce the effects of deferral.

69. The extension of the dividend credit to sales and liquidations would increase the record-keeping burden on corporations and present certain mechanical problems, such as how to allocate earnings when stock is traded during the year. See text accompanying notes 142-48 infra.

70. See text accompanying notes 149-64 infra, for a discussion of the problems involved in adjusting shareholder taxes when corporate taxes change.
only if the corporation distributed more than its reported after-tax income and its taxable income were later changed, or if a refund claim reduced its taxable income below the amount distributed in that year.71

A comparison of these two forms of partial integration suggests that neither form is necessarily preferrable to the other. Although the relative benefits of the shareholder dividend credit would be more certain, the benefits of the corporate dividend deduction possibly would be greater. The credit would better limit revenue loss because of tax-exempt persons,72 It would also permit resolution of the problems of carryover and integration of retained earnings. The deduction, however, would not require changing shareholder taxes when corporate taxes are changed. The risk of shifting the corporate income tax also would be reduced with the deduction. If empirical data shows that the audit and refund claim problem would occur infrequently, and if the political process 73 should decide that shifting is not a serious problem, the credit would be preferable.

The advantages of both forms of partial integration are outweighed by their disadvantages. Both the advantages and disadvantages of partial integration are produced by one feature: the personal and corporate income taxes would be integrated for dividends but not for retained earnings.74 Because only dividends would be integrated, partial integration would require only a relatively minor and easily implemented change in our present system. The major disadvantage of partial integration is its failure to resolve the problem of the taxation of retained earnings.75 Thus, the tax shelter for individuals in high tax brackets would be left untouched.76 In addition, partial

71. This statement is premised on the elimination of the surtax exemption. See note 61 supra. Continuing that exemption would increase the occasions when a change in a corporation's taxes would require an adjustment of its shareholders' taxes.

72. See Hammer, The Taxation of Income from Corporate Shareholding, 28 NAT. TAX J. 315, 324 (1975), which suggests that Germany is shifting from a primarily dividend deduction system to a system including greater use of shareholder credits. This new system will make the policy of controlling the degree of relief provided to different shareholders easier to implement.

73. The social sciences seem unable to determine how the corporate income tax is shifted. See Part I, supra note 2, at 327 n.22.

74. Partial integration also fails to integrate corporate losses into the personal income tax system.

75. The modifications suggested to extend partial integration to retained earnings in text accompanying notes 51, 67-69 supra, would add substantial complexity, thus negating the simplicity which is partial integration's major advantage.

76. See text accompanying note 37 supra.
integration would cause a significant reduction in tax revenue, even more than under full integration.77 Moreover, much of the complexity of the present system would continue because retained earnings would still be subject to two systems of taxation.78 Finally, because retained earnings may be taxed again when stock is sold, the double taxation justification for the capital gains preference would remain under partial integration.79

**TAXING DIVIDENDS AND APPRECIATION**

The personal and corporate income taxes could be integrated by taxing shareholders currently on the benefits of stock ownership. Those benefits would include unrealized appreciation in stock values, which are not taxed under the present system, as well as dividends and realized gains. Because unrealized gains would be taxable, unrealized losses would be deductible, so that only net benefits would be taxed.80

A major issue under a system of taxing dividends and appreciation is whether to eliminate the corporate income tax. The leading advocate of this reform would retain the corporate tax.81 He argues that because that tax is either shifted or capitalized it does not produce double taxation. Moreover, to the extent the tax has been capitalized its repeal would produce windfall gains to those already owning stock, primarily the wealthy.82 These arguments are not persuasive. Although the corporate income tax is probably at least partially shifted, it seems unlikely that it is shifted entirely.83 The part that is not shifted may result in double taxation of corporate earnings. Even the part which is shifted is still being borne by someone—consumers, wage earners, or owners of capital other than corporate stock—and that burden is undesirable. The problem with the argument that if the corporate tax is not shifted, then it is capitalized is

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77. The amount of revenue lost under partial integration depends on corporate dividend policies. In G. Break & J. Pechman, *Federal Tax Reform* 100, 103 (1975), the authors estimate that under present dividend policies, partial integration would lose $15 billion in tax revenues in regard to stock held by individuals, but the similar loss under full integration would be only $7 billion. Under both full and partial integration there would be additional revenue loss because of stock held by tax-exempt organizations. See text accompanying notes 117-24 infra.

78. See text accompanying notes 6-30 supra.


80. Both gains and losses, whether realized or not, should be adjusted for inflation as proposed in Part I, supra note 2, at 337-39.


82. See Part I, supra note 2, at 324 n.12, for data on stock ownership. See text accompanying notes 183-86 infra, for further discussion of capitalization of the present system of taxing corporations and shareholders.

83. See text accompanying notes 38-42 supra.
the uncertainty as to how it is capitalized. The argument is that an unshifted corporate tax would overtax stock ownership, lowering stock prices. The present corporate tax has long existed, so that most shareholders purchased their stock at prices depressed by the tax. Therefore, those shareholders have not been treated unfairly. A repeal of the corporate tax would remove the depressing effect on stock prices, and those shareholders would receive windfall profits. However, income from stock ownership may now be undertaxed because of the benefits of deferral and capital gains. Thus, the present system may have increased stock prices, and a change in the system would produce windfall losses. The effects of any windfall changes in stock prices would be reduced by recognizing unrealized gains and losses under a dividend and appreciation tax. Accordingly, it would seem best to eliminate the corporate tax.

A dividend and appreciation tax has substantial advantages. Repeal of the corporate income tax would eliminate the burden of determining and collecting that tax. Changes in the price of publicly-held stock could be determined easily from market quotations. Dividends would be reported under existing mechanisms. Because all dividends would be taxable, it would be unnecessary to compute a corporation’s earnings and profits or to determine whether the distribution was in complete or partial liquidation. Taxing all dividends would not result in taxing a shareholder on his capital rather than only on his income because he would be allowed to deduct any decline in the value of his stock.

There are several problems, however, which a dividend and appreciation tax would not solve. It could not be applied to foreign corporations, so a special tax would be required for them. Foreign owners of stock in domestic corporations could be taxed on dividends through a withholding tax, but taxing appreciation in their stock might be impractical. It would also be difficult to apply a dividend and appreciation tax to a closely-held corporation’s shareholders because determining the value of stock for which there is no regular market poses problems. Another tax system might have to be developed for those corporations. The two systems would be unfair and would

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84. See text accompanying note 37 supra.
85. See Section 1023(h)(1).
86. See note 50 supra for a discussion of earnings and profits and notes 15, 17-18 supra for liquidations.
87. An example may be helpful. Suppose A’s basis in his stock at the start of the year was $100. If A received $150 as a distribution in liquidation, he would have income of $150 under a system of dividend and appreciation taxation. But his stock at the end of the year presumably would be worthless, so he could deduct a loss of $100. Therefore, his net income would be $50. If the corporation distributed only some of its property, A’s net income would depend on whether the value of his stock declined, and not on such concepts as earnings and profits or liquidation.
distort the market if they did not produce similar results. Special provisions would be required for the transition from one tax system to the other to accommodate corporate shifts between being publicly held and closely held. 88

Dividend and appreciation taxation would cause even more than the normal problems associated with a general system of taxing unrealized appreciation. 89 Problems of equity and distortion of the economy would result from differing tax treatments of different types of investment. Moreover, limiting the taxation of unrealized appreciation to publicly-traded stock might cause excessive fluctuations in government revenue because of the uncertainties of the market. The movements in stock prices often will not parallel the movements in the price of other investments such as real estate or bonds. Fluctuations in tax revenues might be dampened by differing price movements of different investments only if a general tax on all unrealized appreciation were imposed. While taxing all unrealized appreciation may be desirable, the limited approach of dividend and appreciation taxation is not.

**FULL INTEGRATION**

Under full integration corporate income would be taxed to the shareholders as earned, whether the income was distributed or retained, and the shareholders would currently deduct corporate losses. Thus, the corporate income tax would be eliminated. 90 The shareholder's basis would be increased by his share of corporate income and decreased for losses. Distributions received from the corporation would reduce the shareholder's basis in his stock, and would be taxable only after his basis had been recovered. 91

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88. For example, a closely-held corporation might have a public offering of its stock; a public corporation might become closely-held by repurchasing its stock; or a public corporation might merge with a closely-held corporation. 89. See Part I, supra note 2, at 375-86, for a discussion of taxing unrealized appreciation. 90. Although in general over long periods stock prices increase by the amount of retained earnings, Break, *Integration of the Personal and Corporate Income Taxes*, 22 Nat. Tax J. 39, 45-48 (1969), stock prices may change with little regard to retained earnings over the annual accounting period used for income tax purposes. Thus, unlike both full and partial integration, a dividend and appreciation tax is not a means of taxing corporate income to stockholders. 91. A withholding tax might be imposed on corporations. See text accompanying notes 94-98 infra.
Full integration would eliminate the double taxation of corporate earnings because only the shareholder would be taxed on corporate earnings. The double taxation argument for applying the capital gains preference to gain on sale of stock would also be eliminated. Full integration would also eliminate many of the effects of deferral, such as the advantages for shareholders in tax brackets above the corporate income tax rate and the disadvantage for those in lower tax brackets. Finally, eliminating the corporate income tax would solve the problems created by the possible shifting of that tax.

Integrating the personal and corporate income taxes by taxing all corporate earnings currently to shareholders may cause some practical problems. The shareholder, the government, and even the economy may suffer cash flow problems. A variety of mechanical problems, such as how to treat stock sold during the year, complex corporate ownership, and audits also would be created. Finally, the process of transition from the present system of taxing corporations and shareholders to full integration would pose problems which must be explored.

Cash Flow Problems

Paying Shareholder Taxes. Cash flow problems would arise because a shareholder would be required to pay tax on corporate earnings, whether or not distributed, even though he had not received resources with which to pay the tax. Under our present system, however, tax liability may be imposed in a number of situations although nothing has been received or receipts are not in cash. Because individuals normally have a variety of resources, taxation without receipt would not present significant hardship in many instances. No greater hardship is imposed on those who have to sell some of their stock to pay the tax than on those with cash incomes who can buy less stock initially because some of their income must be used to pay taxes.

Cash flow problems might be more acute under full integration than under a system of taxing unrealized appreciation in one significant respect. In taxing unrealized appreciation, normally the gain subject to tax can be realized by selling the property, and thus funds can be obtained with which to pay the tax. Undistributed earnings, however, may not cause an equivalent rise in the price of stock. Consequently, it would be impossible for the shareholder to realize this gain upon which he has been taxed. On the other hand, profitable corporations normally pay dividends. Even if the stock price did not

93. See Part I, supra note 2, at 383-85, for a discussion of taxpayer cash flow problems which would result if unrealized appreciation were taxed.
increase in proportion to retained earnings, dividend payments could ease the burden of paying taxes on gain which cannot be currently realized.

Moreover, any cash-flow problems under full integration may be avoidable. A withholding tax could be collected from the corporation with the stockholder still reporting the entire corporate income allocable to his stock but treating the withholding tax as a credit, much as amounts now withheld on wages are treated. While it may appear to be more efficient to collect the tax once from the corporation rather than in small fractions from each shareholder, this apparent efficiency may never materialize. Except for the relatively few shareholders whose marginal tax rate equals the rate paid by the corporation, individual refunds or additional collections would be required. A more basic problem, however, is that such a system could resurrect the shifting problem and further complicate the tax system.

Corporate managers may view the corporate withholding tax much as they do the existing corporate income tax—as an additional cost to recover. The corporate withholding tax can be recovered either by raising prices or by cutting costs such as wages. As with the existing corporate income tax, this shifting would result not only in regressive sales and wage taxes but also in the undertaxation of corporate earnings because shareholders would be treated as having borne a tax which in fact had been shifted to others. Even though less shifting may occur under a corporate withholding tax system than under the present system, the result would still be undesirable.94

The risk of shifting might be reduced if the corporate withholding tax were geared to the stockholder’s marginal tax bracket rather than applied uniformly. If withholding is based on individual shareholder tax brackets, different corporations will have different withholding, and this non-uniform rate will make shifting more difficult.95 Moreover, since the tax would be based on individual shareholder tax brackets rather than on all corporate income, corporate managers may be less likely to view the tax as a business cost to be shifted. Finally, by individualizing corporate withholding, low-bracket taxpayers would not be required to make, in effect, interest-free loans to the govern-

94. It should be emphasized that the problem is not whether a corporate withholding tax would be shifted, but rather, whether and how fast the effects of shifting under the present corporate income tax would be undone if it were replaced by a corporate withholding tax imposed at similar rates. See McClure, Integration of the Personal and Corporate Income Taxes, 88 HARV. L. REV. 532, 547-48 (1975). McClure regards as dispositive the suggestion that eventually the tax will be unshifted, although it would seem that a five or ten year delay in this process would be a cause for concern.

95. Shifting of the present corporate income tax is eased because most economic activity is conducted through corporations with the same marginal tax rate of 48%. See note 39 supra. The same may be true with a uniform withholding tax.
ment until refunds are returned, and the estimated tax system workload for high-bracket taxpayers could be reduced.

A system of individualized withholding would, understandably, be administratively burdensome. Aside from the complexity involved in an individual determination of each shareholder's tax bracket, such a system might conflict with the stockholder's interests in privacy. Even the implementation of individualized withholding would require some provision to prevent shifting ownership of corporate earnings; otherwise each stockholder would be subjected to the average of the withholding rates.96

One solution to this problem might be to distribute to each stockholder fractional shares representing his share of retained corporate earnings.97 Aside from the difficulty of assigning values to the fractional shares, the added burden of dealing with fractions of shares makes the proposal somewhat questionable. Another possibility would be to treat the amount withheld as an advance payment of future dividends. Unless interest equal to the corporation's rate of return on retained earnings accrued on the early dividend, however, gradual shifts in ownership would occur.98

Perhaps the best general solution to any possible shareholder cash flow problems would be to require corporations to pay dividends. Imposing mandatory dividend requirements would be a significant departure from the present treatment of dividend payments. Normally, such matters are determined by state corporation law and corporate boards of directors. The purpose of a federal mandatory dividend law would not be to control dividends as such but rather to provide a substitute for a withholding tax which could properly

96. For example, a corporation is formed by two individuals, each contributing $100. The corporation earns $20 in its first year of operation. If one individual is in the 20% bracket and the other in the 70% bracket, the corporation would pay $2 and $7 to the government as their respective withholdings. Corporate assets now consist of the $200 contributed plus $11 in retained earnings for a total of $211, $105.50 owned by each stockholder. The 20% bracket stockholder, despite having contributed $100 and having $8 in after-tax earnings for a total of $108, has a claim on only $105.50 in corporate assets. The 70% bracket stockholder also has a claim on $105.50, although he should be entitled to only $103.

97. Under this approach, all corporate earnings would either be paid as dividends, paid as withholding tax, or represented by fractional shares. Because shareholders with low withholding rates would receive more fractional shares, the shift in ownership of corporate earnings or in the burden of the withholding tax would not occur. In the example in note 96 supra, the 20% bracket shareholder would receive stock worth $8 and the 70% bracket shareholder stock worth $3.

98. A corporation would retain more earnings on stock subject to a low withholding rate, but income obtained from investing those earnings would be equally available to all stock. The interest charge, if accurate, would assure that income was allocated to that stock whose retained earnings produced it. If the interest rate is too low, those subject to low withholding are hurt; if too high, those subject to high withholding are hurt.
be imposed. Federal tax provisions encouraging payment of dividends already exist.\textsuperscript{99} Mandatory dividends and withholding taxes have several similarities. Both are compulsory. Both can be used to pay the shareholder's taxes, with any excess to be used as the shareholder chooses. Both would result in a reduction of the shareholder's basis in his stock. Mandatory dividends, however, are less likely to be shifted. In many cases, the mandatory dividend would hardly differ from the dividends normally paid in the absence of compulsion. With dividend reinvestment plans the corporation may be able to retain much of the mandatory dividend in any case. To the extent that mandatory dividends would only be a substitute for a withholding tax and would not significantly displace corporate control of resources, such a program would not be an improper exercise of federal power.

A mandatory dividend program might conflict with a corporation's agreements with its creditors to restrict payment of dividends.\textsuperscript{100} To the extent that the mandatory dividend may be considered a form of withholding tax, it might abrogate these agreements. The creditors could not complain, however, if the mandatory dividend did not exceed corporate income tax liability under the present system.\textsuperscript{101} Perhaps dividend restrictions could be limited to the excess of the mandatory dividend over what a corporation's tax liability would have been had the corporate income tax continued. Alternatively, shareholders might be required to reinvest any portion of the mandatory dividend in excess of their income tax liability on the corporation's earnings.\textsuperscript{102} The problem of dividend restrictions may not be that serious because many corporations subject to dividend restrictions may have net operating losses to carry forward,\textsuperscript{103} and thus may not have significant taxable income for a number of years. Although the interaction of mandatory dividends and contractual dividend restric-

\textsuperscript{99} See the discussion of the accumulated earnings tax and the personal holding company provisions in text accompanying notes 24-25 supra.

\textsuperscript{100} This discussion deals with dividend restrictions in effect when mandatory dividends are implemented. Thereafter, corporations and creditors may allow for mandatory dividends in their contracts, perhaps even obtaining shareholder consent to waive the dividends.

\textsuperscript{101} Those changes proposed in Part I of this article, supra note 2, at 337-52, regarding the measurement of gain and loss, the determination of depreciation, and the deduction or taxation of interest would change the amount of corporate income. Creditors who have obtained a restriction on dividends may fairly be required to bear the risk that such changes might increase corporate tax liability, since they would benefit if changes in the tax laws decreased corporate tax liability.

\textsuperscript{102} This solution is most practical for closely-held corporations. For larger corporations it would present many of the same problems as individualized withholding, discussed in text accompanying notes 95-96 supra.

\textsuperscript{103} Section 172 generally permits net operating losses to be carried forward seven years. Losses incurred before the implementation of full integration would still be carried forward, but subsequent losses would be currently deducted by shareholders.
tions may create problems, they would not be serious enough to warrant the rejection of a mandatory dividend system.

A lower mandatory dividend rate would cause fewer problems. The mandatory dividend rate would ultimately depend upon the individual rate structure, which might be lower under the reforms proposed here and elsewhere. The mandatory dividend rate could also be lowered by using a rate lower than the highest individual tax bracket, such as the highest average tax rate on all income.

Thus, shareholder cash flow problems are not insurmountable. Shareholder cash flow, however, is only one dimension of a larger problem. These cash flow problems should not be resolved at the expense of jeopardizing capital formation. Therefore, any discussion of cash flow problems should also consider the needs of capital formation.

Capital Formation. Capital formation is necessary to continue and increase the productivity of our society. The modern corporation is very efficient at performing this task. Although some capital is obtained by issuing stock, the corporation also relies to a great extent on retained earnings as a source of new capital. The present system of corporate taxation, under which dividends generally are taxed more heavily than retained earnings, encourages retention of earnings.

104. The major reforms not discussed in this article are aimed at expanding the tax base by restricting deductions and exclusions from income. Studies of an expanded tax base have suggested that the current 14% to 70% rates might be reduced. See, e.g., COMMITTEE TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE 7-10 (Fund for Public Policy Research 1973) (4% to 54%); Pechman & Okner, Stimulation of [Canada's] Carter Commission Tax Proposals for the United States, 22 NAT. TAX. J. 1, 11 (1969) (19.8% to 53.1%); DEPT OF THE TREASURY, BLUEPRINT FOR TAX REFORM 9 (1977) (8% to 38%). The rate structure under a reformed tax system would depend on political and policy decisions as to what is to be included in the tax base, how much federal revenues should be, and how progressive the tax system should be. 105. On a joint return taxable income in excess of $203,200 is subject to a 70% rate, but the tax on $203,200 is only $110,980, an average rate of approximately 55%. The tax on $303,200 is $180,980, an average rate of approximately 60%. Setting the mandatory dividend rate at 60% would thus cover the tax liability of a couple with $303,200 in corporate income. Persons with more income and thus a higher average tax rate might be expected to have other resources with which to pay the tax.

106. Some people, seeking to preserve or expand tax subsidies for investment, such as capital gains, accelerated depreciation, and the investment tax credit, have forecast an imminent capital shortage. See, e.g., Tax Reform Hearings Before the House Comm. on Ways & Means, 94th Cong., 1st Sess. 439-446 (June 23-25, 1975) (statement of Reginald H. Jones); Tax Reform Hearings Before the House Comm. on Ways & Means, 94th Cong., 1st Sess. 13-30 (July 8, 1975) (statement of Treasury Secretary Simon). Others in opposing such tax subsidies have noted that of five recent studies on capital needs, only that by the New York Stock Exchange predicted a capital shortage. See Tax Reform Hearings Before the House Comm. on Ways & Means, 94th Cong., 1st Sess. 446 (June 23-25, 1975) (statement of Harvey D. Brazer); id. at 430-39 (statement of Joseph E. Pechman). Determining the existence or extent of a possible capital shortage is beyond the scope of this article.

107. See note 37 supra.
of earnings. Full integration of the personal and corporate income taxes would eliminate the tax penalty the present system imposes on dividends but, in doing so, it may jeopardize capital formation.\textsuperscript{108}

It is possible, however, that full integration may actually result in an increase in retained earnings. Elimination of the corporate income tax would make whatever portion of that tax corporations now bear available to them. If, under full integration, dividends paid do not exceed the sum of corporate income tax payments and dividends under the present system, retained earnings would increase. Thus, capital formation would be encouraged.

Capital formation through retained earnings may have socially undesirable consequences. Concentration of corporate control may be vested in a few corporations, contrary to the policy of our antitrust laws and the tenets of a democratic society. In any case, retained earnings should not always be equated with new investment. Retained earnings are sometimes used to acquire existing businesses which result in further concentration of corporate ownership without generating new capital.\textsuperscript{109} The management which creates the retained earnings may be more adept at managing the existing business of the corporation than at selecting new businesses in which to invest. Therefore, it may be more economically efficient to subject this new investment to the market instead. This is not to say that retention of earnings should be discouraged, but it is unlikely that full integration would significantly discourage retained earnings.

Although retained earnings are a principal means of assembling capital,\textsuperscript{110} it may be misleading to speak of retained earnings as a source of capital. Ultimately, the source of capital is an individual's willingness to save and defer consumption. Retained earnings may be merely a mechanism for saving with the result that an increase in retained earnings produces a corresponding decrease in direct personal savings and vice versa.\textsuperscript{111} Thus it may be better to foster capital formation by improving the general climate for saving or investment.

\textsuperscript{108} Saving through retained earnings is likely to be encouraged under any tax system because the transaction costs of distributing cash and seeking new ways to invest it are avoided.

\textsuperscript{109} The acquisition of an existing business may lead indirectly to new capital formation. For example, the sellers of the old business may use the proceeds to purchase a new plant and equipment, or the purchaser may buy new assets for the old business.

\textsuperscript{110} It has been estimated that two-thirds of investment is from depreciation and retained earnings. Tax Reform Hearings Before the House Comm. on Ways & Means, 94th Cong., 1st Sess. 19 (July 9, 1975) (statement of Treasury Secretary Simon). It is difficult to separate depreciation from retained earnings because the present rules for determining depreciation for tax purposes are inaccurate. See Part I, supra note 2, at 342 n.49.

\textsuperscript{111} For example, an individual with 100x income might want to save 20x. If his income is all in cash, he would personally invest 20x. But if his stock presented 15x in retained earnings and his cash income only 85x, he might
Implementing a number of the reforms proposed in this article would improve the climate for investment. Permitting a correction for inflation would reduce the tax penalty on long-term investment.\textsuperscript{112} Full integration would remove the tax penalty on stock ownership for those with middle or lower incomes.\textsuperscript{113} Although raising capital through the issuance of stock to smaller purchasers may involve heavy administrative costs, a variety of intermediate institutions, such as automatic investment plans, corporate dividend reinvestment plans, mutual funds, pension plans and insurance companies, would reduce the cost of assembling capital. Even if middle and lower-tax bracket individuals invested primarily in stock already issued, this would promote the purchase of new issues by larger investors because they would have a market in which to dispose their existing holdings. While full integration would remove the subsidy for those in high tax brackets, it would only put such investments on a par with other investments. It is unlikely that the wealthy will massively shift resources from investment to consumption without a change much more drastic than that proposed here, and, therefore, investing in general will be promoted.

Additional stimulus to capital formation could be provided through direct subsidies such as the investment tax credit. Even though under full integration a corporation would not be a taxable entity, it could use the investment tax credit against its obligation to pay withholding taxes or mandatory dividends, thereby improving its cash position. Such direct subsidies would be preferable to the present system of stimulating capital formation through corporate taxation because they would be simpler, more equitable, and better suited to stimulate investment in new facilities or in the renovation of existing facilities.\textsuperscript{114} Thus it appears that full integration is unlikely to pose a serious threat to capital formation in our society.

Revenue Effects. The third aspect of the cash flow problem posed by full integration is that of maintaining adequate government revenues. Full integration of the personal and corporate income taxes could reduce government revenues by $20 billion.\textsuperscript{115} Even with total

\begin{itemize}
\item \textsuperscript{112} See Part I, supra note 2, at 335-57.
\item \textsuperscript{113} While individuals of low or moderate income are unlikely to make large investments, the total of many small investments may be substantial. Analogously, the relatively small tax payments of such individuals in sum produce a substantial portion of the federal revenues.
\item \textsuperscript{114} Such subsidies could make purchases of existing assets less attractive than purchases of new assets. For example, under Section 48(c) only $100,000 of used property per taxpayer qualifies for the investment tax credit.
\item \textsuperscript{115} Breake & Pechman, Relationship Between the Corporation and Individual Income Taxes, 28 NAT. TAX. J. 341, 349 (1975).
\end{itemize}
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revenues of around $400 billion, a revenue loss of that magnitude should not be incurred casually. That revenue loss, however, should be put in perspective.

The reforms proposed in both parts of this article are intended to be adopted as a package. To consider only revenue losses resulting from one proposal may be misleading, because these losses may be offset by revenue gains under other proposals. In any case, the fact that tax collections change when present tax rates are applied to income which is more accurately defined only evidences the inaccuracy and inequity in the present system.116

More than $12 billion of the projected $20 billion revenue loss from full integration would accrue to tax-exempt shareholders.117 This revenue loss could be avoided by denying tax-exempt shareholders the benefits of integration, perhaps by imposing an excise tax on dividend income of tax-exempt organizations.118 Such a tax, however, would discourage tax-exempt organizations from owning stock, causing potentially adverse effects on the economy.119


117. If the proposed package of reforms resulted in significant changes in revenue under the present rate structure, the rates could be changed in accord with political choices about the desired level of government spending and the proper degree of progressio.

Because many states have income taxes based on the federal income tax, changes in federal definitions of items of income and deduction such as those proposed in this article may change state income tax collections. Elaboration of the impact of these proposed reforms on state taxes is beyond the scope of this article. As does the federal government, state governments may change the tax rates to be applied to income determined under these reforms. Integrating the personal and corporate income taxes presents an additional problem, however. Taxing corporate earnings only to shareholders will move the tax base from the states where corporations operate to the states where shareholders reside. To prevent loss of revenue, states will probably continue to collect a corporate income tax. Shareholders may be taxed on all corporate earnings, and allowed a credit for corporate income taxes paid to any state. Presumably only that part of the credit attributable to corporate taxes paid to the shareholder's state would be refundable. Full integration—with each shareholder filing an individual income tax return in each state which taxes a corporation whose stock he owns—would be impractical.

118. Break & Pechman, supra note 115. Although tax-exempt organizations are not normally taxed directly (they may, however, be subject to tax on unrelated business income under Sections 511-515), income earned by a corporation attributable to stock they own is subject to the corporate income tax.


120. A similar excise tax could be imposed under the corporate dividend deduction discussed in text accompanying notes 48-52 supra. The same effect could be achieved under the shareholder dividend credit, see text accompanying notes 53-71 supra, by not allowing the credit to tax-exempt organizations.

121. It has been estimated that 24% of all corporate earnings are attributable to tax-exempt organizations. C. BREAK & J. PECHMAN, FEDERAL TAX REFORM 103 (1975).
Under full integration, the propriety of extending exemption benefits would be presented more clearly than under the present system. Perhaps the benefits provided by these tax-exempt organizations would be found to justify the potential revenue loss. If not, an excise tax might be imposed on all income of those organizations. A more refined solution would restrict the organizations and activities exempt from tax, or the rules on deductions for contributions of appreciated property might be tightened. Similarly, the tax exemption for pension plans could be narrowed. The maximum tax-exempt amount under a pension plan could be lowered well below the present limit of $75,000. Thus, refining the present tax-exemption standards could result in the generation of revenues sufficient to replace a significant amount of the losses likely to occur as a result of the implementation of full integration.

By adjusting the existing system of withholding taxes on dividends paid to non-residents, little revenue need be lost to foreign shareholders upon the advent of full integration. Moreover, by ending the deferral of tax on the earnings of foreign subsidiaries of domestic corporations, full integration might even produce a revenue gain of $2 billion.

122. For example, it would be very expensive for the government to support the schools, hospitals, research facilities, museums, etc., now provided by tax-exempt charitable foundations, and it would be unconstitutional for the government to support churches directly. Similarly, the complete tax exemption of private pension plans may be justifiable because they reduce the strain on the Social Security system.

123. Section 501(c) lists over twenty types of tax-exempt organizations. Some, such as "professional football leagues (whether or not administering a pension fund for football players)," Section 501(c)(6), seem hard to justify.

124. Under Section 170, an individual may deduct the fair market value of property he gives to a charitable foundation. If the property has appreciated, he will be denied a deduction for the gain which would have been ordinary income had the property been sold. Section 170(e)(1)(B). Thus, eliminating the capital gains preference will also eliminate deductions for that portion of the value of property which represents appreciation. Under present law, deductions for capital gain appreciation may be halved by Section 170(e)(1)(B), and the total deductions for contributions of property with such appreciation are limited by Section 170(b)(1)(C).

125. Section 415(b)(1). For example, the tax exemption might be limited to plans which would pay pensions only up to some low multiple of the nation's median income. Once an individual's vested interest in the plan provided such a pension, further contributions would not be deductible, and earnings beyond those needed for such a pension would be currently taxed to the individual.

126. See Break & Pechman, supra note 115. The mechanics of taxing international investment are discussed in Bird, International Aspects of Integration, 28 NAT. TAX J. 302 (1975). Bird notes that avoiding discriminatory taxation of foreign investment is simpler if all countries have separate personal and corporate income taxes. He then outlines methods of achieving nondiscrimination for situations in which some countries have separate personal and corporate income taxes, others have partial integration, and others have full integration.

Thus it appears that neither the shareholders' need for cash to pay taxes accruing from stockholdings, the general societal need for capital formation, nor tax revenues will be seriously jeopardized by full integration of the personal and corporate income taxes. Various practical problems in converting to and administering a system of full integration, however, must be considered.

**Mechanical Problems**

**Differences in Corporate and Shareholder Basis.** The theory of full integration is to tax all corporate earnings currently to shareholders as though the income were earned directly by the shareholder. Basis is an important element in determining income, both with respect to measuring gain or loss on sale of property and in computing deductions for depreciation.128 Differences in basis between the corporation and its shareholders or even among the shareholders will complicate the determination of income.

An example may make this problem clearer. A corporation might be formed by A contributing $10,000 cash and B contributing property worth $10,000 but with a basis of $4,000. Under present law B would not recognize gain on his contribution of appreciated property,129 and the corporation would have the same basis in the property as B.130 If the corporation then sold the property it would have a gain of $6,000. If the gain were allocated between A and B, A would be taxed on $3,000 gain, even though he had paid $10,000 for an interest in a corporation still worth only $10,000. B, on the other hand, started with property whose value had appreciated $6,000. He would have an interest in a corporation which had recognized that appreciation, yet he would be taxed on a gain of only $3,000.131

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128. Sections 167(g), 1001.
129. Section 351.
130. Section 362.
131. Similar problems would arise if B sold his stock to C for $10,000 before the corporation sold the appreciated property. B would recognize a gain of $6,000, the $4,000 basis he had in the property being his basis in his stock. Section 358. Since the corporation's basis in the property still would be only $4,000, a gain of $6,000 would be recognized when the property is sold. A and C would be taxed on this gain, even though each paid $10,000 for an interest in the corporation which would still be worth only $10,000. A corporation might buy property which subsequently appreciates. Later the shareholders might sell their stock and then the corporation its property. The original shareholders would be taxed on the appreciation in the property to the extent it is reflected in the value of their stock, much as it would be for B above. That gain would also be taxed to the new shareholders when the corporation sells the property, much as it would be for C above. Similar problems would be presented when the corporation uses the property and takes depreciation deductions, rather than selling it. The corporation's basis in the property for computing depreciation may be less than the amount the shareholders paid to acquire an interest in the property by purchasing stock in the corporation.
Problems would arise, then, when the corporation's basis in property is less than the property's value. Reforms proposed in this article would make such a situation less likely. By increasing basis to correct for inflation, one of the common causes for basis' being less than value would be eliminated. Since basis would be reduced for depreciation, the elimination of accelerated methods of depreciation would result in smaller reductions in basis and thus end another common cause of differences between the property's basis and its value.

The problems arising from differences in the shareholders' and the corporation's bases relate only to when rather than whether each will be fully taxed on their total gain or loss. For example, when A contributes $10,000 cash and B contributes property worth $10,000 but with a basis of only $4,000, each would be taxed on a gain of $6,000 when the corporation sold the property. A would be taxed on $3,000 of phantom gain, and B would be taxed on only $3,000 of his real $6,000 gain. Each shareholder's basis in his stock would be increased by his share of the gain recognized—A's from $10,000 to $13,000, B's from $4,000 to $7,000. When the shareholders later sell their stock, A would have a loss of $3,000, offsetting the $3,000 phantom gain reported earlier, and B would report an additional gain of $3,000, so that all the appreciation is eventually taxed to B. Because of the advantages of tax deferral, the problems created by different stock bases are significant. A would be, in effect, making an interest-free loan to B until B finally bears the full tax consequences of the appreciation in the property he contributed to the corporation. These problems, however, are not as severe as having some gains doubly taxed and others exempt from tax, as under the present system. Perhaps the system could be reformed to account for differences in basis between the corporation and its shareholders, or the resolution of the problems could be left to the market for restructuring of the terms of the transaction by the parties themselves.

By treating differences in basis within corporations like differences in basis within partnerships, this reformed tax system could resolve these basis problems. For example, where A contributed cash and B contributed appreciated property, A and B might be permitted to agree that gain will be disproportionately allocated to B and that depreciation will be disproportionately allocated to A. Similarly,

132. See Part I, supra note 2, at 335-39.
133. Section 1016(a)(2).
134. See Part I, supra note 2, at 339-46.
135. Our present system of taxing corporations does not attempt to deal generally with this problem. But see Section 334.
when a person purchased stock in an existing corporation, the corporate basis in the property might be adjusted in regard to the new shareholder. These provisions, however, may only be practical for closely held corporations with few major assets and whose stock is sold only infrequently. Even then, substantial complexity would result. Nevertheless, such tax provisions might be made available as an option for small corporations under a system of full integration.

To a large extent, the parties to the transaction could eliminate the adverse consequences of different bases between the corporation and its shareholders by simply restructuring the terms of the transaction. For instance, the transaction could be restructured by having B also contribute $10,000 in cash and having the corporation buy B's property. The corporation would have a basis in the property equal to its former value and B would have to recognize a gain of $6,000. Alternatively, B might lease the property to the corporation, thereby avoiding the tax consequences of recognition of gain, but perhaps at the cost of causing cash-flow problems for the corporation.

Another alternative is for the parties to adjust the transaction to reflect more accurately the true value of each contribution. Because A would be temporarily but unfairly bearing part of B's tax burden, A could obtain a larger stock interest than B. If equal ownership shares were desired, B could contribute cash equivalent to the value of the tax deferral in addition to the property. One disadvantage of structuring the transaction in this manner would be that it effectively results in double taxation for B since the value of his property contribution would be reduced by the amount of the future tax liability.

137. Section 743(b). See generally A. Willis, supra note 136, ch. 28.

138. A in effect would be making an interest-free loan to the government from the time he was taxed on phantom gain when the corporation sells the property until he sold his stock and had an offsetting loss. Over a short period the adjustment would be slight. But as the time between corporate sale of property and shareholder sale of stock increased, the value of the offsetting loss deduction would decrease. At the limit, that deduction would have no present value. For example, A might expect a tax liability of $1,000 on his share of the gain of $6,000 when the corporation sells the property. From A's perspective, the half of the corporation for which he paid $10,000 would be worth only $9,000 because he would be exposed to $1,000 tax liability. If his half were worth $9,000, the whole would be worth $18,000. A should insist either that he get five shares for each four that B gets because A is contributing $10,000 to a corporation worth $18,000, or that B contribute $2,000 cash in addition to the property if B is to have an equal interest. If A's ownership increased relative to B's, his share of the gain would increase, suggesting the need for further adjustments in relative stock ownership. Such adjustments, however, would be slight. Increasing A's ownership from one-half to five-ninths would increase his tax liability only $111.11. Again adjusting the percentages of ownership for this small amount would probably not be worth the mathematical computations required.

139. In the example in note 138 supra, if B sold the property, his tax liability might be $2,000; thus, the value of the property net of tax would be
In most cases, however, a substantial adjustment would not be necessary. Where the corporation does not sell the property for several years, the tax advantages of deferral would reduce the degree of adjustment required. If the delay between corporate sale of the property and the shareholder's sale of his stock is short, as it would be in most instances, the adjustments required would be minimal since they would only need to reflect interest on the taxes rather than the taxes themselves.\footnote{140}

The problem of differing shareholder and corporate bases pertains primarily to small, closely-held corporations. The next three subsections discuss problems likely to be more severe with larger corporations: allocating income when stock is traded, issued or redeemed during the corporation's tax year; audits; and complex ownership structures.

**Stock Traded During the Year.** Allocating a corporation's income when no shares are traded, issued or redeemed can be done simply by dividing the income by the number of shares. The process becomes more complex if shares have been traded because income must then be allocated to all holders of the shares during the year. Similar problems are presented when shares are either issued or redeemed during the year. Determining the proper allocation would be simplified because it would only be necessary to consider how much income to allocate to the person holding stock at the end of the year.\footnote{141}

If only $8,000. Contributing property worth $8,000 for a four-ninths interest in a corporation which also has $10,000 cash, or contributing the property and $2,000 cash for a half interest in a corporation with an additional $10,000 in cash, seems fair. But in either case B would still be subject to a tax of either $898.89 or $1,000 when the corporation sells the property. Thus, although in the transaction B's property had been valued as though he had already paid tax on the appreciation, he would still have to pay tax on a part of that appreciation. In effect, B would be doubly taxed.

This problem may not be as severe as presented above. The corporation may not sell the property for several years. The advantage of deferral would reduce A's effective tax exposure, thus reducing the adjustment he may demand and consequently reducing B's exposure to effective double taxation. The problem would be reduced if A's tax bracket were less than B's. A would insist that the value of B's contribution be treated as reduced by the tax liability A would have if he had to recognize the gain in B's property. In effect, the gain would be taxed to B at A's tax rate. B would then in fact be taxed at his own tax rate on half the gain when the corporation sells the property. If A's tax rate were less than one-half B's, B would be better off than if he had sold the property. The efforts of persons with appreciated property to seek out others in lower tax brackets with whom they may form corporations may promote the redistribution of wealth in our society.

It should be re-emphasized that this discussion focuses on the extreme case where there is an infinite delay between the time when the corporation sells the property and when the shareholder sells his stock.\footnote{140. See text accompanying note 135 supra.}  
\footnote{141. It would still be necessary to allocate earnings throughout the year when stock is transferred by gift or inheritance unless the gains or losses on such transfers are recognized. See Part I, supra note 2, at 372-75.}
a person sold his stock before the end of the year, reporting that income or loss would produce an offsetting change in gain or loss recognized on sale of the stock.\textsuperscript{142}

Three methods of allocating corporate earnings are available. The earnings could be entirely allocated to the person holding the stock at the end of the year, entirely allocated to the person holding the stock at the start of the year,\textsuperscript{143} or proportionately allocated among those holding stock during the year. Each of these methods could be easily administered as none would require keeping records of former shareholders.

Allocating all earnings to the person holding the stock at the end of the corporation’s tax year might disrupt securities markets. As the year’s end approached, it might become fairly clear that a corporation would have net income or net loss and what the amount of that income or loss would be. People might then buy or sell particular stocks for their own tax planning purposes. Thus a shareholder desiring to reduce his income might sell stock that had appreciated less than its earnings or purchase stock in a corporation likely to show a net loss. Another shareholder who realized that his taxable income is likely to be abnormally low might sell stock that had depreciated less than its loss or purchase stock in a corporation likely to have substantial net earnings. Although tax considerations are likely to continue to have an important impact on decisions whether to buy or sell securities, tax-motivated trading on the securities markets should not be unnecessarily increased.

Allocating corporate income or loss to the year-end holder would also be unfair. The price of stock purchased near the year’s end

\textsuperscript{142} For example, A might have a basis of $100 in his stock at the start of the year. If later in the year A sold the stock for $125, he would have a gain of $25 if no corporate income or loss were allocated to him. If $10 of corporate income were allocated to him, he would have $10 income, his basis would increase $10 to $110, and his gain would be reduced to $15. His total income, $10 of allocated corporate income plus $15 gain on the sale of stock, would be $25, the same as if no income had been allocated to him. Similarly, if $50 of corporate income were allocated to him, the increase in basis of his stock would produce a loss of $25 on the sale, so his net income subject to tax would again be $25. An allocation to A of corporate loss would reduce his basis, producing an offsetting increase in gain on the sale. With the proposed elimination of the capital gains preference, both the income or loss allocated from the corporation and the gain or loss on the sale of stock would have the same tax treatment.

A restriction on deduction of investment losses such as was discussed in Part I, supra note 2; at 330, 385, 394-96, might make it impossible in certain cases to offset allocated income by loss on the sale of stock. That restriction should not apply to a loss which only offsets income allocated from the stock whose sale produced the loss.

probably would vary according to the corporation's likely income or loss.\footnote{144} If income were likely to accrue, the shareholder would be making an interest-free loan of the tax paid on that phantom gain until the stock was sold. Similarly, if a loss were likely, the shareholder would be receiving an interest-free loan of the tax saved by that phantom loss until he sold his stock. Allocating the entire income or loss to year-end stockholders, then, would result in inequitable shifting of tax liability.

Allocating no earnings to the year-end holder by allocating all earnings to the owner at the beginning of the year would be equally unsatisfactory. Tax-motivated selling problems could be avoided, but this allocation system would still be unfair for those who purchased stock early in the year. Earnings of the corporation during the latter part of the year would not be taxed to anyone that year, and thus would permit the purchaser of stock to defer taxes on the corporation's income during the first partial year he held the stock.\footnote{145} Allocating all earnings to the person holding the stock at either end of the corporation's tax year therefore would be undesirable because the tax system either would be recognizing phantom gains and losses or failing to recognize real ones.

The most appropriate allocation system would be to allocate income according to the amount of time the person owning the stock at year's end has held the stock.\footnote{146} If corporate income were relatively level during the year, such an allocation system should provide relatively little incentive for tax-motivated trading. Difficulties in predicting corporate income early in the tax year would tend to discourage tax-motivated trading. Because the stockowner would be allocated income or loss according to the time he held the stock, tax-motivated trading would also be discouraged later in the year. Problems might be presented, however, if the corporation's income were not uniform throughout the year. For example, the corporation might have profits during one quarter of the year and a loss the next quarter; its business might be highly seasonal, such as retailing Christmas trees; or it might have a large non-recurring gain or loss from

\footnote{144}{For example, stock which sold for $100 at the start of the year might sell for $110 near the end of the year if it appeared that corporate earnings would be about $10 per share. A person buying the stock near the year's end in such a case would seem to be buying $10 that the corporation had already earned, yet he would be taxed as though he had earned the $10 on his investment. Although his stock at the start of the next year would still be worth only $110, he would have been taxed on $10 and his basis would be increased to $120.}

\footnote{145}{If the corporation had a net loss, the shareholder would have to defer a deduction.}

\footnote{146}{The allocation could be based on the number of days the stock was held, or to ease the administrative burden, on the number of months the stock was held.}
sale of some of its major assets. The non-uniformities in corporate income could present problems of tax-motivated trading, recognition of phantom gain or loss, and non-recognition of real gain or loss. These problems could be reduced by allocating income to quarters or months but only at the cost of increasing tax disputes. If earnings were allocated evenly throughout the year rather than entirely at either end of the year, the magnitude of the distortion problem would be reduced. In addition, special allocation rules, analogous to the separate treatment of these transactions on a financial statement, could be developed for large non-recurring gains or losses from a corporation's sale of some of its major assets. Thus, the problem of tax distortion would be unavoidable but could be made tolerable.

Comparable problems could arise when a corporation issues or redeems its own stock. As with sales between individuals, it would be unnecessary to allocate any income to a shareholder whose stock had been redeemed. Similarly, income should be allocated throughout the year to prevent overtaxation of the holders of either newly-issued stock or the remaining shares in a corporation which had redeemed much of its stock. Because both the issue price and the redemption price would likely be influenced by the corporation's earnings that year, those holding newly-issued or unredeemed shares would probably benefit from only part of those earnings. Under time allocation, the corporation's income or loss would be allocated among all shares outstanding for any part of the year, with shares outstanding for the entire year counting as one, and those outstanding for only a part of the year counting as a fraction. As with sales, refinements in the allocation system might be warranted for special circumstances. For example, an issue of new stock or a redemption of old stock might make a significant change in the size of a corporation. In those cases, the corporation's income could be computed separately for the portions of the year before and after the issue or redemption if the administrative burden of these computations were not excessive.

In sum, it would only be necessary to allocate corporate income to year-end shareholders. The amount allocated should be based on

147. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, APB ACCOUNTING PRINCIPLES §2012 (1973).
148. For example, a calendar-year corporation might have 1000 shares outstanding on January 1, and then might issue 200 shares on July 1 and 100 shares on October 1. For allocating that year's income, it would have 1000 full shares, 200 half shares, and 100 quarter shares, for a total of 1125. Its income or loss for the year would be divided by 1125. The amount thus determined would be allocated to each of the 1000 shares, half that amount to each of the 200 shares, one quarter of that amount to each of the 100 shares. The computations would be the same if the corporation had had 1300 shares outstanding on January 1, and then redeemed 100 on April 1 and 200 on July 1.
the time different shares were outstanding and the time a stock-
owner held his share. Mechanisms similar to those now used to
report dividends would be used to report allocated earnings. The
administrative problems of making the allocation would be minor.
More serious administrative problems would arise, however, in allo-
cating corporate income to the shareholder because of revised tax
liability resulting from audits.

Audits. Under the present tax system a change in the determina-
tion of a corporation's income, whether because of an audit by the IRS
or because of a refund claim, normally will affect only that corpora-
tion's tax liability.149 With full integration, however, a change in a
 corporation's income would change the tax liability of each share-
holder as well. Moreover, because an audit or refund claim may
take many years,150 many of the individuals whose tax liability is
affected by a corporation's income for a particular year will have
sold their stock long before the matter is finally resolved.

Some of the reforms proposed in this article would decrease
the number of disputes over income. With the distinction between
ordinary income and capital gain eliminated, there would no longer
be disputes concerning the character of particular gains or losses.151
With full integration of the personal and corporate income taxes,
the likelihood of disputes concerning the characterization of pay-
ments as non-deductible dividends or deductible interest or salary
would be significantly reduced. Nevertheless, resolving disputes
under full integration would be burdensome.

The administrative burdens created by audits could be eased at
the cost of causing some inaccuracy in the system. If the results of
the audit were allocated to those who held stock in the year of the
dispute, procedures and exemptions could be developed to reduce the
burdens of taxing them when the dispute is ultimately resolved.
Alternatively, the change in income could be attributed to those
holding stock in the year the dispute is resolved rather than to those
who held stock in the year of the dispute.

Changes in tax liability resulting from audits and refund claims
could be allocated effectively and efficiently to those who held stock
in the dispute year only by implementing a variety of procedures.
Principally, a final determination of corporate income in one admini-

149. Because under the present tax system dividends are taxable to share-
holders only if the corporation has historic or current earnings and profits, see
note 50 supra, a change in the corporation's income may change the tax
treatment of shareholders' dividends.
150. See, e.g., Stanton v. United States, 186 F. Supp. 393 (E.D.N.Y. 1960),
aff'd per curiam, 287 F.2d 876 (2nd Cir. 1961) (involving tax years 1942-43).
151. See Part I, supra note 2, at 331-32.
FEDERAL INCOME TAX REFORM

strative forum, followed by litigation in one judicial forum would be required. The corporation would control this administrative and judicial proceeding. Shareholders, however, would be entitled to notice of the proceedings and permitted to intervene. A single determination of the tax liability of the corporation and its shareholders could be accomplished by adopting the procedures developed in state and federal courts for handling large class actions and shareholder derivative suits. Changes in the shareholders' liability arising from changes in allocated corporate income could be distinguished from other tax disputes. Other disputes would still be subject to normal audit procedures in the IRS district of the taxpayer's residence. These disputes could be foreclosed by the statute of limitations even though litigation proceeded in regard to the amount of corporate income. Thus the effects of corporate audits would not substantially impair the dispute process in other areas. Once corporate income had been finally determined, the change in the individual's tax liability would be a simple matter of computations, which could be performed by the IRS.

Former stockholders would complicate the process of determining tax liability in a single adjudication. The corporate officers might not adequately represent the interests of former shareholders, especially if most of the corporation's stock had since changed hands. In such a case, former shareholders would be more likely to intervene and might replace the corporate officers as lead representatives in the controversy. Finally, because regular corporate channels could not be used, the costs of notifying former shareholders who

152. Presumably the administrative forum would be before the IRS director of the district in which the corporation had its principal place of business or office. Section 6091(b)(2).

153. Currently, a taxpayer may elect not to pay the deficiency and litigate in the Tax Court, Section 6213, or to pay the deficiency and litigate in the appropriate federal district court, or in the Court of Claims. Section 7422. Actions in the district courts are subject to the venue restrictions of 28 U.S.C. §1402(a) (1970), and review of tax court decisions in the courts of appeals is subject to the venue restrictions of Section 7482(b). If taxpayers are to continue to have a choice of three judicial forums in which to litigate, that choice should be made so that the question of a corporation's income will be determined in one court. The shareholders might be allowed individually to elect whether to pay the deficiency before litigating.


A determination of corporate income would be easier to manage than a large class action. Because the corporate officers could usually be expected to adequately represent the interests of their shareholders, the problems of choosing a representative and determining the adequacy of representation would be fewer than in a class action. Notice could be included in regular communications from the corporation at considerably less expense than if mailed separately. Similarly, identifying members of the class would be much less difficult than in a class action because both the corporation and the IRS would have records of the shareholders.
had sold all their stock in the corporation would be greater than
the costs of notifying current shareholders.156

The problems created by former shareholders could be eased
by exempting them from deficiency assessments if the corporate in-
come attributable to the shares they once held was less than a small
amount, perhaps $100.157 The tax on such small amounts would not
justify the administrative burdens involved in collecting it. Reven-
ues would not be increased by the amount of the tax in any case.
Had the taxpayer reported that income, his basis in his stock would
be increased, thus decreasing the gain or increasing the loss recog-
nized on sale158 and decreasing the taxes owed for the year of
sale. The net effect would depend on the former shareholder's
tax bracket in the dispute and the sale years, the time span between
those years, and the interest rate.159 Because the revenue increase
for the income dispute year would be offset to some extent by a
revenue decrease for the stock sale year, the de minimus exemption
for former shareholders might be fairly large, perhaps even $1000.

The exemption for former shareholders could also be time-based.
If the taxpayer were in the same tax bracket in both the dispute
year and the sale year—a fairly realistic assumption over short
periods with generous averaging provisions160—the only increase in
revenue would be interest accrued between the sale year and the
dispute year. Over short periods the accrued interest might not
warrant the administrative problems of collection. Thus, those who
sold their stock within the first few years after the income dispute
year might be entitled to an even larger exemption. With the exemp-
tion based on both the amount of income and the time between the
dispute year and the sale year, the problems created by former share-
holders could be substantially reduced without endangering revenues.

Allocating the results of the litigation to the stockowners in the
resolution year,161 however, poses a number of substantial problems.
Corporate income would be taxed in the wrong year. Income earned

156. These additional costs of notice should initially be borne by the IRS,
at least where it is asserting a deficiency.
157. A similar exception might also be provided for continuing shareholders.
158. See text accompanying note 142 supra.
159. If the shareholder were in a low tax bracket in the dispute year and
in a high tax bracket when he sold the stock, the determination of an increase
in the corporation's income for the dispute year could entitle the former
shareholder to a net refund.
160. See Part I, supra note 2, at 362-66. Also, tax rates have been stable.
Although there has been some adjustment in the brackets, the tax rates of 14%
to 70% provided in Section 1 have been in effect since 1965.
161. See DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 74
(1977). For example, an audit of a corporation's 1978 income might be re-
solved in 1980 by increasing the corporation's reported income by $100,000.
Under this second approach that $100,000 would be allocated to those holding
stock in 1980 rather than to those who held stock in 1978.
but not reported in one year would not be taxed until the dispute was resolved, possibly many years later, posing severe deferral problems. Because the income would be treated as earned in the year in which the dispute was resolved, charging interest would not minimize the advantages of deferral. Corporate income would also be attributed to the wrong taxpayer if the stock were traded between the dispute year and the resolution year. The person holding the stock when the dispute is resolved would be taxed on that income even though his purchase price presumably reflected the benefit of that earlier-earned income. The person who held the stock in the dispute year would already effectively have been taxed on the disputed income when he sold his stock. That is, had the income been reported, it would have increased his basis in the stock, thereby decreasing the gain or increasing the loss he would recognize on sale of the stock. In effect, both the prior holder and the present holder would be taxed on the same income. Even though the market might adjust for this problem, this inaccurate allocation might disrupt securities markets. Prospective buyers might be reluctant to purchase stock in a corporation involved in a dispute over a relatively large amount of income. These disruptions could also cause corporate managers to settle disputes on terms favorable to the IRS. Because the claim would involve the personal liability of the shareholder rather than just a claim against the corporation's assets, the disruption of the securities market might be even greater with full integration than under the present system. On balance, it would be better to allocate the audit results to stockholders in the dispute year rather than in the resolution year. The complexity of the first approach, eased by the suggested exemptions, is preferable to the problems under the second approach of taxing income at the wrong time and perhaps to the wrong taxpayer, and possibly disrupting securities markets. Either approach, however, is feasible.

Complex Corporate Ownership Structures. The discussion thus far has been in terms of a corporation having a capital structure con-

162. See Part I, supra note 2, at 326-27, 366.
163. The effect of charging interest could be roughly approximated under this second approach by increasing the amount of income from the dispute year by the appropriate interest rate. As long as the shareholder was in the same tax bracket in both the dispute year and the resolution year, increasing the allocated income by the interest rate would have the same effect as allocating income to the dispute year and charging interest on the increase in tax liability. The shareholder's basis in his stock, however, would be increased only by the allocated income, not by the interest charge used to increase that income. The problem with this rough approximation is that if the audit took many years the shareholder probably would not be in the same tax bracket once the averaging period is exceeded.
164. Compare the discussion of differing corporate and shareholder bases in text accompanying notes 138-40 supra.
sisting solely of one class of common stock owned by individuals. Of course the ownership of corporations is often much more complex. Besides common stock, a corporation may also have various types of bonds and preferred stock. Moreover, stock frequently will be owned by corporations rather than individuals, sometimes in interlocking patterns: Corporation A owns stock in Corporation B, B owns stock in C, and C owns stock in A. Full integration must account for such complexities in corporate ownership.

The classic types of investment in a corporation are bonds, cumulative non-participating preferred stock, and common stock. Corporate managers and investors have also utilized many other types of investment in corporations—more than can be described in this article—for various business and tax purposes. The existence of these different types of investment, however, does not significantly affect the feasibility of full integration.

As owners of the residual interest in the corporation, holders of common stock would be liable for taxes on the residual income under full integration. The tax system must determine the proper tax treatment of the holders of superior investment, such as bonds and preferred stock, in order to determine residual income.

With the elimination of the double taxation of earnings on equity investments under full integration, a major source of debt versus equity disputes would disappear. Disputes could still arise because of differences in the tax treatment of debt and equity in regard to timing and inflation correction. Although earnings on equity under full integration would be taxed currently, whether or not distributed, a bondholder using cash accounting would be taxed only when interest was paid or payable and not when it was earned. Yet, if the corporation used accrual accounting, it would have deducted accrued but unpaid interest from the income to be allocated to shareholders. Thus, this interest would not be taxed currently to anyone. The potential advantages of deferral for bondholders could be substantial.

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165. Preferred stock normally is entitled to receive a specified dividend before any dividends are paid on common stock. If preferred is cumulative, it is entitled to receive the specified dividend not only for the current year but also for all prior years before any dividends are paid on common. Cumulative preferred normally has a liquidation preference or redemption price equal to its issue price plus accrued but unpaid dividends. If preferred is participating, it is entitled not only to the specified dividend but also to share in any dividends declared on common. For example, after the specified dividend is paid on participating preferred, those shares might be entitled to half the dividend paid on common or, after a certain dividend on common, to share equally with common in any further dividends. The most frequently used type of preferred is cumulative non-participating. See CAVTCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 4.02[2] (1974).

166. See text accompanying notes 19-20 supra.

167. Section 267 prevents deductions from accruing for amounts owed to a related person who does not have to report them as income.
The advantage of deferral could be restricted by denying the corporation an interest deduction until the bondholder reported the interest income. The bondholder could still obtain the advantage of deferral, but the income of equity holders would be artificially increased. The expected resistance from equity holders would tend to restrict the deferral advantages to bondholders. A more complete solution, however, would be to treat all corporate bonds like original issue discount bonds. Section 1232 makes both the corporation and the bondholder accrual basis taxpayers. Although interest is not paid until the bond is redeemed, accrued interest is currently deducted by the corporation and taxed to the bondholder. Under this approach, holders of both bonds and equity would be taxed currently on earnings, whether or not distributed. Thus, an additional incentive to attempt disguising equity as debt would be avoided.

Under full integration inflation corrections for debt and equity income would also be different. Inflation corrections would be made currently for debt. Interest would be reduced by the inflation rate to determine both the bondholder's income and the corporation's deduction. The principal amount of the bond, however, would not be corrected for inflation. The inflation correction for equity would operate differently. Although the corporation would adjust such items as depreciation and gain on the sale of property, there would be no current correction for inflation for the corporation's continuing assets or for income allocated to the shareholders. Inflation correction, therefore, would be deferred until a sale. This difference in inflation correction reflects real differences in economic rights. The holder of debt has a claim only to a specified number of dollars of income

168. Cf. Section 83(h) (employer's deduction for certain types of salary payments is delayed until the employee reports the salary income).
169. A provision might be made to prevent the accrual of interest for tax purposes on bonds of insolvent corporations. As the corporation became solvent, past due interest would be accrued by both the corporation and the bondholder.
170. See Part I, supra note 2, at 346-52.
171. Id. at 337-46.
172. For example, A and B might form a corporation, A contributing $10,000 cash for all the stock, B contributing $10,000 cash for 9% bonds. In each of its first two years, the corporation might have inflation-corrected income before deducting interest of $2,000. If the inflation rate were 6%, the corporation's payment of $900 interest to B would be treated as a payment of only $300 in computing B's income and the corporation's deduction. Thus A's income would be $1,700 each year. If the corporation were liquidated at the end of the second year, B would receive his $10,000 tax-free as a return of his investment. A's basis would have been increased by two years of 6% inflation to $11,236. The $1,700 of earnings allocated for the first year would increase A's basis by $1,802 when corrected for inflation. Adding the $1,700 for the second year, A's corrected adjusted basis would be $11,236 + $1,802 + $1,700 = $14,738. He would recognize as a gain or a loss the difference between this amount and the amount realized when the corporation was liquidated. Had A been able to correct his income for inflation, he would have had only $1,100 income the first year and $1,034 the second, and an adjusted basis of $12,134.
and to a specified number of dollars as a return of his investment. Thus, this claim can be eroded by inflation. The holder of equity, however, has a claim to the remainder of the corporate income and assets. His claim is dependent on the value of the business and the business’ assets rather than fixed in dollar terms. Because the assets of a corporation are likely to appreciate in an inflationary period, the shareholder’s interest is less likely to be diminished by inflation. Therefore, current correction for inflation is unnecessary for equity holders.

For several reasons, disputes between taxpayers and the IRS as to the characterization of particular investments in corporations would not be likely to occur frequently as a result of the different means of inflation correction. First, the difference in inflation correction relates only to timing. Second, debt may be held pro rata with equity. Investors in such cases would obtain little tax benefit by making part of their investments in debt and part in equity. A current inflation correction, which would reduce interest income, would also reduce the corporation’s interest deduction, and thus increase the amount of corporate income to be allocated to equity. Finally, even where debt and equity were not held pro rata, the conflicting tax and economic interests of debt and equity holders should tend to prevent abuses. Although disputes over the characterization of an investment as debt or equity will continue for corporate law purposes, the tax system proposed here should be close enough to real economic interests to encourage few additional disputes.

Cumulative non-participating preferred stock represents an economic investment more like bonds than common stock. Like debt, such preferred stock is limited in the amount it will produce either as return on investment or as return of investment. Also, the holders of preferred stock have a claim to the corporation’s income and assets which is superior to that of the holders of common stock. Accordingly, the tax system should treat this preferred stock like debt. Dividends on this preferred stock could be treated on an accrual basis both for the corporation’s deduction and for inclusion in the stockholder’s income. The inflation correction could be made currently

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173. One cannot precisely predict how inflation will affect the value of businesses or their assets, but it is reasonable to assume that they, like everything else in the economy, will appreciate at the inflation rate. Only if business assets would not appreciate at all in a period of inflation would it be appropriate to correct equity income for inflation in the manner outlined in the text accompanying note 170.

174. Others have suggested that dividends on preferred stock should be deductible under the present tax system. See, e.g., D. Smith, Tax Treatment of Dividends, in 3 Tax Revision Compendium 1543, 1545-46 (House Ways & Means Comm. 1959).

175. If a corporation’s capital were impaired so that it could not pay dividends, accrual of dividends on preferred would end for purposes of both
as it would be for bonds. Thus the three classic types of investments in corporations would become two for tax purposes. Bonds and cumulative non-participating preferred would both be treated on an accrual basis and would be currently corrected for inflation.

Corporations also provide for other forms of investment. If non-participating preferred stock is not cumulative, its dividends would be recognized for tax purposes by the corporation and shareholder only when paid. Current inflation correction might be appropriate.

If preferred stock is participating, it resembles a hybrid of classic preferred and common stock. For tax purposes, it should be treated as a combination of the two. When the stock is issued, the basis should be allocated between the preferred and the common components according to their respective fair market values.176 Thereafter, each component could be treated as though it were an independent security. The preferred component would be taxed like cumulative non-participating preferred stock. Gain would be allocated to the common component to the extent that it would participate in a dividend. For example, if preferred would receive half the dividend on common, each preferred share would count as a half share in allocating the corporation's earnings.177 Losses would be allocated as the latest retained earnings were. When there are no retained earnings, losses should be allocated in accordance with whose liquidation rights are being impaired.178

176. Compare Section 1232(b)(2) which provides a similar allocation when an original issue discount bond is issued as part of an investment unit which includes other securities. For existing stock the allocation would be based on fair market values on the effective date of full integration.

177. The matter would be more complex if preferred participated only after a specified dividend on common. For example, a distribution might be paid first to preferred $1 per share then to common $1 per share, then to both in a prescribed ratio. If the specified dividend on common were cumulative, earnings per share up to that dividend would be allocated to common and additional earnings would be allocated between preferred and common in the prescribed ratio. If the specified dividend on common were non-cumulative, it would be uncertain who would benefit from retained earnings. The issuance of only one large dividend over a several year period would result in only one specified dividend on common, but annual dividends would produce several specified dividends on common. Preferred would participate in retained earnings only in excess of the specified common dividends. This uncertainty should be resolved against those in control. When common shareholders have voting control, earnings up to their specified dividend should be allocated to them whether or not the dividend is paid. If preferred shareholders have voting control, earnings up to the specified dividend should be allocated to common only if the dividend is paid.

178. For example, if the participating preferred had a liquidation preference based on their full issue price, losses in excess of retained earnings would be allocated first to common. But if that liquidation preference were based only on the preferred component, losses would be allocated between participating preferred and common stock. The deduction for losses would reduce the basis
Problems could arise in accommodating participating preferred in a tax system because the economic rights involved are uncertain. Most of the complexities could be avoided, however, if the corporation currently paid the specified dividends on preferred and common.

Conversion privileges and warrants are often used to create new types of investment in a corporation. A conversion privilege enables a holder of one type of investment to convert it into another type. For example, a bond might be convertible into preferred or common stock, or preferred stock might be convertible into common. A warrant is an option to have the corporation issue a particular type of investment at a prescribed price. Warrants are normally issued in conjunction with another type of investment. The purpose of both conversion privileges and warrants is to create a type of investment which includes both a senior security for protection against loss and the possibility of greater participation in corporate profits by exercising the conversion privilege or warrant.

The exercise of a conversion privilege or warrant poses some problems under full integration because it is likely to change the beneficiary of these retained earnings. The solution would be to make the exercise of such rights a taxable event. The holder should be taxed on the amount by which the tax book value of his new investment exceeded his basis in the converted security or warrant. The existing holders of the type of investment acquired by exercise of the privilege or warrant should be allowed a deduction for the dilution of the tax book value allocable to their shares, to the extent that the diluted allocation is less than their respective adjusted bases in their stock.

The classic types of investment in corporations—bonds, non-participating cumulative preferred stock, and common stock—could be easily accommodated by full integration. The accommodation of other types of investment would be more complicated but still manageable.

179. At present the exercise of such rights is normally not a taxable event to either the holder or the corporation. See G. C. M.-1836, 1937-1 C. B. 101, Rev. Rul. 70-521, 1970-2 C. B. 72. See generally BITTKER & EUSTICE, supra note 6, at § 4.06.

180. A variety of other factors may be used to create different types of investment in corporations: voting rights, subordination of claims, etc. Such factors, while important economically, would be relevant for tax purposes only to the extent that they affect who would benefit from corporate earnings or be hurt by corporate losses. Voting, for example, would seem to have no such affect, while subordination might. The tax treatment of types of investment which contain factors having such effects should be along the lines discussed in text accompanying notes 174-79 supra.
Another complicating factor is the ownership of stock by corporations rather than by individuals. If Corporation A owns stock in Corporation B, B's earnings will be allocated to A, and A's earnings (including its share of B's earnings) will be allocated to A's shareholders. The allocation process becomes even more difficult if B also owns stock in A: B's earnings should include a portion of A's earnings, but A's earnings cannot be determined until B's are, and vice versa. The complexity increases geometrically as more corporations become involved. One solution to the A-owns-B-owns-A problem would be to have A and B each compute their earnings without regard to their holdings of the other's stock, then recompute earnings by including earnings attributable to holdings of the other's stock. Theoretically, this process could be repeated indefinitely but the process could be arbitrarily stopped after one or two rounds. Alternatively, the problem could be resolved by resorting to mathematical formulas.\textsuperscript{181} By including corporate income in a shareholder's income much as partnership income is included in a partner's income,\textsuperscript{182} the problem of interlocking computations could arise only when both or all corporations have the same taxable year. Even there it could be avoided at a cost of some deferral by including corporate items in shareholder income the day after the corporation's taxable year ends. Thus a variety of techniques are available to avoid problems arising from interlocking stock ownership.

\textsuperscript{181} For instance, assume that Corporation A owns X\% of Corporation B and Corporation B owns Y\% of Corporation A. The formula for determining Corporation A's total earnings could be expressed accordingly:

\[ A's \text{ Total Earnings} = A \text{ Earnings} + X\% \text{ of B's Total Earnings} \]
\[ = A \text{ Earnings} + X\% \left( B \text{ earnings} + Y\% \right) \]
\[ \text{of A's total earnings} \]
\[ = A \text{ earnings} + X\% \text{ B earnings} \]
\[ 1 - (X\%) (Y\%) \]

With more corporations, the equations would become more elaborate. For example, if A owned X\% of B and R\% of C, B owns Y\% of C and S\% of A, and C owns Z\% of A and T\% of B, the equation for A's Total Earnings would be:

\[ A \text{ Earn} (1-T\%Y\%) + B \text{ Earn} (X\% + R\%T\%) + C \text{ Earn} (R\% + X\%Y\%) \]
\[ A \text{ Total Earn} = \frac{A \text{ Earn}}{1 - Y\%T\% - X\%S\% - R\%Z\% - X\%Y\%Z\% - R\%S\%T\%} \]

In considering these equations, one should remember that multiplying a number closer to 0 than to 1 by another such number produces a number much nearer to 0. For example, 10\% x 10\% = 1\%, 1\% x 1\% = 0.01\%, etc. Thus if the various percentages of stock ownership are small, perhaps less than 5\% or 10\%, these equations could be simplified without a great loss in accuracy by dropping out all terms which multiply one percentage holding by another. If that were done, the equation at the end of the first paragraph would become A Total Earn = A Earn + X\% B Earn, and the equation at the end of the second paragraph would become A Total Earn = A Earn + X\% B Earn + R\% C Earn.

\textsuperscript{182} Partnership items are included in the partner's income in his taxable year with which the partnership's taxable year ends. Section 706(a).
Transition

The transition from the present system to a system of full integration would be likely to cause two types of problems. The burden of the old tax might have been capitalized so that the change would produce windfall gains or losses. Mechanical problems of how best to effect the transition must also be considered.

It is sometimes said that an old tax is a good tax. That is, an old tax is good, even though it is inequitable and inefficient because the market has adjusted to it. For example, the oil depletion allowance, a provision reducing the tax on income from oil and gas wells, was long a target of tax reformers.\textsuperscript{183} Regardless of the merits of the oil depletion allowance, the market had adjusted to it. When a person purchased an oil well, he also bought the tax benefits of the oil depletion allowance.\textsuperscript{184} When the allowance was limited, however, these purchasers of oil wells were injured because the price they had paid included the value of that allowance. The double taxation of corporate earnings is the mirror image of the depletion allowance. Much as the price of oil wells would increase to reflect the tax benefit of the depletion allowance, the price of stock would decrease to reflect the burden of double taxation. Thus, stock purchasers are not affected by double taxation because they have paid a price which reflects these tax provisions. The elimination of double taxation would result in windfall gains to existing stock owners. The reluctance to bestow these windfall gains makes a reluctance to reform the present system more understandable.

That the market has adjusted to a tax, however, does not mean that the tax does not continue to produce adverse effects. Market forces creating an equal after-tax rate of return for all investments distort the allocation of economic resources. If oil wells benefit from the depletion allowance, more money will be used to drill oil wells. Similarly, if stock is burdened by double taxation, less money will be invested in corporate equity. The over-investment in tax-benefitted areas and the under-investment in tax burdened areas will result in a less productive economy.

The market's adjustment to a tax benefit or penalty, moreover, may not eliminate its effects for all taxpayers. Even though the market will charge everyone the same price and the market clearing price will eliminate the benefit or penalty for investors in one tax bracket, its effects may continue for those in higher or lower tax brackets.

\textsuperscript{183} See, e.g., Baker & Griswold, \textit{Percentage Depletion—A Correspondence}, 64 Harv. L. Rev. 361 (1951). The oil depletion allowance is now restricted by Section 613A.

\textsuperscript{184} This is only one of the possible market adjustments to the oil depletion allowance. Other possible adjustments would include a decrease in the price of oil and an increase in the price of oil drilling rigs.
brackets. Thus market adjustment may not eliminate problems of taxpayer inequity created by a tax benefit or penalty.

The possibility of market adjustment to the present system of taxing corporations and shareholders should not militate against changing that system because it is unclear how the adjustment has been made, and in any case, the adjustment appears to be slight. Imposing taxes at both the corporate and shareholder levels may produce overtaxation, which would depress stock prices, so that a change would produce windfall gains. The revenue loss attributable to taxable shareholders under full integration would only be about $8 billion, suggesting that there is relatively little overtaxation of corporate earnings. Shifting the corporate income tax would further reduce the extent of overtaxation. Shifting, deferral, and capital gains may even result in undertaxation for those in higher brackets. Accordingly, stock prices may have increased so that a change would produce windfall losses. Thus, market adjustment is not a persuasive argument against reforming the present system. The difficulty of discerning the direction and degree of market adjustment further suggests that a change to a system of full integration should not attempt to undo these market adjustments.

In many ways, corporate tax attributes would be the same under full integration as under the present system. For example, although basis would be subject to inflation correction, the corporation would retain the same basis in its assets and shareholders would retain the same basis in their stock. The treatment of corporate distributions would differ, however, under full integration. Under the present system distributions are taxable to shareholders to the extent the corporation has earnings and profits; under full integration distributions would be tax free. Therefore, at least initially, distributions of pre-integration and post-integration earnings should be distinguished. Because post-integration earnings would already have been taxed to the shareholders, those earnings should be distributed tax-free. Pre-integration earnings, however, would not have been taxed at the shareholder level and therefore should be taxed when distributed. Moreover, if pre-integration earnings were not taxed if distributed after the implementation of full integration, corporate distributions would be discouraged in the period immediately preceding full integration.

A method of determining whether a distribution is pre-integration or post-integration is necessary if the two are to be distinguished. Distributions could be treated in any of three ways: (1) as distributions first from pre-integration earnings and then from post-integra-

185. See note 44 supra.
186. See note 115 supra.
187. See text accompanying notes 37, 44 supra.
tion earnings, (2) as distributions first from post-integration earnings and then from pre-integration earnings, or (3) as distributions in part from each. The benefits of tax deferral would be minimized if distributions are treated as if paid first from pre-integration earnings. In addition, past earnings and profits would be eliminated most quickly this way. Shareholders would be taxed on both these distributions and allocated current earnings. But taxing a shareholder on two sets of earnings when he only receives distributions on one set of earnings is unfair and may aggravate existing problems in the system. Furthermore, this solution would impose on all corporations the heavy burden of computing earnings and profits.\textsuperscript{188}

A simpler solution would be to treat dividends as paid first from post-integration earnings and then from pre-integration earnings. Computing pre-integration earnings and profits would be necessary only if dividends exceeded post-integration earnings. Deferral advantages would be available for pre-integration earnings and profits, but no more than are presently available. Moreover, much of those earlier earnings and profits could be from a period when other persons owned the stock.\textsuperscript{189}

Distributions could also be allocated proportionately between pre-integration and post-integration earnings. For example, if a corporation has earnings of both types, distributions could be treated as half from each. This approach would reduce the benefits of deferral. No cash flow problems would be created if the combination of the post-integration and the after-tax part of the pre-integration portion of the distribution exceeded the shareholder's tax liability on the corporate earnings allocated to him. Finally, by providing that after five or ten years, distributions of pre-integration earnings would no longer be taxable, the need for precise computation of pre-integration earnings and profits could be reduced.

Another difference between full integration and the present system is that under full integration when appreciation in stock values is realized the gain would be adjusted for inflation and then taxed as ordinary income, whereas under the present system it would normally be taxed at capital gains rates without adjustment for inflation. Because of the complexity in allocating appreciation between pre-reform and post-reform periods, these reforms should be applied to appreciation existing at the time the reforms are implemented. Although reliance on the capital gains benefit would be frustrated, the unexpected benefit of an inflation correction would offer some compensation.

The transition to full integration should not present serious problems. Little market adjustment to the present system appears to have

\textsuperscript{188} See note 50 \textit{supra}.

\textsuperscript{189} See note 16 \textit{supra}.
occurred, so the transition is unlikely to produce significant windfall gains or losses. Dividends from corporations which have earnings from both before and after the transition can be treated either as paid first from post-integration earnings and then from pre-integration earnings, or as in part from both. In either case, a few years after the transition all dividends might be made non-taxable. Appreciation which occurred before the transition should be taxed like subsequent appreciation. Thus, full integration could be practically implemented.

**Conclusion**

Full integration of the personal and corporate income taxes would eliminate both the double corporate taxation argument for capital gains and the complexity, inequity, and distortion in the present system of taxing corporations and shareholders. Full integration could be achieved without excessive administrative burdens. With implementation of full integration and the reforms proposed in Part I, the major justifications for the capital gains preference would disappear. The capital gains preference could then be eliminated.