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INTEGRATION OF THE CORPORATE AND PERSONAL INCOME TAXES AND THE ALI PROPOSALS

Thomas D. Griffith*

I. INTRODUCTION

Under current law, corporate source income is subject to double taxation: at the corporate level when earned by the corporation and at the personal income tax level when distributed to shareholders. This system has been attacked as both inequitable and inefficient; in recent years, there has been increased interest in and debate surrounding the integration of the corporate and personal income taxes from within the government itself and among commentators.¹

The first part of this article will examine the justifications for, and criticisms of, the corporate income tax. First, this article will examine the “entity” and “conduit” views of the corporation, analyzing the argument that the corporate tax places an unfair burden on taxpayers, in general, and those in lower brackets, in particular. Second, it will evaluate the contention that corporations should be taxed on a benefits received theory. Third, it will examine the effect of the corporate levy on the allocation of capital between the corporate and noncorporate sectors of the economy as well as its impact on the allocation between savings and consumption. Fourth, it will analyze the impact of the corporate tax on a firm’s choice

between debt and equity financing. Finally, it will explore the role of the tax on a corporation's decision to retain or distribute earnings.

The second part of this article will evaluate two different "integration" proposals: dividend relief and the proposal contained in a study by the reporter of the American Law Institute's Federal Income Tax Project. A comparison of the two proposals leads to the conclusion that the ALI proposal is a more desirable method of reform because it reduces the distortions caused by the corporate income tax, but prevents windfall gains to current owners of corporate stock.

II. THE CORPORATION AS A PROPER OBJECT OF TAXATION

A. The "Entity" and "Conduit" Views of the Corporation

1. The Corporation as an Independent "Entity"

A traditional justification for the corporate income tax is that corporations are legal entities distinct from their shareholders and thus are proper objects of an independent tax. Proponents of this view note that corporations have the right to own property, to make contracts, and to sue and be sued; that corporate existence is independent of the lives of its shareholders or officers, that is, the shareholders may pass away while the corporation goes on, perhaps forever; and that individual shareholders are neither legally entitled to earnings until dividends are declared, nor liable for corporate debts. As Justice Holmes stated in *Klein v. Board of Supervisors*, "[t]he corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."

The separation of shareholders from the corporation is...
especially sharp in large, publicly-held enterprises where shareholders are unable to exercise any effective control over corporate policy. Corporations, especially in oligopolistic industries, may seek to maximize their own growth at the expense of maximizing profits which would inure to their shareholders.

The taxation of corporations on an entity theory is no longer widely accepted in the United States; however, in Europe it is generally considered legitimate to tax the corporation as an independent entity, even in those countries that have adopted dividend relief.

2. The "Conduit" Theory

Proponents of integration, on the other hand, argue that "the burden of all taxes must ultimately fall on individuals" and that the corporation "can best be characterized as a 'conduit' through which income earned in the corporation is passed through to shareholders as dividends or retained earnings." Supporters of the conduit theory acknowledge that corporations are often treated as "persons" for legal purposes and that shareholders of publicly-held corporations generally play no part in corporate decisions but they state that this does not alter the fact that corporate income ultimately inures to the benefit of shareholders and thus it should be taxed to them at their individual marginal rates.

3. The "Double Taxation" Argument

Adherents to the conduit theory argue that the dual tax structure violates the basic tax principles of horizontal and

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vertical equity.\textsuperscript{15} Horizontal equity is said to be violated because corporate source income is taxed at a different rate than other income, causing individuals with the same income to bear different tax burdens.\textsuperscript{16} Vertical equity is said to be violated because lower bracket taxpayers are "overtaxed" on their corporate source income to a greater extent than upper bracket taxpayers.\textsuperscript{17}

Under current law, corporate source income is subject to three separate taxes. Corporate profits are subject to the corporate income tax, at rates ranging from 15\% on the first $25,000 of income to 46\% on income over $100,000.\textsuperscript{18} Dividends are taxed to the shareholders receiving them at their individual marginal rates.\textsuperscript{19} Gains from the sale of corporate stock or from qualifying redemptions are taxed at long-term capital gains rates, if holding requirements are met, and such gains benefit from a 60\% exclusion from income of the amount of the gain, as well as from deferral of taxation until the gain is realized.\textsuperscript{20}

As a result of this dual taxation system, currently distributed corporate source income is taxed more heavily than noncorporate source income. For example, $100 of noncorporate source income to a 50\% taxpayer will be subject to a tax of $50, while the same amount of corporate source income will be subject to a tax of $73.\textsuperscript{21} This additional $23

\begin{align*}
\text{tax at corporate level} &= 0.46 \times 100 = 46 \\
\text{tax on net amount paid out to shareholder as a dividend} &= 0.5 \times (1 - 0.46) \times 100 = 27 \\
\text{Total Tax Burden} &= 73
\end{align*}

\textsuperscript{15} McLure, supra note 13, at 535.
\textsuperscript{16} Id. at 537-42.
\textsuperscript{17} Id. at 536-42. In certain cases, a top bracket taxpayer might pay a lower tax rate on his corporate source income than on his other income because of the advantages of deferral and bail-out at capital gains rates. While the possibility of actual tax savings has been sharply cut back by the reduction of the top personal rate from 70\% to 50\%, some savings are still possible. The progressive rate structure of the corporate tax allows a top bracket taxpayer to gain an advantage from deferral by investing in small closely-held corporations whose tax rate may be well below 50\%. These corporations often offer the opportunity to remove profits at capital gains rates through redemptions or liquidations. Moreover, a taxpayer who holds shares in a nondondividend paying corporation until his death will avoid the personal tax entirely because of the step-up in basis under I.R.C. \S 1014 if his shares are redeemed by his heirs.
\textsuperscript{18} I.R.C. \S 11 (Prentice-Hall 1983).
\textsuperscript{19} I.R.C. \S 61(a)(7) (Prentice-Hall 1982).
\textsuperscript{20} I.R.C. \S 1202 (Prentice-Hall 1982).
\textsuperscript{21} The $73 figure is derived as follows:
represents a 46% increase in the tax burden.

For the lower-bracket taxpayer, the "overtaxation" is even greater in both percentage and absolute terms. A 20% taxpayer, for example, would pay a total tax of $56.80 on $100 of corporate source income as compared to a $20 tax on $100 of noncorporate source income. This additional $36.80 represents a 184% increase in the tax burden for the 20% taxpayer.

The apparent "overtaxation" of corporation shareholders disappears, however, if market adjustments in the price of corporate stock to reflect the additional burden of the tax are considered. Assume that all corporate source income is taxed at a 46% rate and is distributed immediately as dividends to shareholders. For X, a 50% taxpayer, the effective tax rate on corporate source income would be 73%, while the tax rate on noncorporate source income would be 50%. A $100 per year pre-tax income stream from noncorporate investment thus yields $50 to X after taxes, while the same income stream from corporate investment yields only $27. Assuming equal risk, X would invest in noncorporate equity.

Y, a zero bracket taxpayer, would also prefer noncorporate investment since $100 of pre-tax noncorporate income would yield a net $100, while the same amount of corporate income would yield only $54. Thus, for an individual at both the highest and lowest personal tax rates, a noncorporate investment generates 85% more income after-taxes.

Because the after-tax return is greater on noncorporate than on corporate equity, investment flows to the noncorporate sector, reducing the return on noncorporate equity and increasing the return on corporate equity. This flow continues until the after-tax return on investment in each sector is equal.\(^2\) Since at this equilibrium, the returns on noncorporate and corporate equity are equal, the burden of a "double tax" on purchasers of corporate shares is eliminated.

Where all corporate earnings are distributed currently, noncorporate investment is preferred to corporate investment to the same extent by both lower and upper-bracket taxpayers. Modification of a 100% payout rate, however, makes in-

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The general solution is \( T = p[I - c]\), where \( T = \) total tax burden, \( I = \) corporate source income, \( c = \) corporate tax rate, and \( p = \) personal tax rate.

vestment in corporate equity relatively more desirable for top bracket taxpayers because the burden of the corporate tax is offset by deferral of the personal tax.\textsuperscript{23}

To illustrate, assume that X, a 50% taxpayer, invests $100 in noncorporate equity yielding a 10% pre-tax return with all earnings reinvested after the payment of the individual income tax. At the end of ten years, X’s $100 will have grown to $162.89.\textsuperscript{24} Now assume that instead X invests in corporate equity yielding a 10% pre-tax return with earnings retained and reinvested by the corporation after paying 46% corporate tax. At the end of ten years, X’s stock is redeemed and the gain taxed at long-term capital gains rates. Here, X’s $100 will have grown to $155.36.\textsuperscript{25} This is less than the yield from noncorporate investment, but because of the deferral of the personal tax and preferential capital gains treatment, the noncorporate investment yields only 4.8% more than the corporate.

The disadvantage of corporate investment in comparison to noncorporate is much greater for low bracket taxpayers. Y, a zero bracket taxpayer, pays no tax on noncorporate earnings, so a ten-year $100 investment will yield $259.37. Y also pays no tax on his capital gains from his corporate investment when the stock is redeemed, but because of the corporate tax a ten-year investment of $100 in corporate equity with 100% retentions will yield only $169.20. For Y, the noncorporate investment yields 53.3% more than the corporate investment.

Since corporate investment is worth relatively more to top bracket taxpayers, a smaller discount is required to induce them to purchase corporate shares than to induce lower bracket taxpayers to purchase such shares. Assuming corporate and noncorporate investments are equally risky and individuals have perfect information, all individuals with marginal tax rates above a certain level will invest in corporate equity, while those in brackets below that level will make

\textsuperscript{23} See McLure, \textit{supra} note 13, at 536-42.

\textsuperscript{24} The general solution is $V=W[1+r(1-p)]^Y$, where $V =$ value of investment at end of term, $W =$ wealth at time of initial investment, $r =$ pre-tax rate of return, $p =$ personal tax rate, and $Y =$ years held. This notation is consistent with that used in Warren, \textit{supra} note 1.

\textsuperscript{25} The general solution is $V=(1-k)W[1+r(1-c)]^Y + kW$ where $V =$ value of investment at end of term, $W =$ wealth at time of initial investment, $k =$ capital gains rate, $c =$ corporate tax rate, $r =$ pre-tax rate of return, and $Y =$ years held.
noncorporate investments.\textsuperscript{26} If, as is likely, the discount on corporate stock is greater than that which would be required to induce a 50\% taxpayer to invest, top bracket taxpayers will be able to purchase stock at prices such that their after-tax return from corporate investments will be substantially greater than their return from noncorporate investments.

Suppose, for example, that stock is discounted so that a 30\% taxpayer is indifferent between corporate and noncorporate investment. Again, assuming a ten-year investment of $100 with a 10\% pre-tax return, a 30\% taxpayer would receive $196.72 from a noncorporate investment, while a corporate investment with 100\% retentions followed by a redemption would yield $160.90. Thus, for a 30\% taxpayer noncorporate investment is worth 22.3\% more than corporate investment. To reflect this, a share of corporate stock representing $100 of assets would sell for only $81.77. This price is a bargain for the 50\% taxpayer who values noncorporate assets only 4.8\% more than corporate and would be willing to pay $95.42 for the stock. Thus, the corporate tax undermines the progressive rate structure by enabling high bracket taxpayers to purchase shares at prices discounted to reflect investments by individuals in brackets lower than their own.\textsuperscript{27}

The corporate tax may also reduce the rate of return on noncorporate investment if it induces a shift in capital from corporate to noncorporate equity.\textsuperscript{28} Such a reduction will be regressive if investors in noncorporate equity tend to be in lower brackets than investors in corporate equity.

The actual market, of course, is far more complex than the model presented here and individual investment choices are more diverse. Upper bracket taxpayers, for example, are more likely than those in lower brackets to invest in corpora-

\textsuperscript{26} See Feldstein & Slemrod, Personal Taxation, Portfolio Choice, and the Effect of the Corporation Income Tax, 88 J. Pol. Econ. 854, 856-57 (1980). The authors point out that Harberger’s assumption that the after-tax yields on corporate and noncorporate investment are equal at equilibrium cannot be true for both high and low income investors. If unequal after-tax yields are incompatible with equilibrium, both classes of investors cannot own both types of assets. Feldstein and Slemrod explain the fact that low and high income taxpayers do own both types of assets as a result of the desire of individual investors to diversify their portfolios.

\textsuperscript{27} A similar windfall is available to top bracket taxpayers who purchase tax-exempt city and state bonds if the rate of return on those bonds is high enough in relation to taxable bonds to attract taxpayers in less than the 50\% bracket.

\textsuperscript{28} See Harberger, supra note 22, at 219 (in the long-run, the corporate tax will depress the return to all capital).
tions that retain all or most of their earnings and individuals may wish to invest in both corporate and noncorporate equity to diversify their portfolios.

4. Existing Theories Are Insufficient

Neither the entity nor the conduit theory provides a satisfactory answer to the question of whether the corporate tax is desirable. Supporters of the entity theory correctly point out that the widely-held corporation has an existence distinct from that of its shareholders, but they fail to show how this justifies an independent corporate tax. Supporters of the conduit theory fail to show that the corporate levy leads to unjust "double taxation" if stock prices are discounted to reflect the tax.

B. The Benefit Theory of the Corporation Tax

The corporate income tax traditionally has been justified as a payment for the benefits of using the corporate form of doing business. The United States Supreme Court justified the tax on this basis in Flint v. Stone Tracy Co. Justice Day, speaking for the Court, described the tax as "an excise upon the particular privilege of doing business in a corporate capacity," noting that the corporate form of doing business offers such important benefits as limited liability of shareholders, ready transferability of shares, and immortality of the corporation. These and other advantages of the corporate form are essential to large, complex business enterprises, but they are an inadequate justification for separate tax on corporate

29. The ability of taxpayers to target their corporate investments according to their marginal tax rates reduces the effects of the corporate tax. A model separating corporate investors into high and low income grounds found the impact of the tax of resource allocation to be only one-third of that indicated by a model that fails to separate the two groups. See Feldstein & Slemrod, supra note 26, at 861-62.

30. See Feldstein & Slemrod, supra note 26, at 856-57.

31. Richard Goode points out that the term "double taxation" is not a helpful one because its emotional content may lead people to reject the corporate tax system without further analysis. The important issue, he contends, is not "double taxation," but the impact of the tax as compared with other forms of taxation. Goode suggests substituting the more neutral terms "relative overtaxation" or "relative undertaxation." See Goode, The Postwar Corporation Tax Structure, in How Should Corporations Be Taxed? 46 (Tax Inst. ed. 1946).

32. 220 U.S. 107 (1910).

33. Id. at 151.

34. Id. at 162.
profits.

The United States tax system seldom levies taxes on a benefits received basis. High bracket taxpayers may benefit more than low bracket taxpayers from government services, but the benefits received by individuals bear little relationship to their relative tax burden. The poorest members of society, for example, may pay no federal income tax, yet they, like all citizens, benefit from federal expenditures in the form of defense, education, and transfer payments.

The limited cases where taxation has been based, at least to an extent, on a benefits-received theory provide no support for the corporate tax. For example, social security taxes are earmarked for the payment of social security benefits. To some extent, the benefits a worker will receive from the system depends on the payments he has made into it. However, unlike social security where the income from the tax approximates expenditures, the corporate tax rate bears no relation to the costs of allowing a business to operate in the corporate form. Moreover, the modest costs to government that are associated with the organization of a business as a corporation generally are borne by the states who charter corporations, not by the federal government.

It also has been argued that various government services are provided to corporations and that an assessment based on corporate profits reasonably reflects the value of such services to the corporation.35 Government services, however, are provided to all businesses and cannot justify a special tax on those operating in corporate form. Moreover, many of the services that most directly touch corporations such as police, fire, and road maintenance services, are provided primarily by state and local governments. If it is desirable to tax businesses based on the services provided to them, a tax such as a value-added tax would be a more appropriate measure of the level of business activity than a tax based on profits. Although it is more likely that a value-added tax would be shifted to consumers than would a tax on profits, if the tax on corporations is justified by a view that government services are a cost of

production, it is proper to reflect the cost of the tax in the price of a product.

Finally, the tax is justified on the ground that, regardless of the cost to the government of the operation of businesses in the corporate form, shareholders benefit enormously from the privileges that businesses gain from the corporate form. These benefits, however, bear little relation to the level of corporate profits. Shareholders of unprofitable corporations, for example, may stand the most to gain from limited liability of corporations.

C. Effects of the Corporation Tax on the Allocation of Capital

1. Short-run Effects of the Tax

The traditional view is that the corporate tax causes a misallocation of capital between the corporate and noncorporate sectors by reducing the return on investment in corporate equity. This view assumes that the corporation and its shareholder bear the burden of the tax, rather than shift it forward to consumers by increasing prices, or backward to labor by decreasing wages. Adherents of the nonshifting theory argue that corporate profits will reduce the amount a firm can retain out of its earnings, but that this will have no influence on prices or wages because any corporate action that would add to profits after the imposition of a tax would also have added to profits in its absence. This argument assumes that firms attempt to maximize profits; however, shifting is

36. See Groves, supra note 35.
38. The term "short-run" refers not to a particular period of time, but to a period set sufficiently short so as to preclude adjustments in fixed capital. Generally, this is estimated to be one or two years. Conversely, the term "long-run" refers to a period lengthy enough so that the allocation of fixed capital has adjusted fully to economic changes.
39. The more common argument is that the tax is shifted by increasing prices to consumers rather than lowering wages to workers. In the remainder of this paper, the term "shifting" will mean the passing of the tax to consumers. Commentators' arguments against shifting are similar, regardless of whether the shifting is forward or backward.

For an argument that the tax is shifted backwards to labor, see Feldstein, Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates, 41 REV. ECON. STUD. 505 (1974) (long-run burden of a general profits tax is likely to be divided between capital and labor).
not, however, dependent upon the existence of a competitive market since a monopolistic or oligopolistic firm would use its market power to raise prices to the profit-maximizing level regardless of the existence of a tax.\(^\text{40}\)

The nonshifting theory was challenged by Professors Krzyzaniak and Musgrave based on an econometric study of the impact of the corporate income tax on the rates of return in American manufacturing during the periods 1935-1942 and 1948-1959.\(^\text{41}\) The professors' approach was to choose variables they believed were independent of the rate of corporate taxation, but were statistically related to the determination of corporate profits. Using statistical techniques, they attempted to isolate the tax variable from other factors influencing profits. They then examined the impact of changes in the corporate tax rate upon the rate of return on corporate investment concluding that there was more than 100% shifting of the tax; an increase in the rate of the tax actually increased the after tax return on corporate equity.\(^\text{42}\) Using the K-M method, other researchers found over 100% shifting in West Germany and Canada.\(^\text{43}\)

Acceptance of 100% shifting would have a substantial impact on both conventional economic theory and tax policy. With respect to economic theory, it would require, among other things, the reassessment of all work based on the assumption that firms generally engage in profit-maximizing behavior and that price is determined at the point where marginal cost and marginal revenues are equal.\(^\text{44}\) With respect to tax policy, it would require abandonment of the theory that corporate source income is subject to the burden of a double tax; instead, the corporate levy would have the impact some-

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42. Id. at 66.


what like a general sales tax on corporate production, albeit
an unusual sales tax because it would be levied at a rate re-
lated to the corporation’s profits rather than on the product’s
value.

The K-M study has been criticized for both methodologi-
cal errors and the absence of a persuasive underlying theory. The basic methodological criticism is that the K-M model
fails to isolate successfully the tax variable from other vari-
ables influencing profits. Because the model fails to determine
adequately corporate profits in the absence of a tax, the tax
variable is forced to bear the burden of explaining the level of
profits. Thus, it is argued, Krzyzaniak and Musgrave showed
only the existence of a correlation between pre-tax profits and
the corporation tax, not a causal relationship. Indeed, one
commentator suggests that the causal connection may be re-
versed: a rise in the profits rate may make Congress more will-
ing to raise the corporation tax rate. It has also been noted
that the K-M theory implies that increases in the corporate
tax rate were responsible for almost all the rise in corporate
profits from the 1936-1939 period to the 1955-1957 period, a
highly implausible conclusion.

Critics of the shifting theory also note that some empiri-
cal studies have found little or no shifting. These studies

45. See R. Goode, supra note 4, at 66.
46. Any empirical study of the incidence of the corporate tax faces substantial
hurdles. Many factors other than the tax rate influence corporate earnings, for exam-
ple, changes in the productivity of labor and capital, nontax-induced shifts in de-
mand, changes in monetary and fiscal policies, movements in the business cycle, and
modifications in the policies of foreign trading partners. See Cragg, Harberger &
Mieszkowski, supra note 44, at 811.
47. See, e.g., Goode, Rates of Return, Income Shares and Corporate Tax Inci-
dence, in Effects of Corporation Income Tax 227-28 (M. Krzyzaniak ed. 1966);
Slitor, supra note 44, at 157; Cragg, Harberger & Mieszkowski, supra note 44, at 812;
Mieszkowski, supra note 44, at 1116-20.
48. Slitor, supra note 44, at 200; Cragg, Harberger & Mieszkowski, supra note
49. Cragg, Harberger & Mieszkowski, supra note 44, at 813.
51. See, e.g., Gordon, Incidence of the Corporation Income Tax in U.S. Manu-
facturing 1925-62, 57 AM. ECON. REV. 731 (1967); Hall, Direct Shifting of the Corpo-
rate Income Tax in Manufacturing, 54 AM. ECON. REV. 258 (1964); Oakland, Corpo-
rate Earnings and Tax Shifting in U.S. Manufacturing, 1930-1968, 54 REV. ECON. &
STAT. 235 (1972); Turek, Short-Run Shifting of a Corporation Income Tax in Manu-
facturing, 10 YALE ECON. ESSAYS 127 (1970); but see Dusansky, The Short-Run Shif-
ting of the Corporation Income Tax in the United States, 24 OXFORD ECON. PAPERS
357, 359 (1972) (found over 100% shifting based on a model where profits were not
were based upon varied hypotheses about firm behavior, ranging from an assumption of profit-maximization\textsuperscript{52} to an assumption of mark-up pricing.\textsuperscript{53} Not surprisingly, the methodology of these studies has also been challenged.\textsuperscript{54}

Various theories have been offered for the alleged ability of corporations to shift the tax, but these theories are unpersuasive. It is argued that businessmen, especially in noncompetitive markets, may not wish to charge all that the traffic will bear\textsuperscript{55} and that managers may consider the tax as a cost of production and set prices to cover production costs with a margin for profit.\textsuperscript{56} It has also been suggested that managers may strive for a target rate of after-tax earnings and adjust their prices to reach that target,\textsuperscript{57} and that firms in an unstable oligopoly may use a tax increase as a signal to raise prices.\textsuperscript{58}

The implication of these theories is that most firms do not seek to both maximize profits and have substantial market power.\textsuperscript{59} Although some researchers believe firms may seek to maximize sales rather than profits once a minimum acceptable profit level has been achieved,\textsuperscript{60} the acceptance of widespread nonprofit maximizing behavior would require the rejection of most conventional economic analysis\textsuperscript{61} and the

\begin{itemize}
\item the only corporate goal. Although most studies have found either virtually no shifting or close to 100\% shifting, a few have concluded that partial shifting occurs. See, e.g., 2 Carter Commission, supra note 14, at 144 (one-third shifting within 3 to 5 years); Mikesell, The Corporate Income Tax and Rate of Return in Privately-Owned Electric Utilities, 1948-1978, 28 Pub. Fin. 291 (1973). The empirical evidence on shifting from less developed countries is also mixed. See Lent, supra note 1, at 730.
\item Oakland, supra note 51.
\item Gordon, supra note 51.
\item Goode, supra note 47, at 207.
\item Id.
\item Id. See Slitor, supra note 44, at 141.
\item Goode, supra note 47, at 209; Slitor, supra note 44, at 141.
\item See Goode, supra note 47, at 211-12; Gordon, supra note 51, at 754-55.
\item See Baumol, supra note 9; Williamson, supra note 9. See also Dusansky, supra note 51, at 359; Slawson, supra note 6, at 665. Slawson suggests that a firm in an oligopolistic industry may not set prices at a profit-maximizing level either because it may fear antitrust actions or because side payments would be required to induce other firms to maintain the prices that would result in maximum industry-wide profits.
\item See supra note 44 and accompanying text.
\end{itemize}
market power needed for 100% shifting would require a much greater concentration of industry in the United States than actually exists. The magnitude of the alleged shifting also calls its validity into question. The K-M finding of 134% shifting implies that a corporation earning a pre-tax rate of return of 10% in the absence of a tax would increase its pre-tax rate of return to over 25% if a 50% corporate tax were introduced.

In light of the mixed empirical data, the far stronger theoretical case for the nonshifting hypotheses should be given substantial weight. In the remainder of this article, it will be assumed that the burden of the tax is primarily borne by shareholders. Even if the tax were completely shifted, however, integration still might be desirable since a shifted tax could cause economic distortions by acting as an arbitrary sales tax on goods produced by profitable corporations, if the tax were shifted forward to consumers, or by acting as an equally arbitrary tax on the employees of such corporations, if the tax were shifted backward to labor. In either case, the tax would be regressive. The shifting of the tax would cut strongly against integration only if no unshifting would occur after its removal. Although there is some econometric evidence that suggests unshifting might not occur, this evidence is weak and lacks a persuasive theoretical foundation.

62. See J. Ballentine, supra note 40, at 17.
63. See Goode, supra note 47, at 209.
64. Krzyzaniak and Musgrave themselves admit that the 100% shifting hypothesis cannot be accepted fully in the absence of a study based on a complete theoretical model. Krzyzaniak & Musgrave, Corporation Tax Structure: A Response, 78 J. POL. ECON. 768, 770 (1970).

Attempts have been made to explain 100% shifting using theoretical models that assume firms do not attempt to maximize profits. See Levy, Professor Baumol's Oligopolistic Model and the Corporation Income Tax, 16 PUB. FIN. 366 (1961); Cauley & Sandler, The Short-Run Shifting of the Corporation Income Tax: A Theoretical Investigation, 20 PUB. FIN. 19 (1974). These studies have been challenged, however, because they assume that the corporation tax does not reduce "normal profits"—those in excess of normal profits. See J. Ballentine, supra note 40, at 26; Ballentine, Non-Profit Maximizing Behavior and the Short-Run Incidence of the Corporation Income Tax, 7 J. PUB. ECON. 135 (1977).
65. See supra note 45 and accompanying text.
66. See 1 CARTER COMMISSION, supra note 14, at 27; M. Krzyzaniak & R. Musgrave, supra note 41, at 66.
2. Long-run Effects of the Tax

The classical view is that in the long-run, after all adjustments in fixed capital have occurred, the corporate tax will be shifted to all owners of capital.\textsuperscript{68} This will occur because the tax will decrease the return on equity invested in the corporate sector relative to other equity, diverting capital from that sector to corporate debt or to noncorporate investment.\textsuperscript{69} The extent of the investment shift depends on how valuable it is to use the corporate form and how elastic the capital supply is with respect to the rate of return.\textsuperscript{70} This shift in investment to the noncorporate sector will result in a reduction in the yield on noncorporate equity and an increase in the pre-tax yield on corporate equity. At equilibrium, both corporate and noncorporate after-tax yields will be equal; but, because the tax induces a shift in investment from more productive uses in the corporate sector to less productive uses in the noncorporate sector, total production will be reduced.\textsuperscript{71} The shift to noncorporate investment leads to a change in business form as well as to a change in the type of production as well as the form of doing business, because certain industries, such as heavy manufacturing or transportation, may find the corporate form more important than others, like retailing and farming.\textsuperscript{72}

The tax-induced shift in investment from more valuable uses in the corporate sector to less valuable uses in the noncorporate sector is claimed to lead to a significant welfare loss.\textsuperscript{73} Harberger's estimate of a loss equal to 0.5% of the

\textsuperscript{68} Even in the traditional view, consumers or workers may bear some of the burden of the tax as a result of shifts in the allocation of capital. For example, if steel production can be conducted only by corporations and the corporation tax reduces investment in that sector, the resulting reduction in steel production will lead to a lessening of the demand for, and wages of, steel workers. Similarly, the tax will increase the price of goods produced by corporations, harming consumers who purchase disproportionate amounts of these goods.

\textsuperscript{69} See R. Goode, supra note 4, at 58; Harberger, supra note 22, at 215-20.

\textsuperscript{70} See Goode, supra note 47, at 208.

\textsuperscript{71} Harberger, supra note 22, at 219.

\textsuperscript{72} See R. Goode, supra note 4, at 56.

\textsuperscript{73} Harberger, Efficiency Effects of Taxes on Income from Capital, in EFFECTS OF CORPORATION INCOME TAX 108 (M. Krzyzaniak ed. 1966). Efficient allocation of capital exists when all uses of capital result in equal marginal product. By making the cost of capital higher to corporations than to noncorporations, capital will be allocated so that the value of the marginal product of capital will be higher in corporate than in noncorporate use. This analysis assumes that the dollar value of the marginal
gross national product is often cited by proponents of integration.\textsuperscript{74} A more recent paper by Fullerton, King, Shoven, and Whalley concluded that the present system results in a welfare loss of 1% as compared with a fully integrated tax system.\textsuperscript{75} An additional welfare loss is said to occur because the reduction of the rates of return on all investment caused by the tax may induce individuals to choose current consumptions instead of savings, thus inhibiting the rate of capital formation and economic growth.\textsuperscript{76}

Despite economic theory which indicates that the corporate tax leads to shifts in investment from the corporate to noncorporate sectors, there is no convincing empirical evidence that such a shift occurs because of the tax.\textsuperscript{77} Both the Harberger and F-K-S-W estimates of the welfare loss depend on many unproven assumptions about factors such as the effect of corporate tax on the level of government services and the elasticity of the labor supply and of savings.\textsuperscript{78} It is also uncertain whether reduced rates of return on investment lead to a decline in savings since the rate of savings may be inversely proportional to the rate of return on investment if individuals save to reach a target level of accumulation.\textsuperscript{79} Moreover, the European experience with dividend relief provides no evidence that the reduction of the corporate tax through dividend relief actually leads to a growth in the savings rate.\textsuperscript{80}

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\textsuperscript{74} C. McLure, supra note 1, at 26 (drawing from findings in Harberger, supra note 73).
\textsuperscript{77} See Goode, supra note 47, at 229.
\textsuperscript{78} One commentator characterized the Harberger estimate of welfare loss as relying on such "sweeping assumptions" that "it is difficult to take seriously." J. Wiseeman & M. Davenport, Theoretical and Empirical Aspects of Corporate Taxation 43-44 (1974). Any calculation of efficiency gains from integration also must consider costs that may be associated with the transition from the present system to an integrated one.
\textsuperscript{80} See Gourevitch, supra note 11, at 82.
In sum, it is uncertain to what extent the corporation tax induces substantial welfare losses by distorting intersectoral allocation of capital.

D. Debt v. Equity Financing of Corporate Investment

The current corporate tax system favors debt over equity financing because the interest on debt is deductible from the corporation's taxable income while dividend payments are not. The consequent overreliance on debt financing is claimed to cause a welfare loss by increasing the vulnerability of corporations to bankruptcy. In addition, the different treatment of debt and equity leads to costly litigation regarding how a particular instrument should be classified.

The majority view that the corporate tax favors debt financing has been challenged, however, by some theorists. In particular, the assertion that reliance on debt financing distorts investment decisions, because creditors will demand higher interest rates to offset costs associated with bankruptcy, has been questioned on the grounds that such costs may not be large enough to play a significant role in a firm's decision making. There is no empirical evidence, however, proving that any actual welfare loss occurs because of a tax induced emphasis on debt financing. The evidence is even inconclusive as to whether the tax significantly alters the debt to equity ratio. A German study, for example, found that the proportion of corporate capital investment financed by new equity dropped in that country despite the passage of a re-

81. See ALI Study, supra note 2, at 330.
82. See C. McLure, supra note 1, at 26; Warren, supra note 1, at 736.
85. See Warren, supra note 1, at 734 n.46.
86. See Miller, supra note 84, at 262-64.
duced tax rate on dividend distributions. Further, a comparison of the debt-equity ratios of firms in the United States revealed no significant change between the 1920's and the 1950's, despite a quintupling of the corporate tax rate. A study of corporate behavior in the United Kingdom, on the other hand, concluded that the tax advantages of debt financing explained more than 80% of the variation in the debt to equity ratio during the years studied.

If a bias in favor of debt exists, it is clearly much stronger with respect to new issues than with respect to retained earnings. In theory, a firm's choice between investing with retained earnings or investing with debt will depend on the tax rates on personal and corporate income and the effective tax rate on capital gains, assuming sufficient retained earnings and no bankruptcy or transaction costs. Either debt or retained earnings, however, are always preferable to new equity. Because there may be little or no advantage to debt, as compared to retained earnings, no bias against equity financing may exist where retentions are readily available to meet a firm's investment needs.

E. Retained Earnings v. Dividends

Current law favors the retention of earnings over their distribution as dividends in two ways. First, by retaining earnings, the burden of the individual income tax is deferred. Second, the full burden of the individual tax may be avoided entirely if the earnings can be removed at long-term capital gains rates through redemption of corporate stock or liquidation of the corporation.

Since favorable tax treatment makes it cheaper to finance investment with retained earnings than with new equity, it is argued that this leads to the misallocation of resources because firms will invest funds internally that might, if distributed, be invested in projects yielding a higher return. The

87. See Gourevitch, supra note 11, at 81.
88. See Miller, supra note 84, at 264.
89. J. BalIentine, supra note 40, at 62 (citing M. King, Public Policy and the Corporation (1977)).
90. J. BalIentine, supra note 40, at 55.
91. Id. at 56; Stiglitz, supra note 84, at 17-19.
92. See J. BalIentine, supra note 40, at 55-57.
93. See C. McLure, supra note 1, at 24.
tax advantages of using retained earnings also are said to favor established corporations with the ability to generate capital internally over emerging corporations dependent on new equity.\textsuperscript{94} The theoretical argument that the corporate tax system favors the retention of earnings is supported by findings that the return on investments in the United States financed by new equity ranged from 14.5\% to 20.8\%, while the return on internally financed investment ranged from 3.0\% to 4.6\%.\textsuperscript{95} A study of British firms also found that retained earnings generated a relatively low rate of return.\textsuperscript{96}

Some commentators have argued that the finding that distributions subject to the "discipline of the market" are invested no more efficiently.\textsuperscript{97} It is also uncertain whether the elimination of the double taxation of dividends, either through full integration or through dividend relief, would significantly increase the percentage of earnings that are distributed.\textsuperscript{98} In addition, some commentators have argued that it is desirable for corporations to retain rather than distribute earnings because retentions will increase the total level of investment if shareholders would consume rather than reinvest dividends.\textsuperscript{99}

\textsuperscript{94} See Gourevitch, supra note 11, at 72.
\textsuperscript{96} Whittington, The Profitability of Retained Earnings, 54 Rev. Econ. & Statistics 152 (1972).
\textsuperscript{98} Evidence from the British experience with dividend relief is mixed. Compare Ruben, The Irrelevancy of the British Differential Profits Tax, 74 Econ. J. 347 (1964) (no impact) with Feldstein, Corporate Taxation and Dividend Behavior, 37 Rev. Econ. Stud. 57 (1970) (substantial impact). See also King, Corporate Taxation and Dividend Behavior—A Comment, 38 Rev. Econ. Stud. 377 (1971) (some impact, but much smaller than suggested by Feldstein). The French and German experiences are even less encouraging. Firms may be reluctant to raise their rate of distribution out of a fear that they may be unable to maintain the higher level. This reluctance may be because dividends are believed to indicate the profitability of the firm and thus influence the future cost of capital to it. Thus, firms may change their dividend policy only when they believe there has been a long-term change in their profitability. See Lynch & Withrell, The Carter Commission and the Saving Behavior of Canadian Corporations, 22 Nat'l Tax J. 57 (1969).
\textsuperscript{99} See Gourevitch, supra note 11, at 72-73. See also R. Musgrave, Fiscal Reform in Bolivia 320 (1981); Feldstein & Frisch, supra note 79, at 41-42 (study of the United States from 1929 to 1966 indicates one dollar of retained earnings adds 25\% more to total private savings than one dollar of dividends); Lynch & Withrell, supra
F. Distributional Impact of the Corporation Income Tax

Supporters of integration argue that the corporate tax system violates vertical equity because corporate income is taxed relatively more heavily for lower bracket taxpayers than it is for upper bracket taxpayers, especially when most corporate income is retained.100 Moreover, if the price of shares is discounted to reflect investment by middle income individuals, corporate investment may be highly advantageous to the wealthy.101

The fact that lower-bracket taxpayers are disproportionately "overtaxed" when they invest in corporate equity does not mean, however, that the elimination of the tax would have a progressive effect. Investment in corporate shares is heavily concentrated in the upper economic classes. The top one percent of taxpayers receives almost 50% of corporate dividends.102 This concentration of corporate stock among top bracket taxpayers may occur, in part, precisely because they are least harmed by the double tax, although the ability of the wealthy to save a relatively high proportion of their income is probably a more important factor. Thus, despite the greater overtaxation of the poor on corporate investment, most corporate taxes are paid by upper income individuals.103 Any inte-

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note 98, at 59-60 (full integration might result in a substantial decline in corporate savings, harming economic growth).

100. McLure, supra note 13, at 536-42. It is assumed here that a progressive tax system is desirable. Progressive taxation has been justified on a number of grounds. First, the wealthy may receive disproportionately more benefits from the government than the poor. See C. Galvin & B. Bittker, The Income Tax: How Progressive Should It Be? 52-54 (1969). Second, it has been claimed that all individuals should pay a proportionate amount of their discretionary income in taxes. Since high income taxpayers have a greater percentage of discretionary income, this requires a progressive tax. Third, money may have a diminishing marginal utility so that social welfare is increased by the equalization of wealth. Fourth, proportionate sacrifice may require a progressive tax system, since a $1000 burden to a $10,000 taxpayer may be greater than a $10,000 burden to a $100,000 taxpayer. Finally, it is argued simply that a just society would act to minimize economic inequality. For a general discussion of the progressive tax, see Blum & Kalven, The Uneasy Case for Progressive Taxation, 19 U. Chi. L. Rev. 417 (1952).

101. See supra text accompanying notes 15-30.

102. See ALI study, supra note 2, at 348; R. Goode, supra note 4, at 77; Slawson, supra note 6, at 630; Surrey, supra note 10, at 339.

Institution proposal must take into account the actual concentration of stock ownership among wealthy investors who purchased shares at a price discounted because of the tax. Eliminating the corporation tax through integration would provide these investors with windfall gains by increasing the after-tax profits of firms doing business in the corporate form.

Proponents of dividend relief have responded to the windfall argument in several ways. First, they argue that in the long-run lower and middle income taxpayers would benefit from integration because dividend relief reduces the impact of the corporation tax proportionally more for lower bracket shareholders than it does for upper bracket taxpayers. This reduction, however, is of little use to middle and lower income individuals who may lack the funds to buy shares in the first place and it seems unlikely that stock ownership among the nonwealthy would increase significantly as a result of dividend relief.¹⁰⁴

A second response, offered by Warren in a recent article advocating dividend relief, is that the discount hypothesis remains unproven¹⁰⁸ and that the "fragmentary" empirical evidence that does exist indicates that corporate stock has not generally sold for less than the assets it represents.¹⁰⁶ The study by Gordon and Bradford¹⁰⁷ that Warren cites as suggesting that stock prices are not discounted provides little support for that claim, however, even if its assumptions and methodology are accepted. Gordon and Bradford found that the marginal value of a dollar of dividends is regarded by the

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104. See Gourevitch, supra note 11, at 80 (dividend relief in France did not increase stock ownership in the lower and middle classes).

105. Warren, supra note 1, at 728 n.32, 757. In theory, share prices would be discounted because of the corporate tax so long as the corporation bore the burden of the tax. A rejection of the discount hypothesis thus implies acceptance of the shifting hypothesis. Full shifting of the corporate tax, however, requires that firms not engage in profit-maximizing behavior. See supra notes 40-45 and accompanying text. But Warren explicitly assumes that firms do maximize profits. Warren, supra note 1, at 731 n.37.

106. Id. at 757 (citing Gordon & Bradford, Taxation and the Stock Market Valuation of Capital Gains and Dividends, 14 J. Pub. Econ. 109 (1980)). It is hardly surprising, however, that there is no conclusive empirical evidence proving the existence of a discount. As in the determination of the incidence of the corporation tax, it is extraordinarily difficult to isolate the effect of the tax. See Warren, supra note 1, at 757 n.113 (quoting Shoup, The Dividend Exclusion and Credit in the Revenue Code of 1954, 8 Nat'l Tax J. 136, 144 (1955)).

market as equivalent to a dollar of retained earnings. This finding cannot support the claim that overall share prices reflect the value of the underlying assets or that the elimination of the tax would not lead to a windfall. Bradford himself has argued from an analysis of an admittedly highly simplified model of a tax on corporate distributions that "in so far as partial integration amounts to eliminating a tax on distributions, it may result primarily in windfall wealth redistribution, reversing the, by now, irrelevant wealth changes that occurred when the tax was introduced . . . ." Moreover, there is substantial theoretical support for the discount theory.

A third response to the windfall argument is that almost all changes in the tax law have a retroactive effect and lead to a windfall or penalty to some group of taxpayers. Thus, it is argued that it would unduly restrict tax reform if otherwise desirable changes in the tax law were rejected because penalties or windfall gains might result. The fact that most tax reforms will disproportionately benefit or penalize particular segments of the population does not, however, mean that windfalls and penalties should be ignored in the formation of tax policy. Rather, the unfairness of allowing the windfall or penalty must be compared with the benefits of the proposed reform on a case-by-case basis.

A fourth argument is that the possibility of favorable tax changes may be capitalized into the price of shares, making it inaccurate to characterize gains due to tax modifications as windfalls. This argument has little merit even if one accepts the contention that financial markets correctly evaluate un-

108. See id. at 111.
110. See supra notes 15-30 and accompanying text.
111. See Graetz, Legal Transitions: The Case of Retroactivity in Tax Revisions, 126 U. Penn. L. Rev. 47, 63 (1977). Graetz contends that it would be appropriate to eliminate retroactively the tax exemption on state and local bond income. Id. at 61. But this seems precisely the type of tax where a grandfather clause is desirable. First, it would be quite easy to administer such a clause by simply allowing a tax exemption to all bonds issued before a certain date. Second, because the purchases of tax exempt bonds paid a premium for them because of their tax advantage, it seems unfair to remove that advantage.
112. Warren, supra note 1, at 757-59.
113. Id. at 757-58.
likely events such as major structural changes in the tax law. The capitalization argument could justify any expropriation of property, even one that is now considered unconstitutional, since the market could have capitalized the possibility, however remote, that such an expropriation would take place. In addition, the mere fact that an investor might have paid a small premium for his stock because of the remote chance of a favorable tax change does not make gains as a result of such a change less of a windfall. Moreover, since most investors are unlikely to plan for remote contingencies, hardships may result if individuals are subject to significant unforeseeable changes in their financial status. Although the gains to shareholders from integration would not create hardships, it may be desirable for the government to adopt a consistent policy of minimizing the retroactive impact of tax changes where it is feasible to do so.

A final response to the windfall argument is that any loss of progressivity as a result of integration could be offset by changes in the marginal rate schedules. Thus, it is argued, issues of vertical equity are relatively unimportant and integration should be judged by its effects on horizontal equity, resource allocation, and corporate financial policy.114 Even if changes in the tax rate offset the overall loss in progressivity, however, individuals with particularly large stockholdings would obtain a windfall. More important, the enactment of integration would be unlikely to be accompanied by an increase in the progressivity of the rate structure, given the likely political opposition to such a change.

The Canadian experience is instructive regarding the politics of tax reform. In 1966, the Royal Canadian Commission on Taxation released its famous “Carter Commission Report.”115 This comprehensive proposal included among its recommendations the full integration of the corporate and personal income taxes.116 The top individual and corporate tax rates were to be harmonized at 50% and each resident shareholder was to include in his income his share of divi-

114. C. McLure, supra note 1, at 40.
dends or allocated retained earnings, grossed up by the corpo-
rate tax paid. The shareholder would then receive a refund-
able tax credit for the proportionate share of the corporate
tax paid. Canadian capital gains on corporate shares, previ-
ously not taxed at all, were to be taxed at ordinary rates. The
Commission regarded the integration and capital gains pro-
posals to be linked, believing that the windfall that sharehold-
ers would receive from integration in the absence of full taxa-
tion of capital gains was unwarranted, as would be the burden
of the full taxation capital gains in the absence of integra-
tion.\textsuperscript{117}

The business community attacked both the Carter Com-
mission proposals\textsuperscript{118} and the "White Paper" reform proposals
issued in 1969\textsuperscript{119} which retreated from complete integration,
but still suggested the full taxation of capital gains, introduc-
ing a provision for the periodic deemed realization of gains in
widely traded shares.\textsuperscript{120} The tax changes that finally emerged
from this process in 1971 contained neither integration of re-
tained earnings, full taxation of capital gains, nor deemed re-
alization of corporate shares. However, the changes did con-
tain provisions for partial dividend relief, a proposal favored
by the business community and by wealthy taxpayers.\textsuperscript{121} The
Canadian government argued that the modifications made in
the Carter Commission proposals indicated its responsiveness
to the wishes of Canadian taxpayers, but in reality only the
views of the small but vocal business segment of the commu-
nity were heard.\textsuperscript{122}

The prospects for comprehensive reform appear no better
in the United States. A study of the revenue effect of the im-
plementation of Carter Commission-style integration in the
United States indicated that several controversial reforms,
such as the full taxation of capital gains and social security
benefits and the elimination of most personal deductions,
would be necessary if revenue lost by eliminating the corpo-

\begin{itemize}
  \item \textsuperscript{117} 4\text{Carter Commission, supra note 14, at 27-28.}
  \item \textsuperscript{118} Gourevitch, supra note 11, at 85-86.
  \item \textsuperscript{119} Hon. E. Benson, Proposals for Tax Reform (1969).
  \item \textsuperscript{120} At one point up to 7,000 letters of protest arrived at the capital each day,
as the financial press and business groups rallied opposition. In particular, the provi-
sions calling for integration and deemed realization of accrued share gains came
  \item \textsuperscript{121} Id. at 25.
  \item \textsuperscript{122} Id. at 39.
\end{itemize}
tion tax were to be replaced without substantially raising individual rates.\textsuperscript{123} The prospect of passage of such reforms is bleak. Proponents of integration in the United States are split between supporters of full integration, largely from academia, and supporters of dividend relief, who are more often drawn from the business community.\textsuperscript{124} The campaign to enact either full integration or a comprehensive tax reform package which would include dividend relief and the full taxation of capital gains might well result in the passage of only dividend relief instead. Once such relief is enacted, it may be difficult to generate support for further integration.

In sum, the distributional impact of integration is a cause for serious concern. The elimination of the corporate income tax would lead to windfall gains to shareholders who are predominantly from the wealthiest sector of the population. Such gains would reduce vertical equity and might undermine respect for the tax system among middle and lower income taxpayers. The arguments that such a windfall should be accepted are not persuasive. Although integration proposals that result in a windfall should not be rejected out of hand, it is important to balance the likely gains from any integration proposal against the potential loss in equity and to search for ways to achieve the goals of integration without allowing a windfall to current shareholders.

III. INTEGRATION PROPOSALS

A. Dividend Relief

Dividend relief eliminates the corporate tax on distributed earnings while leaving the separate tax on retentions intact. The two basic techniques of implementing dividend relief are the dividends paid deduction method and the withholding method. Under the dividends paid deduction method, the corporation is allowed to deduct distributed earnings from its taxable income, much as interest can currently be deducted by the corporation. Under the withholding


method, the corporation pays taxes at the corporate rate on all its earnings but shareholders are allowed a credit for, and must include in income, the corporate taxes paid on the earnings distributed to them. Each method leads to identical results.\(^\text{125}\)

Dividend relief is touted as eliminating or reducing the distortions caused by the separate tax on corporate profits. From the individual investor's viewpoint, it eliminates the bias against investing in corporate equity as long as corporate earnings are not retained. Even where such earnings are retained, it reduces that bias.\(^\text{126}\) Thus, dividend relief lessens the welfare loss, if any, caused by a tax induced misallocation of resources between the corporate and noncorporate sectors.\(^\text{127}\) It also reduces any bias against investment in general which may be caused by the burden that the corporate tax places on all capital.\(^\text{128}\)

Dividend relief would also eliminate any bias, from the corporation's viewpoint, in favor of debt over equity financing,\(^\text{129}\) so that any increased risk of bankruptcy caused by tax-induced reliance on debt financing would be eliminated. Further, it is argued that dividend relief would encourage corporations to increase the portion of earnings distributed as dividends, improving the allocation of capital by subjecting funds to the "discipline of the market."\(^\text{130}\)

The elimination or reduction of any economic distortions which may be caused by the corporate tax is desirable. There is no empirical evidence, however, that the tax leads to a substantial welfare loss; the experience of European countries with dividend relief provides little evidence that it actually leads to increased capital investment,\(^\text{131}\) higher dividend payout rates,\(^\text{132}\) or reduced reliance on debt financing.\(^\text{133}\)

The speculative gains from dividend relief must be weighed against its administrative and equitable costs. Al-

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125. McLure, supraj note 13, at 554-56; Warren, supra note 1, at 744-45.
126. See Warren, supra note 1, at 746 (retaining earnings will benefit upper bracket and harm lower bracket taxpayers).
127. See supra notes 38-80 and accompanying text.
128. See supra note 76 and accompanying text.
129. Warren, supra note 1, at 747-49.
130. See supra notes 92-99 and accompanying text.
131. See supra note 80 and accompanying text.
132. See supra notes 92-99 and accompanying text.
133. See supra notes 81-91 and accompanying text.
though administrability is not an especially serious problem for dividend relief proposals, policy decisions must be made concerning such matters as the treatment of tax preferences and nonresident taxpayers. Equitable considerations are a more serious problem since dividend relief would provide an unfair windfall for upper bracket taxpayers.

B. The American Law Institute Reporter's Study Proposals

Like dividend relief, the ALI Reporter's Proposals are designed to eliminate the biases caused by the corporate tax, but, unlike dividend relief, they attempt to avoid windfall gains to current owners of corporate stock. The ALI study proposes a deduction for dividends paid on new equity at a rate equal to the interest deduction that would have resulted from an equivalent level of debt financing. If dividends are less than the maximum allowable deduction, with respect to the new equity, the difference is carried forward for three to five years. Further equalization of the treatment of debt and equity is achieved by limiting the corporate interest deduction from debt instruments held by 10% or greater shareholders to the rate allowed on new equity. The bias in favor of redemptions over dividends also is eliminated by subjecting non-dividend distributions to a corporate-level excise tax.

C. Evaluation

The ALI proposals offer substantially more promise than simple dividend relief. Like dividend relief, they largely eliminate the bias in favor of debt over new equity and in favor of noncorporate over corporate investment by ending the "double tax" on new equity. Unlike dividend relief, however, the ALI Reporter's Proposals neither result in a windfall to current shareholders nor lead to a dramatic loss in tax reve-

134. See C. McLure, supra note 1, at 92-145.
135. Id. at 185-214.
136. See supra notes 99-124 and accompanying text.
137. ALI Study, supra note 2, at 328-29. For a general description and discussion of the ALI proposals, see Beghe, The American Law Institute Subchapter C Study: Acquisitions and Distributions, 33 Tax Law. 743 (1980).
138. ALI Study, supra note 2, at 366.
139. Id. at 369.
140. Id. at 368-69.
141. Id. at 442.
nues because no dividends paid deduction is allowed for earning attributable to old equity. The ALI proposals also increase the uniformity and preserve the progressivity of the tax system by insuring that funds removed from corporate solution bear a tax burden similar to the tax on ordinary dividends.

The ALI proposals have been attacked by Professor Warren, however, as being less neutral among various forms of investment than dividend relief. In particular, Warren argues that under the ALI Reporter’s Proposals the yield on an investment in a corporation that retains all earnings is less than the yield on a noncorporate investment.

Consider an individual with $100 to invest under the ALI Draft proposal, where tax and return rates are the same for corporate and individual investors, as is often assumed in the Draft. If he invests on individual account or in nonshareholder debt, he will have $162.89 on disinvestment if the tax rate is 50%, the pretax rate of return is 10%, and all earnings are reinvested for ten years. But if he invests in new corporate equity, with earnings retained for ten years, a shareholder will have only $156.45 on disinvestment, even if the distribution in year ten is deductible as a dividend to the extent of 10% times the years invested times the initial equity contribution.\(^{144}\)

Warren’s calculations assume that a corporation retains all earnings. In such a case the maximum dividends paid deduction on a ten-year investment of $100 of new equity is only $100 (.10 x 10 years x $100).\(^{144}\) This deduction is insufficient to provide for the tax-free distribution of all profits derived from the new equity because retained earnings are not deemed new equity for purposes of calculating the maximum dividends paid deduction, even where the retained earnings are derived from new equity. If corporate earnings are distributed annually, however, and are subsequently reinvested by the shareholders in the corporation, such earnings would be deemed new equity, thus increasing the allowable dividends paid deduction and causing corporate and noncorporate investments to have equivalent yields. The results cited by Warren can only be reached if the corporation retains all earnings

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143. *Id.* at 755-56 (footnotes omitted).
144. See *id.* at 756 n.108.
to the disadvantage of its shareholders. Full deductability of earnings on new equity could also be achieved by deeming such earnings to be new equity for purposes of calculating the maximum dividends-paid deduction.

Warren's main objection to the ALI Reporter's Proposals is that they do not lead to identical yields for corporate and noncorporate investments. But the largest difference in investment yields occurs where a corporation retains all of its earnings and, as just explained, this case is based on questionable assumptions. If this case is eliminated, Warren's calculations show that the after-tax returns for various types of investment by a top bracket taxpayer range from $128.63 to $134.39 under the ALI proposals, as compared with a range of $134.39 to $137.73 under dividend relief. Given the limited evidence that a significant welfare loss is caused by the much greater differences now existing in the yields on corporate and noncorporate investment, it seems sensible to accept the slightly greater variation under the ALI Reporter's Proposals to prevent windfall gains to current shareholders.

Professor Warren, however, is unwilling to accept these variations and proposes eliminating the differences that remain under dividend relief because of the advantage of deferral where the maximum personal rate exceeds the maximum corporate rate. He would accomplish this by reducing the maximum individual rate to the corporate level and allowing corporations to make deemed allocations of retained income to shareholders. Under such a constructive dividend rule top bracket shareholders would suffer no effect from the allocation, while lower bracket shareholders would receive refunds because the corporation would have overpaid the tax on income attributable to their share of corporate income.

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145. Id. at 769.
146. Compare id., at 767, with id., at 747.
147. Warren, supra note 1, at 746. At the time Warren's article was published, the top personal rate was 70%. The reduction of the top individual rate to 50% has largely eliminated the advantages of deferral.

It would be possible to permit or require the deemed allocation of retained earnings to shareholders even if the top personal rate exceeded the corporate rate. Under such a system, if a corporation made few or no distributions, a top bracket taxpayer would be required to pay taxes despite no actual receipt of cash with which to pay them. This is not a serious problem, however, since such an individual could easily raise cash by selling some of his shares or by borrowing against them.

148. Id.
Professor Warren points out that such a proposal was suggested by the Canadian Carter Commission as a "corollary of integration."\textsuperscript{149} The Canadian integration proposal, however, tied integration to a substantial broadening of the tax base, including the full taxation of the previously tax-free appreciation of corporate shares, so that the reduction of the top individual rate would not provide a windfall to upper income taxpayers.\textsuperscript{150}

Warren also suggests a one time windfall gains tax as an alternative to the ALI proposals.\textsuperscript{151} No method of taxing windfall gains is proposed, however, and such a tax may be extraordinarily difficult to design since it would be impossible to isolate the influence of dividend relief from other factors influencing the price of shares.

IV. Conclusion

The separate tax on corporate income is criticized for creating a bias against investment in corporate equity, for causing overreliance on debt financing of corporations, and for encouraging the retention rather than distribution of corporate profits. Some economic waste may occur from each of these biases, but the evidence suggests that such waste may be less significant than many proponents of integration claim. If these biases are to be reduced through the partial integration of the corporate and personal taxes, the ALI Reporter's Proposals should be adopted rather than dividend relief because the ALI proposals do not lead to windfall gains for current shareholders.

\textsuperscript{149} Id.

\textsuperscript{150} 4 Carter Commission, \textit{supra} note 14, at 27-28. Warren himself also favors wider reforms, including full taxation of capital gains and the taxation of redemptions at ordinary rates. Warren, \textit{supra} note 1, at 737. He does not, however, make his endorsement of dividend relief contingent on the enactment of these other reforms.

\textsuperscript{151} Warren, \textit{supra} note 1, at 759.