INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXATION

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INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXATION

By

GEORGE EDWARD PHILIPS

AN ABSTRACT

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ABSTRACT

Federal corporate and individual income taxation in the United States is not at present integrated because the corporation pays a tax, essentially at a flat rate, on its entire income, while the shareholders are taxed only on the distributed corporation income, largely without regard to the corporate tax paid. Corporation income is likely to be subject to total income taxes that are either greater or smaller than would have been paid if the same amounts of income had been taxed directly to the shareholders. Full integration would require that the entire corporate income, whether distributed or not, be subject to progressive individual taxation.

The case for integration on grounds of equity or fairness in taxation is very strong. An attempt to come close to full integration would substantially increase tax administration and compliance problems, while the economic effects of integration are not clearly favorable or unfavorable. An evaluation of the extent to which integration is desirable involves weighing greater equity against administrative disadvantages.

One's attitude towards integration depends in part on the concept of income accepted. The "accretion concept," which is consistent with integration, has great merit as an ideal or directional guide in tax policy questions and in accounting theory. The prospects for sound progress in accounting principles and practice and for settling

many of the current theoretical controversies in accounting would be much improved if the accretion concept of income were to receive more attention. The accretion concept emphasizes changes in economic power rather than "realization" of income. The special treatment now given to such income items as capital gains and state and local bond interest is a major source of administrative problems of achieving nearly full integration. Integration could be accomplished much more easily if distinctions among kinds of income were eliminated. Even without integration, tax administration would be greatly simplified by such a step. Relatively little has been done to analyze or explore in any detail the administrative problems of integration. More thorough study of these problems is desirable.

Proposals for less than full integration include (a) taxing corporations only on undistributed income, (b) treating the corporation tax as a withholding of individual income tax, (c) excluding a portion of dividends from taxable individual income, and (d) allowing individuals a credit against tax based on dividends received. In general these proposals involve relatively little administrative difficulty but achieve partial or full integration of only distributed corporate income and are questionable with regard to equity. Other possible approaches to integration include partial use of the partnership approach (taxing corporate income directly to shareholders) and the capital gains approach (taxing shareholders on dividends received plus either the change in market value of the stock or the gain or loss on disposition of the stock).

Aside from questions of political feasibility, the most promising approach to nearly full integration appears to be a combination of two methods. Shareholders of large, widely held, corporations would be taxed on dividends plus the change in market value of stock, while shareholders of small, closely held, corporations would be taxed on dividends plus their share of undistributed profits. A choice between the two methods might be given to companies which do not clearly fit either of these categories. This combination approach to integration has some conceptual and practical advantages over other approaches.

Certain provisions of the Internal Revenue Code, including the option (Subchapter S) given certain corporations to be taxed somewhat like partnerships, are related to integration. As a whole, these provisions accomplish little towards integration, only partially correct the relative overtaxation of income derived from corporations, and do not eliminate any of the relative undertaxation. Subchapter S could be used as a starting point for gradually coming closer to integration by making the election compulsory for at least some corporations.

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TABLE OF CONTENTS

LIST OF TABLES

INTRODUCTION

This study attempts to provide a basis for evaluating different approaches to the integration of corporate and individual income taxation. Consideration is given to fairness and equity and to economic effects of various methods by which integration might be achieved or approximated, and particular emphasis is placed on administrative problems of the various approaches. There are no easy answers in this complex and difficult subject. Even if the analytical problems were simple ones, the necessity for making value judgments at key points would prevent the researcher from arriving at a universally acceptable prescription. It is hoped that this study will make a contribution towards clarifying the issues involved in deciding which, if any, of the various approaches to integration should be adopted.

The basic idea of integration is the taxation of corporate income to the natural persons who share in it. Complete integration would require elimination of the corporation income tax and taxation of corporate income, whether distributed or not, to the individuals who "own" it, the shareholders. If this were done, the relative over-taxation (often called double taxation) of distributed corporate income and the over or undertaxation (depending on the shareholder's tax bracket) of undistributed corporate income would be eliminated. In addition, the income would be taxed to individuals at the time it is earned rather than when (and if) it is distributed. This would be especially significant because of progressive individual income tax rates and the fact that an individual's tax bracket typically varies over time. The essential features of integration and the case for and against it are discussed in Chapter I.

Whether or not integration is seen to be desirable depends, in part, on the concept of income accepted. Income concepts are discussed in Chapter II, where it is pointed out that there is much merit in what has been termed the "accretion concept." This concept of income has substantial merit as a normative standard or directional guide in taxation, accounting, law, and economics. Under this concept, income is measured as the accretion to economic power; that is, as an individual's consumption plus the increase in his net worth during a given period of time.

Complete integration could be accomplished by taxing corporate shareholders much as members of partnerships are now taxed. There is no income tax on the partnership as an entity, but each partner includes his full share of profits on his individual tax return. The "partnership approach" is discussed in Chapter III, with special attention given to administrative problems of this approach.

Alternative methods by which some degree of integration could be accomplished are analyzed briefly in Chapter IV. Most of these involve eliminating or reducing the overtaxation of distributed corporate income by giving tax relief to either the corporation or the stockholder. These methods include allowing corporations to deduct dividends paid from taxable income, treating the corporate tax as a withholding tax on the shareholder and allowing individuals a dividends received exclusion or credit. The "capital gains approach" which is also discussed in Chapter IV involves an attempt to integrate undistributed, as well as distributed, corporate income by taxing capital gains on stock at full ordinary income rates.

In 1954 and 1958 some new provisions related to integration were added to the Internal Revenue Code. Individuals may now take advantage of a dividends received exclusion and credit (both rather small) and, to a limited extent, businesses may elect whether they will be taxed as corporations, proprietorships or partnerships. These provisions are discussed in Chapter V, which also includes a consideration of the prospects for achieving more complete integration either by using these provisions as a starting point or by more drastic changes.

Although the necessity for making value judgments precludes final and definite answers to questions of tax policy, it is believed that the following conclusions are supported by the analysis in this study:

1. Full integration of corporate and individual income taxation would result in a major improvement in tax equity by eliminating both overtaxation and undertaxation of income derived from corporations relative to other income of individuals. It is probably impossible to

determine whether or not the economic effects of integration would, on balance, be favorable, but these do not appear likely to be serious enough to outweigh the equity gains. Administrative problems would be serious, and the achievement of an optimum solution would primarily involve weighing greater equity against administrative disadvantages.

2. The accretion concept of income can contribute much to the fields of taxation and accounting and deserves careful study. This concept, as an ideal or directional guide, can be the basis for solving controversial problems in tax policy and accounting theory and practice.

3. Administrative problems of proposals for tax changes deserve careful analysis in considering the merits of such proposals. More can be done in analyzing administrative aspects than is typically reflected in tax literature.

4. Administrative problems of achieving some degree of integration are greatly increased by the special treatment given to certain "kinds" of income--capital gains, tax exempt interest, percentage depletion, and so forth. Elimination of such special treatment is consistent with the accretion concept of income and would greatly simplify the practical problems of integration. Actually, many of the most serious administrative difficulties under the present tax structure are due to such specially treated items.

5. Full integration would not necessarily result in a major loss of tax revenue to the government although the federal corporation income tax would be eliminated. Taxation of undistributed, as well as distributed, corporate income directly to individuals would make up a large part, if not nearly all, of the revenue lost by dropping the income tax on corporations.

6. Aside from questions of political feasibility, the most promising approach to nearly complete integration appears to be a combination of two methods. Shareholders of large, widely held, corporations ("public" corporations, which earn the bulk of corporate income and account for most shareholdings) would be taxed annually on dividends received plus the change in market value of stock, while shareholders of smaller, closely held, corporations ("private" corporations) would be taxed on their share of both distributed and undistributed corporate income (the partnership method). The problem of drawing a line between the two classes of corporations might be met by allowing some firms an option of one or the other method. This combination approach would minimize the admittedly serious administrative problems of full integration and also would appear to conform best to the accretion income concept (and achieve greatest equity) for shareholders of both "public" and "private" corporations.

7. The 1954 Internal Revenue Code provisions discussed in this study (Chapter V) accomplish little towards integration and would

not be much improved in this regard even if the amounts of the tax benefits involved were increased. The dividends received exclusion and credit reduce, somewhat arbitrarily, the relative overtaxation of distributed corporate income but do nothing about undertaxation. This is also true of the elections under Subchapters R and S, because they are not compulsory. It would be possible to gradually come closer to integration by making more corporations eligible for the Subchapter S election (to be taxed somewhat like partnerships) and by making this treatment compulsory for at least some companies.

CHAPTER I

FACTORS TO BE CONSIDERED IN APPRAISING THE MERITS OF INTEGRATION

The most serious criticisms of the present system of taxation of individual and corporate incomes in the United States involve inequities. Whether or not "double taxation" of dividend income takes place is controversial, but there is general agreement that the tax burden on a given individual is often greatly affected by the extent to which his income comes to him through corporations. He may be over or undertaxed depending on the extent to which corporate income is distributed, his tax bracket, when (if ever) retained corporate income is realized by him, and whether or not some corporate income is realized in the form of capital gains.

Even if equity were the sole criterion for an acceptable system of taxing incomes, there would be many problems to resolve. Some of the problems involving equity are: arriving at a definition or concept of income, determining whether differentiation of types of income and deductions is justified, and establishing a progressive rate structure. But equity is not the sole criterion. There are many other important aspects of taxation that must be considered. Prominent among these are economic effects and administrative problems. Perhaps "political expediency" should be included among the criteria, but an attempt to establish an "ideal" on equity, economic, and administrative grounds seems well justified. It may never be enacted, but it should contribute to orderly thinking on this complex subject.

Among the economic effects of income taxation are effects on investment and incentives, prices, and such things as methods of financing and form of business. While an analysis of the equity of our present federal income tax structure almost inevitably leads to serious criticisms, this is not always the case with an analysis of economic effects. There is wide disagreement as to what the economic effects are and as to the relative importance of different effects. Much of the uncertainty is a result of the difficulty of determining the incidence of taxes, especially the corporation income tax.

Many who would otherwise favor drastic revision of our income tax structure are hesitant because of administrative difficulties of otherwise desirable changes. Administrative feasibility has been of great importance in affecting congressional action and must be given serious consideration in any plan for major tax revision.

Any well founded proposal for tax revision must involve a compromise among the often conflicting objectives of equity, economic desirability, and administrative feasibility. It is the aim of this study to present an analysis of a number of ways in which an attempt might be made to more fully integrate corporate and individual taxation, placing particular emphasis on administrative problems. It is felt that most of the literature on tax reform gives less attention to administrative problems than is justified by their importance and the possibilities of research.

Integration and Equity

Equity in taxation has both a vertical and a horizontal aspect. Horizontal equity involves equality of treatment of persons in substantially the same position. Vertical equity involves fairness in the relative treatment of persons whose circumstances differ. The principal problem of vertical equity is whether and to what extent taxation should be progressive. Both horizontal and vertical equity require definitions of "person" and "position" or "circumstances." Should corporations be considered as persons for tax purposes? Are a person's circumstances best measured by income, wealth, consumption expenditure, benefits received from the government, or some combination of these or still other factors?

Fiscal theory has not progressed to a point where such questions can be answered definitely. The necessity for making value judgments cannot be escaped entirely and may be of crucial importance in making policy recommendations. The following statement explicitly recognizes the significance of value judgments in public policy matters:

> Unlike some economic purists of today, I admit to more than only a scientific motivation; intelligent and civilized conduct of government and the delineation of its responsibilities are at the heart of democracy. Indeed, the conduct of government is the testing ground of social ethics and civilized living. Intelligent conduct of government requires an understanding of the economic relations

involved; and the economist, by aiding in this understanding, may hope to contribute to a better society. This is why the field of public finance has seemed of particular interest to me; and this is why my interest in the field has been motivated by the search for the good society, no less than by scientific curiosity. The form of this good society involves value judgment, and value judgment may enter into the issues that the economist chooses to examine. From there on, however, the economist's function is to aim at a scientific and thus objective answer.[1]

Democratic thinking, based on the postulate of man's individual worth, seems to establish a presumption of equality, both political and economic. But equality applied to economic matters can be interpreted in different ways, and the choice among different interpretations is a matter of value judgment.[2]

It is probably impossible to avoid making implicit value judgments in any analysis of matters involving public revenues. In this dissertation an attempt is made to indicate as explicitly as possible the values on which a given discussion is based and to indicate alternative conclusions that would follow from different judgments that might reasonably be expected.

The term "equity" is sometimes used with the fairly precise meaning of equal treatment of equals, sometimes as only a vague concept of fairness, or justice. The more precise meaning is most often used in connection with horizontal equity, while vagueness is often associated with vertical equity. The search for a fundamental

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[1]Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), pp. v-vi.

[2]*Ibid.*, p. 19.

theoretical basis for either horizontal or vertical equity leads to serious conceptual difficulties. In the case of horizontal equity the problem is in selecting the appropriate base for equality of treatment. At least four different bases have each been advocated by various tax theorists. These are (1) benefits received from the government, (2) property owned, (3) consumption (expenditure), and (4) income.

The benefits received approach to equity is discarded with little discussion by most recent public finance text-writers.[3] These writers recognize, of course, that a few areas of government operations such as special local improvements and, perhaps, highways can be best financed on a benefits basis. These areas are generally thought to be of limited importance, however. The great bulk of the expenditures of government are for things the benefits of which cannot be ascribed meaningfully to individuals.

A surprisingly good theoretical case could be made for property as a basis for horizontal equity in taxation. If property were defined broadly as any kind of economic power, then it could be maintained that persons with equal property should make equal contributions in support of government. Even if it were possible to arrive at a practical and conceptually satisfactory broad definition of property for tax purposes (which is doubtful at best), such a tax would have the effect

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[3]See John F. Due, Government Finance (rev. ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1959), pp. 107-09, and Harold M. Groves, Financing Government (4th ed.; New York: Henry Holt and Company, 1954), pp. 16-19.

of placing a premium on consumption relative to an income tax. Thus, under a broad property tax, if one of two otherwise equally situated taxpayers consumes more, and the other less, than his income, the former will find his taxes reduced and the latter will face an increase since his property will have increased. An income tax would tax the two equally, regardless of their relative consumption, while an expenditure tax would reverse their positions by placing a tax penalty, rather than a premium, on consumption. Consumption expenditure has received notable support as a base for tax equity. The widespread support for income as an ideal tax base has run counter to the ideas of some of the most noted economists. J. S. Mill, Alfred Marshall, A. C. Pigou, and Irving Fisher all indicated a belief that an income tax is conceptually inferior to a tax which exempts savings.[4]

There is no doubt that income has become very widely, though not universally, accepted as the most reasonable index of equality among taxpayers. Even if it were universally agreed that income, rather than benefits, property, or consumption, should be the principal basis for taxation, we would still have to face the problem of defining "income." Chapter II of this study is devoted to an exploration of different concepts of income.

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[4]Specific references will be found in Nicholas Kaldor, <u>An Expenditure Tax</u> (London: George Allen & Unwin, Ltd., 1955), pp. 11-12 and 79-86.

Vertical equity is concerned primarily with questions of progressive taxation. Most people today probably would not agree with McCulloch's well known statement in defense of proportional taxation: "The moment you abandon, in the framing of such taxes, the cardinal principle of exacting from all individuals the same proportion of their income or of their property, you are at sea without rudder or compass, and there is no amount of injustice and folly you may not commit."[5] But disagreement with this statement does not rest on having found "rudder and compass"--that is, an objective guide to establishing the degree of progression of tax rates. Rather, it rests on the belief that the desirability of progression is strong enough to outweigh the uncertainty as to the precise rates that would be best.

Much effort has gone into the refinement of "sacrifice" theories of taxation based on the diminishing marginal utility of income.[6] This analysis has not led to conclusive results. The conclusions depend, among other things, upon the concept of sacrifice chosen[7] and assumptions as to the shape of utility curves. A major weakness in the analysis is due to the necessity of interpersonal utility comparisons:

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[5] J. R. McCulloch, A Treatise on the Principles and Practical Influence of Taxation and the Funding System (2d. ed., 1865), quoted in John F. Due, op. cit., p. 129n.

[6] These theories are summarized and discussed in Elmer D. Fagan, "Recent and Contemporary Theories of Progressive Taxation," Journal of Political Economy, XLVI (August, 1948), 457-98.

[7] Equal, equal-proportional, or equal-marginal sacrifice.

> . . . this entire discussion rests on the assumption that interpersonal utility comparisons can be made in a meaningful fashion. This assumption is basic to a subjective view of the ability-to-pay doctrine. Yet it is an assumption generally rejected by the "new" welfare economics. If such rejection is valid, the entire concept of equal sacrifice becomes so much nonsense and must be discarded--lock, stock, and barrel.[8]

The lack of a solid theoretical foundation for determining vertical equity is reflected in the vagueness of meaning associated with "ability to pay." This phrase always implies a value judgment though the values are seldom made explicit.[9] Part of the difficulty is that ability to pay has become a "loaded" phrase. It gives an impression of good as opposed to evil. Yet few advocate carrying taxation according to ability to the extreme where all persons are made equal in economic position.

Much clarity of thought can be gained by concerning ourselves with vertical equity not so much as a matter of taxing according to ability as a matter of distribution of economic power. It is probably

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[8] Musgrave, op. cit., p. 108.

[9] Vickrey decries the widespread use of the phrase to support various prejudices: "In a strict sense, 'ability to pay' is not a quantity susceptible of measurement or even of unequivocal definition. More often than not, ability to pay and the equivalent terms 'faculty' and 'capacity to pay' have served as catch phrases identified by various writers through verbal legerdemain with their own pet concrete measure to the exclusion of other possible measured. Ability to pay thus often becomes a tautological smoke screen behind which the writer conceals his own prejudices." William Vickrey, Agenda for Progressive Taxation (New York: The Ronald Press Company, 1947), pp. 3-4.

true that there is no tax that is neutral in the sense that it does not affect the relative economic power of individuals. Although we do not escape the necessity of making value judgments, it is useful to view vertical equity as a matter of bringing about greater (or lesser) economic equality and, perhaps, of redistributing economic power in favor of those who possess some chosen characteristic, the encouragement of which is considered socially desirable.[10]

Complaints of inequity in the federal tax structure of the United States are common. Some of these complaints are obviously nothing more than special pleading for favored treatment. Aside from these, many (perhaps most) of the criticisms are based on assumptions which can be summarized in three propositions:

1. Equity is a matter of equality of treatment or fairness among individuals.
2. Accretion[11] is the proper concept of income for tax purposes.
3. Distinguishing different "kinds" of income is not of value in seeking tax equity.

Each of these propositions involves value judgments and thus cannot be proven or disproven. It can be said, however, that

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[10]The case for a spendings, as opposed to an income, tax seems to rely heavily on the latter aspect of redistribution; i. e., on the belief that those who save (and thus make provision for economic growth) should get tax encouragement.

[11]The accretion concept of income is discussed in Chapter II. Briefly, this concept defines income as accretion to economic power; an individual's income equals the net change in his economic power between two points in time plus his consumption.

each has wide, though not universal, support in the academic community and meets with at least some approval in the rather inscrutable mind of the "general public." Each of these propositions is of special importance to the question of integration of corporate and individual income taxation.

Basically, justice or fairness relates to persons, not things. Various kinds of property and institutions, including the corporation, are inevitably involved in questions of tax equity, and justice is not likely to be served by treating similar things differently. Nevertheless, though justice usually includes treating like things alike, it is persons that are the concern of equity. This point of view seems to imply that we should look through the corporation to the persons involved. This position is widely accepted, at least as an ideal.[12] In view of this, the suggestion in the following quotation of "general agreement" is rather surprising.

> It is clear that a compulsory application of the partnership method would tax the incomes of many relatively small companies much more severely than the incomes of the largest corporations in the country are now taxed. Probably there is general agreement that such a tax policy would be intolerable. At any rate, this discrimination between corporations, added to the defects noted above, seems to me to make conclusive the case against a compulsory application of the partnership method.[13]

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[12]See the discussion of the partnership approach in Chapter III.

[13]J. Keith Butters, "Should the Profits of Small Corporations Be Taxed Like Partnership Earnings?," in How Should Corporations Be Taxed, Symposium conducted by the Tax Institute (New York: Tax Institute, Inc., 1947).

This quotation undoubtedly reflects a belief that there is a (widely approved) value in promoting the interests of small rather than large corporations. But, if this is so, it is discrimination between corporations which is sought, not opposed. This appears to be a good illustration of the confusion which often arises between the sometimes conflicting objectives of tax equity and subsidization of something socially desirable.

The second proposition, that accretion is the ideal income concept towards which we should aim in tax policy precludes the idea that some other tax base (government benefits, consumption, property) is preferable. The choice cannot be made without making a value judgment. The proposition does not preclude departures from the ideal in practice; some departures, and even some fairly important ones, are inevitable. These matters are discussed in the next chapter.

The third proposition follows from the second. The idea that "kinds" of income are not significant for income tax purposes is important, however, because of the special treatment given, or urged for, capital gains, windfalls, state and local bond interest, and other items. If the accretion concept is accepted, then special treatment given to certain "kinds" of income must be based on some objective other than equity. These problems are also further discussed in the next chapter.

In general, considerations of equity appear to call for rather drastic revision of the federal tax structure. The three propositions stated above support the conclusion that corporate and individual income taxes should be integrated, and the integration should be as complete as possible, that is, income accruing to individuals through corporations, whether distributed or not, should be taxed at full rates to those individuals. We consider below some limitations on the possibility of achieving complete integration. The limitations arise from possibly conflicting economic objectives and from administrative difficulties.

It must be recognized, of course, that integration of corporate and individual income taxes--even if it were possible to closely approximate "ideal" concepts of income and equity in bringing about the integration--would not solve all equity problems. As long as there are different kinds of federal taxes and taxation at the state and local levels, equity must be sought in terms of the tax system as a whole. There is even the possibility that what appears to be an improvement in the equity of a particular tax may result in the over-all worsening of equity. Alfred Marshall stated the problem as follows:

> Onerous taxes, imperial and local, must be treated as a whole. Almost every onerous tax taken by itself presses with undue weight on some class or other; but this is of no moment if the inequalities of each are compensated by those of others, and variations in the several parts synchronise. If that difficult condition is satisfied, the system may be equitable, though any one part of it regarded alone would be inequitable.[14]

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[14] Alfred Marshall, Memorandum on Imperial and Local Taxes (c. - 9528), p. 113, quoted in A C. Pigou, A Study in Public Finance (London: Macmillan and Co., Ltd., 1928), p. 75.

Limitations in our knowledge of tax incidence prevent the possibility of being precise in evaluating the over-all equity of the tax system. Yet there is little doubt that equity would be improved if a way could be found to avoid the arbitrariness of our present system of taxing corporate derived income.

An important reason for being especially concerned with the equity of tax burdens is that in the United States we are essentially dependent upon voluntary compliance for the success of the federal income tax. Voluntary filing and self assessment are still important features of our income tax in spite of the increased use of withholding taxes.[15] A fairly high degree of public confidence is necessary to the the success of this system.

> Our fiscal system cannot survive unless the majority of the citizenry retain confidence in the equity and uniformity of our tax system. Preferential treatment breeds disrespect for the revenue laws, and without respect there will be no effort made to abide by them.[16]

> . . . if the average taxpayer finds our tax laws more and more checkered with special legislation, the danger is that disrespect will spread and make enforcement impossible. Whatever may be the economic limit upon taxes, there is a practical and psychological limit which is probably short of it.[17]

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[15] At this writing, there seems a strong possibility that a system of withholding on dividends and interest will be adopted.

[16] William L. Cary, "Pressure Groups and the Increasing Erosion of the Revenue Laws," in Federal Tax Policy for Economic Growth and Stability, Papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Committee on the Economic Report (Washington: U. S. Government Printing Office, 1955), p. 261.

[17] *Ibid.*, p. 272.

Economic Effects of Integration

There is little certainty as to what are the economic effects of either corporate or individual income taxation. It is generally agreed that any type of taxation is sure to have at least eventual effects on investment, prices, and national income; but it is difficult to trace these effects and repercussions through the economy. It is not unusual to find reputable economists holding quite opposite viewpoints as to a likely effect of a particular tax. A good example of this is the question of the effects on incentives of high progressive income tax rates. Some insist that progressive rates as high as 90 percent must certainly cause serious damage to incentive and are a clear danger to economic progress, while others minimize these effects, point to cases where high marginal rates may well increase incentives, and generally doubt that our present rates have seriously affected incentives.[18] The question is made more complex by the fact that the high rates in the present law are marginal rates, the over-all effective rates on any individual are below his "bracket" rate; and, even more importantly, by the fact that much income (under the accretion concept) is taxed at special low rates or escapes tax entirely.[19] Those with large incomes have generally

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[18] See Due, op. cit., pp. 199-207.

[19] See Joseph A. Pechman, "What Would a Comprehensive Income Tax Yield?" in Tax Revision Compendium, papers submitted to the Committee on Ways and Means (Washington: U. S. Government Printing Office, 1959), pp. 251-81.

been able to make extensive use of favorable tax treatment of such things as capital gains and state and local bond interest.

Because of the uncertainties in the analysis of the economic effects of different taxes, it is not possible to arrive at a definitive answer to the question whether or not the economic effects of integrating corporate and individual income taxation would be, on balance, favorable. It is possible, at best, to indicate certain major factors, the likely effects of which are fairly clear and to carry the analysis further by making alternative assumptions as to such matters as incidence.

In general, the case for integration is not as well established on grounds of economic effects as it is on grounds of equity. It appears, however, that the equity case is closely related to the economic effects and that improvements in equity likely improve some economic effects. For example, if integration of corporate and individual income taxes should result in increased public confidence in the equity of the federal tax system, it is possible that the danger of adverse psychological reactions of businessmen to tax changes would be reduced. This, in turn, might mean greater economic stability, insofar as business fluctuations can be traced to tax changes.

The major economic effects of integrating corporate and individual income taxation can be classified as effects on (1) prices, (2) investment and incentives, and (3) tax neutrality. Broadly, the question of effects on prices is the question of the incidence of business profits taxes. This question is basic to the whole area of economic effects as well as to equity.

It is not obvious that corporation income taxes are more or less likely to be shifted than are other taxes (such as the income taxes paid by partners and proprietors) on business income. When the question of the incidence of the corporation income tax is treated as a separate issue, there seems to be an implication that a significant difference exists between this tax and other business income taxes with regard to incidence. Perhaps, the differences between "kinds" of corporations are more significant than the differences between some corporations and other forms of businesses. Corporations subject to the corporate tax include both giant, widely-held companies ("public corporations") and small, closely-held companies ("private corporations"). The differences with regard to ability and intention to shift income taxes between these two types of corporations may well be more significant than the differences between the latter and similarly situated partnerships and proprietorships.

Economic theory tends to support the view that an income tax will not affect selling price. This is based on the reasoning that the tax does not affect marginal cost and therefore will not affect price if the sellers are attempting to maximize profits.[20] Considerable

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[20]Excellent discussions of the theory of incidence and qualifications of theory which are necessary for a corporation income tax can be found in Richard Goode, The Corporation Income Tax (New York: John Wiley & Sons, Inc., 1951), pp. 44-72, Musgrave, op. cit., pp. 276-87, and Due, op. cit., pp. 223-31.

doubt as to the applicability of this theory to our economy arises, however, because of evidence of, and sometimes plausible reasons for, businessmen not attempting to maximize profits. It is pointed out that, especially in smaller businesses, prices are often set by customary formulas (margin percentages, etc.) which likely include income taxes as a cost an increase in which will "automatically" raise prices. Another possibility, chiefly relevant to larger corporations, is that imperfectly competitive firms (especially in oligopoly) may not maximize profits because of uncertainty as to the reactions of others to price changes. Reactions of competitors, labor unions, and the government may be uncertain. An increase in corporate taxes may lead to a price rise if managements believe unfavorable reactions are not likely.

Business profits taxes, and the federal corporation income tax in particular, are levied on a somewhat larger base than what the economist would consider "pure profits," principally, because some of the cost of capital is not deductible. There is a possibility that over the long run the supply of capital is reduced by business income taxes. It is not clear, however, in what sense this involves a shifting of tax, what would be the effect on price levels, and whether or not aggregate economic income would be changed.[21]

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[21] See Goode, op. cit., pp. 57-62.

Some writers have concluded from historical data that the corporation tax is not shifted,[22] while others reach the opposite conclusion.[23] Without much doubt the truth lies somewhere in between.[24] Some shifting takes place and some of the tax is never shifted; the extent of shifting varies with degree of competition, size of firm, trade customs, and other factors. Probably the great majority of economists would agree that most of the burden of the corporation income tax, like business profits taxes in general, is not shifted either forward or backward through higher prices or lower wages and purchase prices. Thus Musgrave, although emphasizing the possibility of shifting, has guessed that about two-thirds of the tax is not shifted.

> On balance, the theoretical argument lends more support to the moderate conclusions that short-run adjustments in price (1) play a significant role, and (2) that a part of the tax is passed on, than it lends to the extreme position that no such adjustments occur.[25]

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[22] M. A. Adelman, "The Corporate Income Tax in the Long Run," Journal of Political Economy, LXV (April, 1957), 151-57, and Edward T. Thompson and Charles E. Silberman, "Can Anything Be Done about Corporate Taxes," Fortune (May, 1959), pp. 121-24 and 260-68.

[23] E. M. Lerner and E. S. Hendriksen, "Federal Taxes on Corporate Income and the Rate of Return in Manufacturing, 1927 to 1952," National Tax Journal, IX (September, 1956), 193-202, and John C. Clendenin, "Effect of Corporate Income Taxes on Corporate Earnings," Taxes (June, 1956), pp. 389-98 and 418-19.

[24] See Carl S. Sharp, "Some Problems in the Incidence of the Corporation Income Tax," American Economic Review (Papers and Proceedings), L (May, 1960), 457-69.

[25] Musgrave, op. cit., p. 286.

> Thinking along these lines, I have assumed in other connections that approximately one-third of the tax is shifted. This, to be sure, is rather arbitrary, but less extreme than the usual hypothesis that the entire tax falls on profits. See Musgrave, et al., "Distribution of Tax Payments by Income Groups: A Case Study for 1948," National Tax Journal, vol. 4, no. 1, pp. 1-53, March, 1951.[26]

To the extent that the tax is shifted, the argument that income earned through the corporate form is over or undertaxed is changed. With shifting, "double taxation" of dividends cannot exist and undistributed corporate income escapes income taxation entirely. As was seen above, the case for integration rests heavily on the inequities of over and undertaxation of corporation derived income. The possibility of shifting reduces the likelihood of overtaxation and increases the likelihood of undertaxation (from the point of view of income taxes). Forward shifting renders the tax equivalent in effect to a selective excise, under which taxed items are selected according to form of business organization and ability to shift the tax burden. The equity case for such an arrangement is obviously not strong. On economic grounds, also, there would be little justification for the distortion of resource allocation which would result from differences in ability to shift the tax and differences in form of organization.

Probably the most important area of economic effects of the corporation income tax (and of integration) has to do with effects on investment and incentive. There is some doubt as to whether

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[26] Ibid., p. 286n.

integration would stimulate or hinder investment and also some doubt whether or not stimulation would be desirable. The type of tax policy advocated by a given individual depends to a great extent on whether his concern is mainly with counteracting possible tendencies toward economic stagnation or with avoiding inflationary pressures. An increase in investment can be an important part of the solution to either of these problems. Increased investment demand raises the total level of effective demand and, with multiplier and accelerator effects, can be the key to overcoming deflationary tendencies. On the other hand, investment increases the stock of capital goods and makes possible increased output which will help to offset inflationary pressures.[27]

It is rather obvious that exemption of business profits from taxation would tend to stimulate investment both by increasing available funds and by the greater inducement to invest. Such an exemption, however, would be extremely unlikely of adoption and of questionable merit. The relevant question, then, is not whether the corporation income tax discourages investment (which any tax does), but whether investment is more discouraged under our present tax system than if corporate and individual income taxes were integrated

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[27]See Goode, op. cit., p. 112. Goode emphasizes the "money-income-creating" aspect of investment. Musgrave indicates the importance of the size of capital stock where wage and price rigidities exist and points out that this is basic to dynamics and growth analysis (op. cit., pp. 472-500). He also points to the likely desirability of increasing capital goods in inflation with unemployment situations as well as in underdeveloped countries (ibid., p. 497).

with total revenue unchanged. In addition to answering this question, it must be determined to what extent and under what circumstances it is desirable to encourage investment and how the investment effects of integration are related to other economic effects.

It is not possible here to present a thorough analysis of these complex problems, but a few general observations appear to be in order. If integration were accomplished by eliminating the corporation income tax and the same amount of revenue raised by taxing full corporate earnings to stockholders (the partnership approach) it is by no means clear whether the net effect would be to stimulate or to retard total investment.[28] For example, the greater availability of retained earnings to corporations resulting from elimination of the corporate tax would encourage investment but this might be approximately offset by the increase in progressiveness from taxing all corporate income to shareholders. It should also be noted that in the large, widely held, corporations investment decisions are made by management, possibly with more regard for the interests of the corporation as such than the

[28] Goode concludes that the differences among different taxes in their effects on investment is probably not as great as often thought: "If both direct and induced effects are taken into account, the corporation income tax probably restricts private investment more in proportion to its net yield than any other major federal tax. The margin of difference is probably least between the corporate tax and the individual income tax and widest between the corporate tax and some of the excises on commodities of inelastic demand. At present there is no way of measuring the differences among the various taxes more exactly. It seems, however, that in many discussions there has been a tendency to exaggerate the influence of taxation and to overstate the differences among taxes." Goode, *op. cit.*, p. 147.

interests of individual stockholders so that shifting the tax from the corporate to the individual level could have important effects.

Although the prospect of removing hindrances to investment does not appear to be a telling argument in favor of integration, at least it does not appear likely that hindrances would be increased by integration. In any event, if investment stimulation is desired, it could be achieved through such measures as liberal depreciation write-offs.

A quality which is generally desirable in any tax is neutrality. That is, a tax should not unintentionally distort economic relationships where avoidable. No tax is perfectly neutral in an economic sense, with the possible exception of a poll tax.[29] The degree of neutrality varies greatly among different taxes, but it is very difficult to measure the precise nature of the effects and to sort out intended from unintended results.

The most publicized defects of the corporation income tax with respect to neutrality relate to favoring certain legal forms of business organization and favoring debt over equity financing. The provisions for optional taxation as a corporation or partnership[30] were primarily intended to eliminate the lack of neutrality with respect to form of organization. The debt versus equity problem has been the

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[29] Due, op. cit., p. 105.

[30] These are discussed in Chapter V.

subject of an extensive study by Dan Throop Smith.[31] In addition to these problems, there has been much criticism of increasing complexity in our tax laws, and of the necessity to take tax effects into account in making many business decisions. Much of the complexity is traceable to our present treatment of corporate income, and integration would eliminate or minimize many serious problem areas. Some new ones would be created, however. The problems of neutrality and complexity are discussed further in Chapters III and IV.

Unfortunately, it does not seem possible to outline a system of taxation which will approach perfect neutrality and simplicity. Although we might conceivably arrive at "ideal" concepts of income, equity, and economic effects, administrative limitations require more or less serious modifications of the ideals in practice. It becomes necessary to weigh the relative merits of sometimes conflicting objectives.

Administrative Problems and Integration

There are very considerable differences in the administrative problems of the various approaches to integration discussed in the following chapters. This is true of the difficulties the various plans would create and also of those which would be eliminated or lessened.

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[31] Dan Throop Smith, Effects of Taxation: Corporate Financial Policy (Boston: Harvard University Graduate School of Business Administration, 1952).

For this reason, detailed consideration of administrative aspects will be found in later chapters. Some of the more important or widely applicable problems are outlined here.

Administrative problems, as conceived here, include any and all practical difficulties in implementing tax laws. Thus, a required increase in the efforts of an individual taxpayer in filling out a tax form is a problem of administration no less than a comparable required increase in the efforts of tax administrators. In general, simplicity in the tax law minimizes administrative difficulties while complexity increases them. But simplicity is here more a matter of clarity and consistency of concepts than brevity. When concepts are clear and generally agreed to by the taxpayers and administrators, the law can be uncomplicated.

Any proposal for integrating corporate and individual taxes must take into account the problems relating to capital gains and losses. A great deal of the administrative difficulty of our present law can be traced to the special treatment of capital gains, resulting in efforts of taxpayers to reduce taxes by getting capital gains treatment, and attempts to close "loopholes" by which capital gains treatment is achieved. This is of special importance to the question of integrating corporate and individual income taxation because undistributed profits are a principal source of capital gains. Integration would not necessarily require that special treatment of capital gains be eliminated, but as will be seen, such elimination (either for all capital gains or only for those involving corporate stock) could accompany integration and would do away with many troublesome administrative problems. Indeed, it has been argued forcefully that the only administratively feasible way to approximate integration of corporate and personal taxation is to tax capital gains at ordinary rates when realized.[32]

Complete integration by the partnership approach would cause the disappearance of a number of troublesome problem areas of present tax law, such as problems of personal holding companies and unreasonable accumulation of earnings.[33] However, in general the problem areas that would be eliminated affect relatively few taxpayers while the new problems created are likely to be troublesome to rather large numbers of individuals. Thus, not many taxpayers are close to a situation where they might become subject to the personal holding company tax provisions, and even the number of those who might like to form such a company if there were no penalty is probably very small compared to the numbers of stockholders who would be put to at least some inconvenience if corporate income were allocated to them.

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[32] Henry C. Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938). This is discussed in Chapter IV.

[33] The United States has adopted what amounts to partnership treatment of foreign personal holding companies. Undistributed foreign personal holding company income is required to be in gross income of American shareholders. Sec. 551, 1954 Internal Revenue Code.

The administrative problems involved in the partnership method of integration are fairly obvious, and many writers appear to discard the method as impractical without going beyond two or three of these fairly obvious problems. Without belittling the seriousness of the administrative problems, however, it can be pointed out that (a) the problems are of different severity (and even nature) for corporations of differing size and other characteristics, (b) problems which are rather obvious are sometimes easier of solution than more subtle ones, even if large numbers of people are involved, and (c) a rational conclusion requires comparing the administrative problems involved in different schemes, including the present tax system, then further comparing these features with differences in equity and economic effects. Comparing administrative with other aspects of taxation requires, of course, value judgments. We cannot objectively score one plan 80 on equity, 70 on economic effects, etc., and thus arrive at the best over-all system. Subjective comparisons must be made, however, if we are to have any hope of improvement in taxation.

As will be seen in the chapters which follow, proposed approaches to integration other than the partnership method generally involve lesser administrative difficulties, but also sacrifice in some degree the objectives of integration. Here it becomes necessary to compare the administrative "saving" with the degree of loss of other objectives.

Accounting and Integration

The most significant relation of accounting to the question of integration of corporate and individual income taxation has to do with the accounting theory of income determination. It is in this area that accounting has its most important (and perplexing) theoretical problems. A discussion of integration can make use of accounting income theory and can also contribute to it by aiding in, if not forcing, a consideration of the basic income concept which underlies accounting theory. This important topic is discussed in some detail in the chapter which follows. An attempt is made there to show that a single fundamental concept of income is valid, and also useful as an "ideal" or directional guide, not only in accounting but also in taxation and for many purposes in law and economics.

Another area in which accounting is pertinent to the question of integration is the accounting concept of business entity. Income tax integration involves attributing corporate income directly to the stockholders. This appears to be in opposition to the accounting insistence on the business entity. The conflict is probably more apparent than real and, in any event, not too serious. There has been, however, some rather heated controversy among accountants over the "entity" versus "association" or "proprietary" views of the corporation. Most of the differences can likely be resolved by recognizing that the purposes of the entity concept are limited and, at the same time, that these limited purposes are generally quite valid and useful. Controversy arises when the entity concept is extended to cover purposes which are of questionable validity. Perhaps the most extreme form of this is reached when the business entity is treated as being so "real" and "separate" as to have the same status as an individual. The "legal entity" is important for many purposes of the law but is not necessarily dominant for income tax purposes.

The entity concept in accounting gives a reasonable basis for determining financial position and results of operation of a business or other enterprise. The notion of an entity is essential to the preparation of meaningful financial statements using double-entry bookkeeping. Thus when one person is the sole proprietor of several unrelated businesses, each is properly accounted for as a separate entity. But no one would argue that these several entities should have much significance for income tax purposes. Certainly it would not be equitable to apply income taxes at progressive rates on every separate entity.

It is argued that the entity concept becomes much more significant in the case of large, widely-held corporations than for proprietorships, partnerships, or even closely held corporations. A more reasonable view, and one which appears more likely to be productive of clear thinking and progress in accounting concepts, is that the difference is not one of kind or degree of entity, but rather one of defining "realization." Accountants would generally agree that it is reasonable to say that a sole proprietor has "realized" income to the extent that his business has earned profits. Some, but not all, accountants maintain that a parent corporation should include in its assets its entire equity in a wholly owned subsidiary, thus reflecting a "realization" of the subsidiary's profits or losses as they are earned. Yet a great many, probably most, accountants would insist that a shareholder in a widely-held corporation has not realized income until he receives a dividend. The differences in these situations are not inherent differences in "entity," but rather differences in factors which make for a reasonable determination of realization. These factors include such things as degree of control over the "income" and certainty of receipt.

The problem of realization pervades all accounting and is even more important and complex in the determination of the entity income in the first place than it is in ascribing that income to those who share in it. The relationship of realization to income concepts and tax integration is discussed further in Chapter II of this study.

Another area in which accounting and accounting practice are related to the question of integration is administrative practicability. Accountants would inevitably have much to do with implementing any of the proposals discussed in this study, and are in a good position to assist in judging the difficulties of various methods. For example, if it is determined that public corporations should be treated differently from private corporations, accountants should be able to contribute much to evaluating alternative bases for drawing a line between the two. A more detailed discussion of accounting aspects of administrative problems is included in the separate discussions of specific proposals in the chapters which follow.

Other Factors Related to Integration

A few other matters which are difficult to classify under the above headings seem important enough to be considered separately here. These include the relation of integration to such things as revenue needs, windfall gains and losses from tax changes, the desirability of diversity in taxes, and the encouragement of small business and competition.

The problem of meeting revenue needs is practical rather than theoretical. Even from the viewpoint that we must have tax revenues sufficient to cover expenditures, any revenue losses from integration could be met by changes in rates and exemptions of the individual income tax. It is not certain that integration would require an increase in individual rates. Depending on the particular approach taken, it might even be possible to reduce rates.

If the corporporation tax were abolished and no other major changes made, there would obviously be a great loss of revenue. But this could hardly be called integration; it would simply mean that corporate income would not be taxed to the individuals who benefit from it unless and until it is distributed as taxable dividends. Some revenue loss would also be inevitable from any approach to integration which is aimed solely at eliminating the element of "double taxation" of distributed corporate income. Thus, to the extent that corporations are given a credit for dividends paid or individuals are given a credit for dividends received or are permitted to treat the corporate tax as a withholding of individual tax, there is a reduction of revenues with no automatic compensating increase.

The direction of the effect on revenues of the partnership approach is not so clear. The elimination of the corporation tax would be at least partially offset by taxing full corporate profits to individuals. In order to avoid a revenue loss, it would be necessary for the total individual tax on these profits to equal the present combined corporate and individual taxes on dividends plus capital gains taxes that would not be collected because of increases in basis resulting from the taxation of retained income to shareholders. Revenue would be reduced to the extent that individuals are now "overtaxed"; that is, insofar as stockholders who are not subject to tax or are in low brackets are bearing the burden of a higher rate of corporate tax. Revenue would be increased to the extent that presently "undertaxed" individuals would pay tax at a high personal rate on their entire share of corporate profits. Estimates of the dollar effects on revenue of various changes are possible, but with less accuracy for some than for others. Analyses of available data and attempts to estimate likely revenue effects are included in the later chapters of this study which deal with specific approaches to integration.

Any of the major proposals for integrating corporate and individual income taxation might lead to substantial windfall gains or losses to individuals. Insofar as prospective corporate taxes are capitalized in the market value of stock, any change in effective rates of tax will raise or lower stock values. In an extreme case, it is conceivable that the entire burden of a tax is borne by the holder of stock at the time the tax is imposed, subsequent purchasers of the stock getting a "full" investment return by paying a smaller purchase price. Our knowledge of incidence and other effects of taxation is too limited to draw firm conclusions, but it seems unlikely that this extreme case would hold for the corporate income tax. In general, taxes are capitalized (and the burden borne by those who hold property at the time the tax is imposed or raised) only when the tax is discriminatory and not a general tax. Thus a truly general tax is not capitalized except in the sense that certain long-run adjustments (in capital supply, etc.) can be expected.[34] In addition, to some unknown extent, the windfalls from integrating taxes would affect the same persons who were affected by the present taxes when imposed or raised.

The problem of windfalls is primarily one of equity. The equity argument for integration is undeniably weakened by the fact that windfall gains and losses resulting from integration cannot be expected to exactly offset prior losses and gains of the same individuals.

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[34] Musgrave, op. cit., p. 384.

However, even if we make rather extreme assumptions as to prior capitalization of over and undertaxation of stockholders' income and as to subsequent changes in ownership, the equity case for integration would still appear strong, since new inequities would be avoided even if old ones cannot be corrected.

There are at least two ways in which the impact of windfalls might be lessened. One would be to find a way to tax them (or give refunds in the case of negative windfalls), another would be to attempt to make the price adjustments and resulting windfalls come about gradually. It would not be possible to achieve perfect equity in taxing windfalls. In addition to the difficulties of distinguishing windfalls caused by integration from other price changes, there would be difficult administrative problems. At best, only rough accuracy would be possible. There is also a danger that undesirable complexities would be introduced into the law relating to specific transaction dates. Henry Simons has stressed this type of danger:

> We should not perpetuate or multiply temporal categories in the law. Some temporal concessions to vested interests are often desirable, but traditional lawyer solicitude about "retroactive" effects of changes in tax accounting is a serious obstacle to necessary simplification. There is no sense in March 1, 1913, values, in special treatment for dividends "paid out of" pre 1913 earnings, or different basis rules for gifts made before and after 1921.[35]

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[35]Henry C. Simons, Federal Tax Reform (Chicago: The University of Chicago Press, 1950), p. 30.

The windfalls we are concerned with are changes in the price of capital assets (especially common stock) resulting from the capitalization of changed expectations of income because of tax changes. The impact of these price changes would be less severe if the price changes were gradual rather than sudden, because the windfalls would likely be spread among more individuals and because there would be less danger of an exaggerated speculative reaction. However, achieving a gradual effect on stock prices would not be simply a matter of taking gradual steps toward integration. As Goode points out, if a plan for gradually reducing corporate taxes were definitely announced, "the effect on security prices might be almost as great as if it had been put into operation immediately."[36] Goode suggests that a gradual price adjustment is likely to be possible either if changes are made gradually and not announced all at once (and not strongly anticipated) or if the change is made "only after discussion over a period of years during which investors came to anticipate [it] with a gradually increasing degree of confidence."[37]

Although simply eliminating "double taxation" of distributed profits would clearly involve a revenue loss and amount to a reduction of taxes on corporate income, there would be an at least partly offsetting

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[36] Richard B. Goode, The Postwar Corporation Tax Structure (Washington: Treasury Department, Division of Tax Research, 1946), reprinted in U.S. Congress, House, Revenue Revisions, 1947-48, Hearings, Committee on Ways and Means, 80th Congress, 1st Session, Part II, p. 1151.

[37] Ibid.

tax increase in the case of the partnership approach, as was pointed out above. The increase results from taxing, at progressive rates, undistributed profits. At present, undistributed profits are subject only to the essentially flat-rate corporate tax and often completely escape personal tax or are realized at favorable capital gains rates. When this is considered along with the possibility of taxing all capital gains at ordinary rates, it is clear that integration does not necessarily imply a revenue loss, or even an over-all reduction in taxation of corporate income.[38]

Under the partnership approach, then, it is not clear that windfalls would be always windfall gains from increases in stock values. It is even conceivable that offsetting influences and market uncertainty would result in no significant changes in stock prices. Another matter which has some bearing on the question of the desirability of integration is whether we should maintain a measure of diversity in taxes. Goode includes this as an important point in arguing for retention of the corporation income tax.[39] He insists that any given tax will have some economic and administrative defects and these become more serious as reliance is placed on fewer taxes and correspondingly higher rates

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[38]Goode appears to ignore this possibility. He states, "Starting from approximately the present relation between corporate and individual tax rates, all approaches to coordination of individual and corporate taxes would be likely to result in some loss in revenue. Generally, the more nearly 'complete' the coordination or integration, the greater would be the loss of revenue." Ibid., p. 1139.

[39]Goode, The Corporation Income Tax, op. cit., pp. 214-16.

are imposed. This reasoning assumes that the defects of different taxes tend to offset each other, which is not always the case. In the face of the obvious inequities of the present taxation of corporate income, the argument is far from convincing. It should also be recognized that simplification does not necessarily mean over-all higher rates. Thus, elimination of special treatment of capital gains may make possible lower over-all income tax rates.

As a matter of political expediency, diversity may have more merit. As Goode points out, "pressure groups identify their interests with different tax programs."[40] An integrated, simplified income tax structure might actually hinder "working compromises" among various interests simply because of the (otherwise admirable) quality of having rather clear-cut effects. This "realistic" argument should not, however, be allowed to interrupt the search for the ideal of taxation or even hinder the attempt to get wider understanding of such an ideal.

A final problem to which integration is related is that of encouraging small business and maintaining competition in business enterprise. This objective is popular in the United States and has been the basis for many special tax provisions. In spite of some excellent studies,[41] it is not clear whether the net effect of our present tax

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[40] Ibid., p. 215.

[41] See especially J. Keith Butters and John Lintner, Effect of Federal Taxes on Growing Enterprises (Boston: Harvard University Graduate School of Business Administration, 1945).

structure encourages or discourages small business and competition. Aside from the special provisions aimed at helping small business,[42] the present relatively favorable treatment given to undistributed corporate profits is favorable to corporate expansion. This is true of both small and large corporations, but is especially the case for closely held corporations whose stockholders are in high tax brackets. Of some significance is the fact that the corporate tax rate is lower on the first $25,000 of taxable income and that a credit of $100,000 is allowed against the accumulated earnings tax of Section 531 (formerly Section 102). On the other hand, the very existence of a separate tax on corporation income reduces the "internal" funds available for expansion and may affect investment incentives. To some extent tax factors have been significant in encouraging the merger of small companies into larger ones.[43]

On the whole, while not much can be said for integration as a means of encouraging small business and competition, neither can much be said against it. Integration would not hinder the effectiveness of tax benefits such as accelerated depreciation allowances for small businesses. Probably a system of direct subsidies would be more to

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[42] Such as the "Additional First-Year Depreciation Allowance for Small Business" enacted in 1958 (Sec. 179, 1954 Internal Revenue Code).

[43] See John Lintner, "Tax Considerations Involved in Corporate Mergers," in <u>Federal Tax Policy for Economic Growth and Stability</u>, <u>op. cit.</u>, pp. 690-702 and J. Keith Butters, John Lintner and W. L. Cary, <u>Effects of Taxation: Corporate Mergers</u> (Boston: Harvard University Graduate School of Business Administration, 1951).

the point in maintaining the competitive position of small business than special tax treatment. Buehler doubts the effectiveness of tax adjustments in this area:

> The tax student is sympathetic with the purpose to eliminate bad business, whether it be called monopoly or be given another name. The tax system does not, however, because of its lack of selectivity as a regulatory device, appear to be an effective medium for checking the particular monopolies which society wishes to curb.[44]

The case for integration rests primarily on the need for greater equity in taxation. The over and undertaxation of corporation derived income is a serious defect in our present tax structure. The economic effects of integration would not clearly be either good or bad, while administrative problems would, on balance, probably be increased. Administrative difficulties can be considerably lessened by attempting only partial integration, but this involves a sacrifice of equity. The chapters which follow attempt to provide a basis for judging the relative merits of various possible approaches to integration.

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[44] Alfred G. Buehler, "Should the Tax System Be Used To Check Monopoly," in How Should Corporations Be Taxed, op. cit., p. 108.

CHAPTER II

INCOME CONCEPTS

In this chapter an attempt is made to demonstrate that there does exist a single concept of income which is of major importance in accounting, economics, and taxation. The concept, which has been termed the "accretion concept" of income, is not difficult to comprehend, has been well stated by a number of writers, and has been given at least some recognition by many accountants and economists. It has been increasingly accepted by fiscal theorists, but it has rarely been given the important position it should hold in accounting as a basis for a unified theory and as a standard by which to judge alternatives in practice.

The case for integration is closely tied in with income concepts. As will be seen, if the accretion concept is accepted, integration is necessary in order for individuals to be taxed on their accretion income. If, on the other hand, a strict realization concept[1] is insisted upon, the case for integration is rather weak. It is not here contended that the accretion concept is the only valid or true concept of income, or even the only useful one; other concepts are relevant in

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[1] That the emphasis on realization is a relatively recent development in accounting is pointed out by Reid K. Storey in "Revenue Realization, Going Concern, and Measurement of Income," Accounting Review, XXXIV (April, 1959), 232.

certain contexts. The accretion concept, however, has a much wider applicability than is usually recognized. Accounting and tax theory and practice have suffered because of a tendency to consider hopeless the search for a theoretical income concept. The idea that there are many different income figures which are proper for different purposes exaggerates the situation. The circumstances in which concepts of income other than accretion are applicable are usually of relatively minor importance.

Neglect of the accretion concept has hindered progress in accounting theory and practice. If wide recognition were given to the concept, many of the current heated controversies would be seen in a clearer light and a more solid foundation would be available for lessening the much decried variations in accounting practice.

The names of Schanz, Haig, and Simons stand out prominently in the history of the accretion concept of income. Each of these economists has been influential in bringing about an increasing interest in accretion as an ideal concept of income and as a standard by which taxes can be judged.[2] The specific proposals of these writers were not identical, but each advocated basic reliance on much the same comprehensive concept of income.

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[2]Georg Schanz, "Der Einkommenbegriff und die Einkommensteuer-gesetze," Finanz Archiv, XIII (1896), 23. Robert Murray Haig, "The Concept of Income: Economic and Legal Aspects," in R. M. Haig (ed.), The Federal Income Tax (New York: Columbia University Press, 1921), chap. 1. Henry Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938).

The simplest expression of the accretion concept is that income is the "net accretion to economic power between two points of time."[3] For an individual, income equals consumption plus any increase (or minus any decrease) in net worth. For a business or other entity, income equals the change in net worth adjusted for contributions of and withdrawals of capital. Under this concept, income can be either positive or negative and is recognized whether or not it is "realized." The determination of income requires a valuation of all assets and liabilities at the beginning and end of each income period.

One of the most significant features of the accretion concept of income is that it does not include a requirement of realization. This is especially important because of the great emphasis that has been placed on realization in accounting and legal thought and practice. It is not argued here that it is either possible or desirable in practice to do away entirely with the "realization requirement." Nevertheless, it is believed that realization more properly should be viewed as a departure from "income" (which departure is sometimes justified by the need for objectivity and the availability of funds to pay taxes) rather than as an essential feature of the income concept.

Economic Concepts of Income

It is not possible to outline a clear concept of income which would be acceptable to all, or even most, economists. Kaldor, in a

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[3]Haig, loc. cit., p. 27.

stimulating and scholarly discussion of the economic theory of income[4] states that "income, unlike some other notions which have been taken over into economics from everyday usage, is not generally subjected to any searching or systematic analysis in economic textbooks."[5]

Economists are clearly concerned with income in their studies of distribution. Thus, wages, interest, rent, and profits involve the distribution of income as factor rewards. Much is sometimes made of the difference between "profits" in this distributional sense and profits or net income as measured in accounting. This difference is not as serious as it might seem. It is clear that the accountant is not concerned with dividing income into its components. Thus, if reported profits include implicit interest on invested capital or implicit wages for the owner's services, this is not significant to the accountant--he properly wants to measure the entire net income of the entity. He is not concerned with dividing gross income into distributional shares as wages, interest, etc., nor is he concerned with segregating profit into parts according to its causes or sources. Accountants would be very pleased, indeed, if they could tell the extent to which business profits result from relative managerial efficiency, from fortunate price fluctuations, from exercising monopoly power, or from other causes,

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[4]Nicholas Kaldor, An Expenditure Tax (London: George Allen & Unwin Ltd., 1955), "The Concept of Income in Economic Theory," appendix to Chapter I, pp. 54-78.

[5]*Ibid.*, p. 54.

and accounting analysis which tries to get such information is often worthwhile; but the accounting concept of income certainly does not require such a breakdown. It is a concept of income of the entity.

The economist, on the other hand, is concerned with components of income in distribution theory and in his attempts to arrive at a theory of profit. In these connections, the economist does not usually show much concern for indicating how total income is to be determined. Often the concept of income is taken for granted without any specific definition; "profit" is any income which is not interest, rent, or wages.

There are two principal areas in which economics is especially concerned with the concept of income in total. One of these is tax theory, where the income concept is important as a tax base; the other is national income analysis. In the area of tax theory, economists have tended toward the accretion concept, as the best base for tax equity. Practical problems of measurement and administration and the desire to further specific economic and social objectives make this concept an ideal or guide rather than a tax formula. There is important and growing support for this concept, and the improvement of taxation in the United States may well depend on still wider acceptance. This view is supported in the following quotation, which also indicates the essential features of the concept.

> The concept of taxable income which has gained increasing acceptance among fiscal theorists is that of total accretion. Income is defined to equal consumption during a given period, plus increase in net worth. According to this concept, all accretions to wealth are included, in whatever form they are received or from whatever source they accrue. Factor earnings such as rents, interest, profits, and wages, are included along with gifts, inheritances, gambling profits, and any kind of windfall. All of these accretions are included independent of whether they accrue at regular or irregular intervals, whether they are expected, and whether they are realized (translated into cash). Similarly, all diminutions of wealth are allowed for, whether they take the form of wear and tear, technical obsolescence, decline in value due to change in the market, gambling losses, or what not. Administrative considerations do not always permit drastic adherence to this general concept of accretion, but this does not obviate the need for a consistent theoretical concept. Without such a concept as a normative standard, we have no basis from which to deal with each practical problem as it arises.[6]

Some, although inclined to favor the accretion concept, would reject the notion that gifts should be included in income. There are obviously policy problems to be faced (no one would advocate that very small gifts be required to be reported for tax purposes), but there are also conceptual difficulties. In the writer's opinion the difficulty is as much a matter of defining the tax entity as it is of defining income. If the income tax is a tax on persons, based on the income of each, we must define "person." This might be easy if everyone were an "economic man," but some persons, such as very small children, do not fit this category. A related problem, which also

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[6]Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), p. 165.

seems to be essentially one of defining the proper tax entity, is whether it is equitable to allow income splitting on joint returns. The accretion concept does not supply ready answers to these questions, which involve value judgments.

Economists have devoted much research to attempting to define and measure "national income." They are primarily concerned with the aggregate real output of goods and services.[7] It does not appear to be necessary, even as a conceptual ideal, for this total to be exactly equal to the total of taxable incomes. For example, government transfer payments such as social security benefits are not part of "national income," but it would seem logical to tax them to the recipients (unless exempted for social or economic reasons) without any offsetting income reduction to those who pay taxes to support these payments.

Economists are not agreed as to whether or not any or all capital gains are properly excluded from "national income."[8] Some capital gains may reflect a "real" increase in wealth, such as discovery of mineral resources. Others may reflect only an increase in "scarcity value," as when urban land values rise. Still others reflect relative

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[7] There are, of course, conceptual and practical problems in defining and measuring national income, including the distinction between economic and non-economic activity which is a problem of any income concept. It is not feasible, and not essential to the point being made, to go into these problems here. See Simon Kuznets, National Income: A Summary of Findings (New York: National Bureau of Economic Research, Inc., 1946).

[8] See Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, Inc., 1951), pp. 49-51.

price changes, but may nevertheless be the result of deliberate economic (perhaps speculative) activity. Gains and losses from price level changes are discussed in another section of this chapter. Under the accretion concept, any gain or loss accruing to an individual or business entity is reflected in income.

Underlying any concept of income is the notion of utility. Both income and wealth are dependent on the ability of things to satisfy wants. The ultimate foundation for income is what has been termed "psychic income." Any economist will agree that not all psychic income is economic income, but it is often difficult to distinguish the two. Because there is no objective way in which we can measure utility or make interpersonal comparisons of utility, there does not exist an income concept that is both truly fundamental and capable of objective measurement. The accretion concept is by definition concerned only with economic income (accretion to economic power). But even if we agree as to what are economic activities we still are faced with measurement problems which are related to "realization."

The accounting convention of realization generally insists on a definite event before recognition is taken of a gain or loss. Receipt of cash, exchange for a more liquid asset, or the like is required. Under the accretion concept, income is recognized whether realized (in this sense) or not. Thus if an asset increases in value for whatever reason, the owner has income. But imperfections of knowledge and foresight limit our ability to measure value changes.

For example, if a man believes he foresees a shortage of some commodity, buys a large quantity of it, and later sells it at a substantial profit, at what point did his income accrue? It is impossible to answer this question so as to have both a completely unambiguous concept and an objective measure of the result. The difficulty is essentially a result of uncertainty. The gain to the man in our example was possible because of uncertainties about the future, and at various points of time this man was himself more or less uncertain as to the outcome. The accretion concept achieves a degree of measurability and avoids problems of uncertainties as to the future by recourse to market values in measuring changes in net worth. This approach can properly be viewed as a compromise which sacrifices some of the objectivity and certainty of the conventional realization approach, but which also avoids much of its arbitrariness and sometimes unrealistic results.

Irving Fisher, seeking the ultimate subjective basis for income and, at the same time, a way to measure it, concluded that income could only be satisfactorily defined in terms of consumption:[9]

> It is these events--the psychic experiences of the individual mind--which constitute ultimate income for the individual . . . .

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[9] Irving Fisher, The Nature of Capital and Income (New York: The Macmillan Company, 1906). His ideas on income are more briefly summarized in Chapter I, "Income and Capital" of The Theory of Interest (New York: The Macmillan Company, 1930) and in his article on "Income" in the Encyclopedia of the Social Sciences (New York: The Macmillan Company, 1937).

> . . . enjoyment income is a psychological matter and hence cannot be measured directly. So we took real income instead. The cost of living . . . is the practical, homogeneous measure of real income . . . . Between it and real income there are no important discrepancies as there are between money income and real income. Money income practically never conforms to real income because either savings raise money income above real income, or deficits push money income below real income.[10]

A number of writers have pointed out that much of this is simply a matter of definition. If we wish to call consumption "income," we can do so, but we will have to come up with a new term for what we now call income. There are two reasons for going into Fisher's income concept in some detail: Fisher himself strongly urges that an income tax should apply only on "real income" (consumption)[11] and Canning has used Fisher's concepts as a point of reference in a classic study of the relations of economics to accounting.[12]

Fisher's contention is essentially a question of whether consumption or income (accretion) is a better tax base. This was discussed in Chapter I. The case for a consumption tax is far from secure on grounds of economic effects and administrative feasibility and is highly questionable on grounds of equity.

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[10]Fisher, The Theory of Interest, op. cit., pp. 4, 12.

[11]Irving and H. W. Fisher, Constructive Income Taxation (New York: Harper & Brothers, 1942).

[12]John B. Canning, The Economics of Accountancy (New York: The Ronald Press Company, 1929).

In Constructive Income Taxation, Fisher relaxed his insistence on defining income to exclude savings, and indicated that accretion is the proper concept for some purposes, including corporation accounting:

> For many years the present writer argued for confining the use of the word "income" to one of these two concepts--what is here called yield. However, experience has proved that, paradoxically, the best way, in this case, to avoid ambiguity is to recognize income in both senses, but always to use the term with a modifier such as yielded or earned . . . .
>
> While yield is the more fundamental concept, accretion is, for some purposes (other than taxation), the more useful. For instance, given the accounts of a corporation for a single year, we naturally strive to extract from these accounts as much of the whole picture as can be expressed in a single figure. Merely to know the yield, or dividends, in that year tells us little. The earnings or accretion tell much more; for the earnings include capital increase; and from capital increase (in this case, undistributed profits) we can get some idea as to future yields.[13]

Fisher's argument that accretion is not a proper concept for income taxation relies ultimately on the notion that true income must be psychic income. He maintains that what is saved is not income but rather postponed income. But psychic income is a useful concept for tax purposes only if it can be measured, or at least approximated. "Consumption" is not necessarily approximately equal to psychic income. For example, a person's total psychic satisfactions might be much greater if he accumulated wealth in a given year than if

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[13] Irving and H. W. Fisher, op. cit., pp. 49-51.

he spent all his earnings. Accretion might in this case be a better measure of psychic income than would consumption. It seems futile to try to choose between accretion and consumption concepts of income on the basis of which best conforms to psychic income. We have no way of measuring psychic income in any given case.

If the notion that psychic income equals consumption is rejected, there is little basis for the corollary idea that taxation of accretion income involves double taxation of savings. When an individual invests some of his current earnings he expects a future flow of interest. To tax both his current earnings and the future interest earned on the portion of these earnings invested involves taxing the same thing twice only if it is held that there is nothing to tax now--that there is no real "income" until the future interest is earned (and consumed).

Neither accretion nor consumption can claim to represent psychic income in any fundamental sense. It is not clear that consumption gives a closer approximation to psychic income, and even if it were, accretion might still be a preferable tax base since it conforms better to "ability to pay" in terms of economic power.

It is perhaps unfortunate that Canning chose Fisher's income theory as a basis for comparing economics and accounting. Fisher's notion of income as consumption is, as Canning points out, not used by accountants nor is it really relevant to accounting objectives.

Nor are Fisher's ideas on proper income taxation at all widely accepted by economists. It is quite possible that Canning's work would have been more influential in hastening the clarification of accounting theory had he devoted less attention to Fisher's concepts and more to the similarities between the accretion concept and what accountants seek to measure.

The following passage illustrates Canning's awareness of the inapplicability of Fisher's concepts to accounting:

> Realized income, in Fisher's sense is, indeed, the more elementary and fundamental measure. But not only is it often impossible to lay down approximate future schedules of it, but also these schedules would need to be interpreted by conversion into successions of capital value and of earnings. The proprietor and those beneficially interested in proprietorship wish chiefly to know what net changes in power to command future final income have occurred within a year by reason of the enterprise activities. . . . in short, for every major purpose for which information about enterprise income is wanted the earnings figure is more immediately significant than is the figure for realized income.[14]

Yet Canning adopts Fisher as the "sole representative of economists' views on income" for a number of reasons.[15] Seen in the light of the developments in theory in the thirty years since Canning's work was published, the choice seems to have been a poor one.

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[14] Canning, op. cit., pp. 169-70.

[15] He explicitly lists seven reasons, including: "His concept more nearly parallels that of the accountant than does that of any other economist" and "Fisher's theory of income is by far the best that has appeared in the literature." (Ibid., p. 145.)

It is not to detract from Fisher's monumental work, especially in capital and interest theory and statistical research, to point out that his income concept has not been widely accepted among economists and, in particular, fiscal theorists. The accretion concept had been defended prominently prior to Canning's study by Schanz[16] and Haig,[17] but interest in it had not yet been stimulated by Simons' classic work.[18] The recent emphasis on the accretion concept by fiscal theorists suggests that if Canning had chosen this concept as a basis for comparing economics and accounting, his work would have been both more relevant to current accounting theory problems and more influential. The relevance of the accretion concept to accounting theory and practice is discussed in the following section of this chapter.

Income Concepts in Accounting

Anyone familiar with the accounting literature of this century realizes that there has been an almost universal and continuous desire to see the wide acceptance of a body of principles or a theory of accounting. The benefits of this would include formation of a basis for settling controversies and for reducing the wide variations in accounting practice. Despite some notable progress in reducing variations in

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[16] Schanz, op. cit.

[17] Haig, op. cit.

[18] Henry C. Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938).

practice,[19] accounting controversies have been, if anything, increasing in intensity, and there is often little sign of any basic concept or normative standard among the disputants.[20] This shows up with particular force in discussions of price level adjustments and capital gains. It is likely that more general recognition of the accretion concept of income as an ideal or normative standard would result in significantly greater unity and progress in accounting theory and practice. This would not by any means settle all accounting controversies, but it should be invaluable in clarifying issues and pointing up the really significant differences in various methods and approaches.

The nature of the accretion concept has been discussed above and it has been indicated that this concept has received wide and growing recognition as a broad guide to "proper" taxation of income. It remains to be shown why the concept should have a similar importance in accounting.

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[19] The variations are still disturbingly common and important. Some, perhaps most, of the credit for reductions of variations in recent decades must be given to the influence of government, particularly through the Securities and Exchange Commission and income tax enforcement.

[20] The American Institute of Certified Public Accountants has shown concern about this problem in setting up a new accounting principles board and establishing research projects on accounting. See "Report to Council of the Special Committee on Research Program," Journal of Accountancy, CVI (December, 1958), 62-68.

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The accretion concept of income is not something novel or foreign to accounting thought. It has been widely recognized as at least theoretically sound but has been all too quickly discarded as impractical. There is some evidence that while economists have been showing a growing acceptance of the accretion concept, accounting theory and practice has been tending away from it.

In 1920 Professor Haig, in developing the accretion concept, pointed out the similarity of the concept to the concept of income underlying accounting:

> These statements present nothing which is really novel. This same doctrine has long been taught by that faithful handservant of the practical businessman--the accountant. When one examines the standard books dealing with the theory of accounting he finds the definition of the net profit of a business undertaking stated in almost the precise words used in the general definition given above.[21]

The tendency of accountants in recent years to put less emphasis on accretion income and more emphasis on "realized" income is illustrated in the discussion of the writings of prominent accountants which follows. The same tendency is revealed in the report of the study group on business income of the American Institute of Accountants.[22]

In his early writings, Professor Paton shows some tendency to favor what is essentially the accretion concept:

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[21] Haig, op. cit., pp. 11-12.

[22] Changing Concepts of Business Income (New York: The Macmillan Co., 1952). See especially pp. 21-25.

> . . . it should be emphasized that the broad definition of net income as measuring the difference between the true economic position of a business at the beginning of a given period and its position at the end of the period (allowance being made for investments and withdrawals) has considerable force.[23]

> The solution of the matter [price fluctuations and depreciation] lies in the revision of orthodox accounting policies with regard not to depreciation methods but to closing valuations. The values which the accountant uses in closing the books and preparing statements ideally should be based upon economic conditions at the moment of closing. If plant and equipment assets were valued at the close of each period on the basis of costs of replacement--effective current costs--depreciation charges would be increased in a period of rising prices and the other concomitant effects would be registered in the accounts in a rational manner.[24]

In more recent years, Paton, like most accounting theorists, has emphasized other more arbitrary "principles" of accounting in the measurement of income. Particular emphasis is placed on realization and the process of matching costs and revenues. There has been a tendency to view these concepts as essential parts of an income theory rather than as departures from theory justified by the need for objectivity.

The following excerpts from Paton and Littleton's important monograph are perhaps typical of the present dominant view among accountants:

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[23] W. A. Paton, Accounting Theory (New York: The Ronald Press Company, 1922), pp. 464-65.

[24] W. A. Paton, "Depreciation, Appreciation, and Productive Capacity," Journal of Accountancy, XXX (July, 1920), 6-7.

> Earning must not be confused with realization . . . . As a basis for revenue recognition in the accounts, realization is in general more important than the process of earning. It is one thing to say that revenue is earned as the result of the entire process of production; it is quite another to hold that revenue can be measured and recognized prior to completion and disposition of the product.[25]

> Does appreciation represent recognizable income? A negative answer to this query is fully justified. Without doubt the movement of prices has an important bearing on the economic significance of existing business assets, but there is little warrant for the view that sheer enhancement of market value, however determined, represents effective income.[26]

> Recognition of the inadequacy of recorded cost . . . as a continuous expression of market value should not lead to the conclusion that accounting based on cost is unsound and should be replaced by an accounting for values. The primary purpose of accounting . . . is the measurement of periodic income by means of a systematic process of matching costs and revenues. Substitution of estimated current market values for recorded cost factors enroute to assignment to revenue would bring about a radical modification of the standard scheme of income determination. Periodic net, instead of representing the excess of revenue over attaching costs incurred, would then include the effect of all write-ups and write-downs of the cost factors involved.[27]

It is probably fair to characterize most accounting today as having no central concept of income and thus as having no general theory to be used as a guide in settling disputes and choosing among alternatives

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[25] W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (American Accounting Association, 1940), p. 49.

[26] Ibid., p. 62. The use of the qualifying adjectives, "recognizable" and "effective," perhaps implies a recognition of the accretion concept of income, but the force of the statement is obviously opposed to it.

[27] Ibid., p. 123.

in methods of recording and presentation.[28] In 1929, Canning said that accountants' "generalizations about income, to the extent that they go beyond procedure at all, are too inchoate . . . to permit one to suppose that they have ever put their minds to the philosophical task."[29]

Acceptance of the accretion concept by accountants would not instantaneously settle all their differences but would encourage progress by making clear the bases of the differences. If it were agreed that accretion income is what we would like to measure and present in financial statements, but that we must often depart from it, mainly for reasons of objectivity of measurement, then it would be much easier to weigh the merits of different accounting procedures. Instead of seeing problems as involving a choice between conflicting theories, we would see them as a matter of judging how far it is necessary or wise to depart from what it is agreed we would ideally like to present. For example, perfect conformance to the accretion concept would require that income reflect the effects of changes in values on a business entity. If the value of inventory or any other balance sheet item rises or falls in an accounting period there is a corresponding increase or decrease

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[28] The statement that income is determined by "matching costs and revenues" does not provide a basic concept of income. This is merely a guide as to what costs to deduct from revenues which have been accepted as "realized."

[29] Canning, <u>op. cit.</u>, p. 160.

of income. If we could satisfactorily measure these changes we could present an income figure which would be of greatest value to management, investors, government, and others. When we insist on leaving these items at cost and ignoring changes in value we do so not for conceptual reasons but because we want our figures to be reasonably objective. The problem, then, is one of weighing the advantages of (the particular obtainable degree of) objectivity against the disadvantages of the resulting departure from "economic reality."

Professor Littleton has been even more emphatic in his defense of cost and realization than has Professor Paton. Professor Littleton's monograph on accounting theory[30] implies that rather than being a departure from an "ideal," present accounting practice is quite reasonable:

> It is hoped that the present monograph may succeed in indicating that enough sound reason and good logic is evident within accounting to justify it completely. That inner structure of reasonableness, it will be noted, has been achieved, not by a few people philosophizing principles deductively from some great undeniable truth (the usual concept of theory derivation), but rather by trial and error in the field through generations of use and professional practice.[31]

The growth in status of accounting and accountants has been to a great extent the result of an emphasis on objective, disinterested reporting. But there is an inescapable conflict between the need for

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[30]A. C. Littleton, The Structure of Accounting Theory (American Accounting Association, 1953).

[31]Ibid., p. vi.

objectivity and the need to accurately portray economic realities. It is primarily the desire for objective, independently verifiable, data that has caused the insistence on cost rather than value in accounting records and statements. So long as relative prices as well as the general price level remain fairly stable, statements prepared on a cost basis make a satisfactory presentation of accretion income or "economic reality." Although by insisting on using cost the accountant retains a high degree of objectivity, the value of that objectivity is greatly lessened when prices fluctuate substantially. Respect for the accountant is probably more a result of his presenting a true, or at least fair, picture of financial position and operations without being influenced by the opinions of management or other parties than it is a result of his use of independently verifiable data. Somewhat ironically, the insistence on cost because of the desire for objectivity has resulted in a loss of objectivity in the sense of presenting a "true" picture.

The pressures for changes in accounting to take account of price fluctuations are difficult to evaluate without a clear concept of income. The desirability of wider acceptance of the accretion concept among accountants is greatly strengthened by the recent tendency to emphasize only part, or only one side, of a problem. In many cases this tendency is obviously simply a matter of a vested interest seeking advantage, but all too often it appears in what would be expected to be impartial studies.

The outstanding example of this is the tendency to insist that depreciation charges should reflect current (higher replacement) costs, without taking account of other adjustments which would seem to be called for by price-level changes. Some writers, including Professor Paton in his early writings (cited above), have pointed out that increasing the depreciation charge is only one side of the picture; that, conceptually, it is difficult to ignore in computing income the value increment which justifies the higher depreciation, and that over the life of the asset, the value increment and the increase in depreciation offset each other.[32] The recent tendency to emphasize only the desirability of higher depreciation charges[33] would probably be lessened if the accretion concept were more widely and explicitly recognized.

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[32]See, for example, Sidney S. Alexander, "Income Measurement in a Dynamic Economy," in Five Monographs on Business Income (New York: Study Group on Business Income of the American Institute of Accountants, 1950), p. 5.

[33]See, for example, Ralph C. Jones, Effects of Price Level Changes on Business Income, Capital, and Taxes (American Accounting Association, 1956); W. A. Paton, "Significance of Depreciation Accounting with Special Reference to Plant Replacement," in Federal Tax Policy for Economic Growth and Stability, Papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Committee on the Economic Report (Washington: U. S. Government Printing Office, 1955), pp. 528-38; W. A. Paton, "Depreciation--Concept and Measurement," Journal of Accountancy, CVIII (October, 1959), 38-43; and Willard J. Graham, "An Analysis of Accounting Provisions," in Tax Revision Compendium, papers submitted to the Committee on Ways and Means (Washington: U. S. Government Printing Office, 1959), pp. 1175-81.

The problem of adjustments in accounting data, including depreciation charges, to more closely reflect economic reality is made more complex by the "illusory" nature of gains and losses which merely reflect changes in the general level of prices. Confusion over the significance of real versus money measures of income has been a hindrance to progress in accounting theory in recent years. This question is of obvious importance to tax policy and is analyzed further in a separate section of this chapter under the heading, "Price Level Changes."

Legal and Tax Concepts of Income

Historically, the early concern of the law with income was primarily in connection with estates and trusts.[34] The legal problems involved and the predominantly agricultural production at the time led naturally to an emphasis on distinguishing "between income and principal in the sense of what could be rightfully consumed by the life-tenant as against what belonged to the *corpus* or body of the estate."[35] Economists' concepts of income similarly emphasized the distinction between the "tree and the fruit" or, in general, income as something separate from and flowing from capital.[36] This emphasis gave a concept that was

[34] See Lawrence H. Seltzer, *op. cit.*

[35] *Ibid.*, p. 26.

[36] See the series of articles by P. H. Wueller, "Concepts of Taxable Income," *Political Science Quarterly*, LIII (March, 1938), 83-110, LIII (December, 1938), 557-83, and LIV (December, 1939), 555-76.

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much less broad than the accretion concept. Irregular, extraordinary, or unexpected gains were considered something other than income.

More recently, as the corporation has grown in importance, the law has increasingly become concerned with the contractual and legal rights of corporate creditors and stockholders. Problems in this area are to a great extent concerned with distinguishing income from capital. Thus, the determination of whether a dividend is paid out of income or invested capital is important to protect creditors and to avoid misleading stockholders.[37]

The determination of income for legal and tax purposes, as in accounting, is necessarily greatly affected by practical considerations. These include the desirability of reasonably objective means of measurement and administrative feasibility. Also, in taxation, departures from what might be agreed to be income may be deliberately made in order to promote some economic or social policy objective. These facts, however, do not diminish the desirability of clarifying and seeking wider acceptance of a basic income concept to serve as a standard.

Price Level Changes

Price fluctuations are of special importance to the question of integration of corporate and individual income taxation because of

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[37] For a detailed study of legal aspects of income, see Roswell Magill, Taxable Income (rev. ed.; New York: Ronald Press Company, 1945).

wide disagreement as to their effects on business and personal income. Whether integration is seen to be desirable depends in part on the concept of income held, which, in turn, depends partly on the point of view taken toward price fluctuations. Basically, the problem can be viewed as one of defining, measuring, and choosing between "real" and "money" income. This problem is one of the most significant and controversial areas of economic and accounting income concepts and also involves some important tax policy questions in addition to the question of integration.

The accretion concept does not eliminate the problems caused by changes in the general price level. This is true not so much because it is conceptually impossible to determine "real" income as because the accretion concept is (deliberately) formulated in terms which do not take account of price level changes. The failure of the accretion concept to take account of price level changes is justified primarily by the need for measurability. Current controversy, however, is not over whether we should adopt a tax base which would take full account of price level changes (which would require a concept much less measurable than the accretion concept), but rather whether we should make tax and financial statement adjustments for only one or two of the effects of price level changes. It is possible to make a good defense of taxing <u>money</u> income under the accretion concept rather than <u>real</u> income on the grounds that there is greater equity in doing so than there would be in making the limited adjustments for depreciation and inventory that have been advocated.

There has been much confusion between price level changes and changes in relative prices. If a person (or a business) holds a fixed money claim or cash over a period of rising prices, there is a loss of real economic power. This loss exactly equals a real gain to the debtor. A person who holds property which advances in price at the same rate as the general price level has no real economic gain or loss. When income is measured (as in the accretion concept) according to the change in wealth or economic power without adjusting for changes taking place in the value of the monetary unit, the debtor and creditor show no gain or loss, while the property owner does. When relative prices of different kinds of property change, there is a real gain or loss to various property owners which will be accurately reflected by the accretion concept if the over-all level of prices has remained stable.

From the point of view of achieving ideal tax equity, there is probably no basic difference between a real gain or loss caused by a change in relative prices and one caused by a change in the price level. It is nevertheless important that the two be distinguished clearly in discussing tax and accounting policy because of differences in the way they are reflected in (a) conventional accounting, (b) the accretion concept, and (c) "economic reality." The common failure to make such a distinction has clouded much of the controversy over what adjustments to accounting and taxable income should be made to take account of price fluctuation. Of course, the two types of price changes are not, in practice, entirely distinguishable events. Relative prices change constantly, often quite sharply for some items, whether or not the over-all price level (as best we can define and measure it) remains stable.

Changes in relative prices do not pose as much of a conceptual problem as do changes in price levels, though this has often not been recognized. The discussion of which particular price index should be used to adjust accounting data illustrates this. If any price index should be used, it should be one which reflects the general level of prices, not prices of particular types of assets. This follows from the fact that changes in relative prices do result in real economic gains and losses. If an asset is held during a period when its value rises relative to the general price level, the owner has a real gain. This gain may or may not have been expected or even the result of deliberate economic activity, but it is in any case a real gain. Under conventional accounting practice, such a gain would not be included in income until realized. If the gain is subsequently offset by a loss through a relative price decline (prior to realization), neither the gain nor the loss will appear in the accounting statements. If the relative price increase is permanent, however, it will eventually show up as accounting income. (This is true even under a LIFO inventory procedure--which pospones recognition until the time of dissolution or reduction of inventory quantities.) Under a strict application of the accretion concept, changes in relative prices affect income of the periods in which the price changes occur.

Changes in the general price level, on the other hand, do not result in real economic gain or loss to those who hold assets which change in price in proportion to the price level change, but do cause real gains or losses to those who have fixed money debts or claims. Both the accretion concept and conventional accounting practice fail to accurately reflect these real income effects. But the practical difficulties of attempting to achieve even rough justice by converting money income to real income during inflation or deflation are very great if not insuperable. Conventional accounting practice probably gives a more equitable result than any practicable direct adjustment could achieve, and a closer approximation to the accretion concept would improve the results of conventional accounting practice. The reasons for this conclusion can best be seen by considering separately (a) fixed money claims and debts, (b) property income, and (c) other income. To simplify presentation, the discussion is in terms of rising prices.

In a period of inflation, part of the real wealth of a nation is, in effect, transferred from those who hold fixed money claims to those who owe the corresponding debts. To tax the real income of the individuals and entities involved, it would be necessary to reduce the taxable incomes of creditors and increase those of debtors. To make an annual (accretion) adjustment would require that each taxpayer prepare a balance sheet. If the adjustment were to be made only at realization (payment of the debt) it would be necessary to use various adjustment factors depending on the age of the debt. No one has seriously proposed either approach. Insofar as fixed money items are concerned, the only hope for tax justice would appear to lie in achieving approximate price level stability. The seriousness of the problem is lessened to the extent that taxpayers' debts offset their fixed money claims.[38]

As was pointed out above, the effects of inflation on "property income" are different from the effects on fixed money claims and debts. Here the problem is not that there is a real gain or loss not reflected in the accounts, but rather than the accounts show a gain when in real terms there is none. If an asset is held which increases in value in exact proportion to the rise in the price level, there is no real gain, but if cost of goods sold or depreciation charges are stated at cost a gain will appear on the financial statements. Even the

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[38]See William A. Paton, Jr., A Study in Liquidity: The Impact of Inflation on Monetary Accounts (Michigan Business Studies: Vol. XIV, No. 2; Ann Arbor: School of Business Administration, University of Michigan, 1958).

accretion concept will show a gain.[39] The frequent proposals for revising depreciation deductions upward using a price-level index are intended to eliminate these "unreal" gains. But upward revision of depreciation deductions, even if combined with inventory cost adjustments, would eliminate only some "unreal" property gains. An increase in the value of land or a share of stock is as unreal as an equivalent increase in the value of depreciable property.

Incomes other than property incomes also pose serious problems. Of greatest importance here are wage and salary incomes. For various contractual and institutional reasons some incomes are fixed or very stable; while others fluctuate with price levels, business conditions, and other factors. Equity in making adjustments for price level changes would appear to require making adjustments for "unreal" increases in these types of incomes (or, perhaps, adjustments for "real" losses of those who have fixed incomes).

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[39] The timing of recognition of the gain will differ between conventional and accretion accounting, especially for long-lived assets. For example, suppose an asset is acquired at the beginning of year A, just before a sudden rise in prices to a higher stable level. Under conventional accounting with straight-line depreciation, the gain will be spread evenly over the life of the asset as "economic cost" exceeds depreciation expense. Under the accretion concept, depreciation (which is reflected in the changing value of the asset) will properly reflect "economic cost" after the first year, but a large gain will show up in year A. Different timing patterns result when the change in price levels is gradual over a period of years.

Taking the problem of price level fluctuations as a whole, it is clear that upward adjustment of depreciation and inventory cost figures would at best correct for only a portion of the "unreal" gains and losses of inflation. Another argument against making such adjustments is that they reduce taxation of the very persons who are most likely to benefit from inflation:

> Those hardest hit by taxation of fictitious gains will be, in the main, not those who have suffered in other ways from the depreciation of money. Indeed, they will still be far better off than those whose property has been in the form of bonds, mortgages, and annuities. Taxation of fictitious gains, therefore, may serve to produce a not inequitable counterredistribution of income and property.[40]

The distinction between adjustments for price level changes and adjustments for relative price changes is important. Most of those who argue for upward revisions of depreciation changes seem to disregard this distinction, which is vital to the conceptual and equity case for such adjustments. Suppose that since the acquisition of a factory building the general price level has risen 20 percent while the price level for construction of factory buildings (and prices of existing buildings) has risen 100 percent. Although it is clear that the real economic cost of use of the building is 100 percent greater than would be recorded under cost basis accounting, it does not follow that the only adjustment necessary to give "true" income is to double the depreciation figure. "True" income must also reflect the real economic gain which

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[40] Henry C. Simons, Personal Income Taxation, op. cit., p. 156.

accrued when the building rose in value more than the general price level. The impropriety of basing depreciation charges on asset appraisals or a specific index other than a general price index becomes obvious in the extreme case when the general price level remains stable. Since total depreciation charges will eventually exceed total cost, it will be necessary to record some kind of "appraisal surplus." (The only alternative would be to carry a negative balance among the assets--this would be ridiculous after the asset is retired.) If the general price level has remained constant, it cannot be claimed that this appraisal surplus represents an "unreal" increase in net worth. It obviously represents a real increase in net worth and there does not appear to be any reason why it should never be reflected in income and subject to tax. As was pointed out above, it is reflected in income under conventional accounting practice; the understatement of depreciation expense eventually exactly offsets the failure to record the "real" appreciation increment. Under the accretion concept, the increase in value of the particular asset would appear in income of the periods in which the value rose and there would be no understatement of depreciation expense, so the eventual income total would be the same as in conventional accounting so far as this asset is concerned.

It might be argued that gains and losses resulting from price changes should not be reflected in accounting income which is chiefly concerned with reflecting "operations." From the point of view of business management there is indeed much to be said for distinguishing between "operating" and "non-operating" revenue and expense. Insofar as this distinction can be made in a way that is meaningful to management and others, it should certainly be encouraged. It is not possible, however, even conceptually, to draw a clear line between operating and non-operating items. For example, acquiring inventory at favorable times and prices is certainly an operating objective, and success in this should be reflected in a higher operating income figure; but how are the inevitable unexpected, or windfall, inventory gains and losses to be sorted out from these? Insofar as it is possible to clearly define and measure operating income, the figure is a valuable one, but this does not diminish the significance of the over-all income figure for managers, creditors, security holders, and others in addition to the taxing authority. Disagreement over the importance of these two income figures is reflected in the controversy between those who uphold the "all-inclusive" as opposed to the "current operating" view of the income statement. It seems likely that those who lean toward the accretion concept of income would favor the all-inclusive income statement.

In summary, price level changes and changes in relative prices pose difficult conceptual and practical problems in income determination. It is important to distinguish between the effects on income of relative as opposed to general price changes and to recognize the differing results of conventional accounting practice, accretion income, and "economic reality." Although accretion income does not conform exactly with economic reality when price levels fluctuate, a good case can be made that it, or even conventional accounting, gives more equitable results than the inventory and depreciation adjustments which have been widely proposed. An evaluation of the merits of integrating corporate and individual income taxation must be based on a clear understanding of income concepts and the effects of price fluctuations on income.

Income Concepts and the Question of Integration

If there were no practical difficulties in the way of adherence to the accretion concept of income, there would not appear to be any justification for a separate income tax on corporations. If individuals were taxed on their accretion income, any income or loss of corporations would be fully reflected in the taxable income of those individuals who "own" the corporation. A separate tax on the corporation might be justified on other grounds (e.g., a privilege tax) but not as an income tax.

Practical difficulties and, especially, the desire for objectively measurable, independently verifiable, figures have prevented close adherence to the accretion concept in accounting practice and tax policy. In both these areas, however, there is a great need for a generally acceptable concept of income to serve as a guide or normative standard. The accretion concept has received wide and growing acceptance as such a standard among fiscal theorists, but appears to have gotten, if anything, diminishing attention from accountants. It seems likely that progress in accounting theory and practice would be furthered by a wider acceptance of this concept.

Integration of corporate and individual income taxation is but one (though a major) step in the direction of the accretion concept. There are important practical difficulties which make complete integration impossible, just as perfect adherence to the accretion concept is impracticable. A decision as to the desirability of integration depends heavily on an evaluation of the seriousness of these practical difficulties. The chapters which follow include a discussion of the extent to which various proposed approaches to integration actually approximate taxation of individuals under the accretion concept and the seriousness of the practical difficulties of the various proposals.

CHAPTER III

THE PARTNERSHIP APPROACH TO INTEGRATION

The Partnership Approach Compared with Other Approaches to Integration

Of the types of approaches to integration of corporate and individual income taxation to be considered in this and the next chapter, only the partnership approach, which taxes both distributed and undistributed corporate income directly to shareholders, can really claim to "integrate" the taxation of income. The other approaches involve partial adjustments which, in greater or lesser degree, approximate the objectives of integration. Integration is desirable primarily on grounds of equity in taxation. The equity case for integration would be much less significant if it were not for progressive tax rates. If income taxes were proportional to income (a flat-rate tax on income), it would not be very important to ascribe income to the particular individuals to whom it accrues; almost all of the tax could be collected by withholding at source without concern as to who the recipients might be. Also, many troublesome administrative problems would not exist if this were possible.

It is generally agreed, however, that income taxes should be levied at progressive rates increasing with the income of the individual, and so it is necessary to determine, with reasonable accuracy, the income of each individual. The present method of taxing income

of corporate stockholders is defective in this regard, and integration is aimed primarily at correcting or alleviating this defect. The present system treats undistributed corporate profits differently from distributed profits.[1] Distributed profits are taxed twice, at essentially a flat rate to the corporation and again at progressive rates to the dividend recipients. As a result, all taxpayers pay higher effective rates on distributed profits than would have been paid if there were no corporate tax and dividends had been increased by the amount of applicable tax. The burden of these higher effective rates is much heavier on low than on high-bracket taxpayers. For example, assume a corporation distributes all of its profits and pays a corporate income tax of 50 percent. A stockholder whose income level is such that his marginal tax rate is 20 percent, pays an effective rate of 60 percent on his share of corporate profits. (Each $100 of corporate earnings results in a $50 corporate tax plus a $10 personal tax on $50 of dividends.) There is a difference of opinion as to how degrees of progression should be measured and compared, but a tax range of 20 to 90 percent would no doubt appear to most people to be more significantly progressive than a range of 60 to 95 percent.

When undistributed corporate earnings are considered separately from distributed earnings, the applicable corporation tax

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[1]See Daniel M. Holland, The Income-Tax Burden on Stockholders, A Study by the National Bureau of Economic Research (Princeton: Princeton University Press, 1958).

is seen to be proportional to income and not progressive at all. (The lower rate on the first $25,000 of a corporation's income is disregarded. This feature of the corporate tax could be either progressive or regressive to individuals since there is no necessary connection between the size of a corporation and the income levels of its stockholders.) The flat rate tax on undistributed corporate profits significantly reduces the degree of progression from what it would be if these profits were taxed to the shareholders when earned. If these earnings (after taxes) are later distributed as taxable dividends, they will be subject to progressive individual rates, but insofar as there have been transfers of stock or changes in the income levels of stockholders, the rates will differ from those which applied to stockholders at the time the income was earned. If these undistributed earnings are later realized as long-term capital gains, there will be some element of progression in the tax applied to the 50 percent of the gain which is included in taxable income, but this progressive effect is limited by the maximum rate (now 25 percent) on long-term capital gains. If the stock appreciates in value because of the undistributed earnings and is not sold before the death of the stockholder, the income involved will never be subject to personal income tax because whoever inherits the stock can use market value at the date of the donor's death as his basis and because the gain is not subject to income tax to the decedent.

If the corporate tax were eliminated and corporate profits taxed in full to the stockholders, the discrepancies indicated above would be eliminated and income taxation fully integrated. This is the partnership approach. As will be seen in Chapter IV, retention of the corporate tax with special adjustments at the corporate and/or individual level, such as a dividends paid credit or a dividends received credit, can achieve only some of the features of integration. Proposals along these lines usually have the advantage of involving relatively slight administrative difficulties, but they generally give rather arbitrary results which represent much less progress toward "equal treatment of equals" than would a partnership approach.

A somewhat closer approximation to integration would be provided by taxing capital gains in full at ordinary rates when realized. This would make almost mandatory a provision for some kind of averaging of income, but, like the partnership approach, could logically be accompanied by abolition of the corporate income tax. This approach relies (from an equity standpoint) on the assumption that corporate earnings are eventually either distributed or realized as gains at sale or transfer, and disregards the postponement of the tax from the time of earning until such realization. This approach is also discussed in Chapter IV.

Equity and Economic Effects of Full or Partial Partnership Methods

Complete integration by the partnership approach would require that partnership treatment be compulsory for all corporations. A partial application of this approach could involve compulsory partnership treatment for only some corporations and/or optional partnership treatment. As will be seen, compulsory application of the partnership method to all corporations has often been cited as the ideal, but frequently rejected as impractical, especially for widely held companies. There has been considerable support for compulsory application of this method to "private" companies. Since 1958 a partnership method has been available on an optional basis to certain closely-held companies under Subchapter S of the Internal Revenue Code. This new provision in the law is discussed in Chapter V along with certain other provisions which might be considered approaches to integration.

If the partnership method is to be required for some but not all corporations, a difficult problem of drawing a line between corporations must be solved. The difficulty of making a satisfactory distinction between those corporations which would be required to use the method and other corporations has discouraged some students of the problem from advocating any compulsory partnership treatment. A variation of the compulsory partnership approach has received little attention but appears to have much equity and administrative merit. This proposal would require compulsory partnership treatment unless the corporation's stock has a reasonably determinable market value, in which case income or loss would be recognized according to movements in the market value of the stock.

The major alternative applications of the partnership approach may be outlined as follows:

1. Compulsory for all corporations
2. Compulsory with market value of stock used as a basis for stockholder income in the case of actively traded corporations
3. Compulsory for some corporations
    a. Compulsory for all but widely held, actively traded corporations
    b. Compulsory for a relatively small number of corporations
4. Optional for all or for a limited number of corporations

There are, of course, an almost limitless number of possible variations in the number of corporations that may be required or allowed to use the partnership method corresponding to different definitions of those eligible. The categories shown appear to be adequate for distinguishing the major differences in equity and economic effects of different alternatives and are at least a good starting point for a discussion of differences in administrative difficulties.

If the accretion concept of income[2] is accepted, alternative (1) would appear to give the best approximation to an ideal of equity.

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[2] See the discussion of this concept in Chapter II.

With compulsory partnership treatment of all corporations, every stockholder would report his full share of business income as it is earned. Instead of a flat rate corporate tax plus personal tax on the distributed portion of the income, there would be high or low personal rates (or no tax at all) on the entire corporate income depending on the tax status of the stockholders.

It has been objected that this approach would create hardship in that it would require the stockholder to pay tax on income which he has not actually received in cash or property. "Ability to pay" is sometimes thought of in terms of having a cash flow from the taxed income sufficient to pay the tax. This objection does not appear to have much validity, although real problems could arise in extreme cases. It seems likely that stockholders would in almost all cases have sufficient cash on hand or coming in from other sources to pay the tax without serious difficulty. Where serious difficulties of payment exist, it would be possible to permit deferring the payment of tax. The improvement in equity from taxing increases in economic power as they accrue appears to outweigh the cash flow objection. There are a number of situations in which we now tax income not received in cash, including some property exchanges and some income "in kind."

A more serious objection to the universal application of the partnership method can be raised because of a conceptual difficulty which might be significant in some cases. The partnership method may not always give the best measure of stockholders' accretion income. This is especially likely to be true in the case of small stockholders of large, widely held companies. The rationale of the partnership approach is that if a corporation has earned income there must be individual persons who "own" that income, whether distributed or not, and these persons should be taxed on it. But perhaps it is possible for a corporation to earn income without increasing any person's economic power, or at least not increasing it by as much as the corporation earns. We now treat partners as though they have realized their proportionate share of the earnings of the partnership. No doubt, this is usually a fair presentation of the situation, and would hold good for many corporations, especially those closely held. But it is typical of giant corporations that few, if any, stockholders have a significant amount of control over corporate policy. When this is the case, the accretion concept would appear to call for valuing the stock at market value rather than imputing to the stockholder the per-share earnings of the corporation.

To impute corporate earnings to stockholders is equivalent to determining the income of the stockholders according to the change in the book value of a share of stock. It is well known that fluctuations in market value are not always correlated with changes in book value, even in what might be considered the "long-run";[3] and this is not due

[3]The Cowles Commission study of stock prices indicated that between 1871 and 1937 an average of about 72 percent of retained earnings of New York Stock Exchange listed firms was reflected in higher market values of stock. Alfred Cowles, 3rd and others, Common Stock Indexes, 1871-1937 (Bloomington, Indiana: Principia Press, 1938), p. 42.

solely to differences between accounting income (the basis for measuring change in book value) and accretion income. It is not uncommon to find that an increase in dividends results in a rise in market value, though book value is reduced.

The controversy over the proper taxation of cooperatives and mutual savings and insurance companies illustrates the conceptual problem involved.[4] The amount of earnings that is distributed or credited to members or policyholders is not at present subjected to "corporate" tax. Some argue that these amounts should be treated analogously to dividends and not allowed to the company, as deductions but there appears to be wide agreement that allowing a deduction is proper. The proper treatment of undistributed or unallocated earnings is more controversial. If the partnership method were applied generally to corporations, it would seem that these undistributed earnings should be imputed to the members and policyholders. But since there is typically no market (comparable to trading in common stock) which would even theoretically reflect this increase in "book value," the only way in which the individuals involved could realize this increment would be upon liquidation of the company. But even this would not result in realization because of large losses that would

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[4]A number of papers on the tax treatment of these types of companies are included in Tax Revision Compendium, papers submitted to the Committee of Ways and Means (Washington: U. S. Government Printing Office, 1959), pp. 1767-2066.

accompany such liquidation. Here, then, is a case where there appears to be real economic income which cannot reasonably be imputed to any individual persons. The difference between the person in this situation and the owner of a small amount of stock in a large corporation is perhaps more a matter of degree than of kind.

At least a partial solution to the equity problems involved in these situations would result from a plan of taxation of type (2).[5] Under this plan the stockholder would be taxed on the change in market value of stock in corporations for which market value can be reasonably well determined. Stockholders in smaller and more closely held companies would be required to use the partnership method. If it is possible to set up a workable basis for distinguishing the two general classes of corporations, this plan appears to offer hope of reasonably approximating taxation according to accretion income.

On grounds of equity the case for integration either by compulsory partnership treatment of all corporations or by a combination of partnership and market value of stock treatment is very strong. The economic effects of integration along these lines are not so clear. From the point of view of economic neutrality, the net effects likely favor integration. For example, the present artificial tax differences between stocks and bonds would be eliminated and choice of form of business organization would no longer so importantly depend on tax effects.

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[5]See the list of partnership methods at the beginning of this chapter.

It is more difficult to come to a conclusion about the net effects of partnership treatment on incentives and levels of saving and national income. There are wide differences of opinion as to how urgent it is to encourage saving and investment and as to how greatly and in what direction present tax rates and methods affect these.[6] Since there would be no corporate tax as such under the partnership method, corporations would be able to substantially increase dividend payments and still have more retained earnings than previously to finance expansion. Whether the increased dividends would make up for the higher personal tax liability from taxing all corporation earnings to stockholders would depend on the tax rates applicable to each stockholder. Without changes in present rate schedules, one effect would be to increase over-all tax rates for high income stockholders. This would almost certainly reduce funds available for saving and could conceivably hinder incentives. There is no reason, however, why tax rates could not be adjusted to levels which would encourage saving and incentives to the desired extent.

The partnership method has one feature which is strongly in its favor with regard to economic effects as well as equity; this is its greater degree of certainty. The schedule of progressive tax rates

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[6] For an expression of doubts about the reasonableness of the current concern about executive incentives and saving and investment see Arthur Smithies, "Individual Income Tax Rates" in Tax Revision Compendium, op. cit., pp. 2261 and 2263.

will not be so easily avoided by high income taxpayers and there is much less uncertainty about tax incidence. Whereas it is now unknown whether nearly all or hardly any of the corporation income tax is shifted, the incidence of tax under partnership treatment would be quite certain. Further, if the corporation tax is actually largely passed on in higher prices (and if such a tax is not felt to be undesirable), it would seem preferable to have a general excise tax to raise this revenue from all businesses, not just those organized as corporations.

While the equity case for application of the partnership method on a compulsory basis to only some corporations is fairly strong, a system of optional partnership has little to recommend it on equity grounds. The great majority of corporations are rather small and very much like partnerships or proprietorships except for legal form. The difference between the "corporate giants" and these small corporations appears much greater than the difference between the latter and typical partnerships. At present a company is generally free to decide whether or not to incorporate, and the decision is often determined primarily by tax considerations. A serious equity problem arises from the possibility of high bracket taxpayers avoiding or postponing tax by retaining earnings in a corporation. Low bracket taxpayers are "overtaxed" by the separate corporate tax except insofar as earnings are lessened by the deduction of executive salaries and sometimes rent and interest. Compulsory partnership treatment effectively subjects all stockholders to equality of treatment. Optional partnership treatment increases equity only insofar as it enables low bracket taxpayers who incorporate for non-tax reasons to escape the overtaxation of a separate corporate tax. It does nothing to mitigate the tax avoidance of those in high brackets.

Not a great deal can be said about the economic effects of partial-compulsory or optional partnership treatment. The general conclusions reached with regard to universal-compulsory application of the partnership method would seem to apply here, though with even greater uncertainty. The principal motive behind the passage of Subchapter S (discussed in Chapter V), which permits optional partnership treatment to a limited number of closely-held corporations, appears to have been a matter of tax neutrality; that is, non-interference with the choice of form of business.[7] It has been maintained that, rather than enabling companies to choose legal form without concern for tax consequences, Subchapter S has resulted in a situation where a company must consider the tax results of operating in one of three

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[7] The report of the Senate Select Committee on Small Business stated with regard to Subchapter S: "Your committee has often expressed a desire to see that all business is treated equitably, regardless of its legal form of organization. There are many reasons, legal, technical, and practical, why one concern may choose to incorporate and another to operate as a proprietorship or partnership. The influence of the Federal tax system in making such a determination should be minimized. Business should be permitted to operate in the form best suited to its needs, without penalty through the amount of Federal taxes it must pay." "Tax Problems of Small Business," Report of the Select Committee on Small Business, U. S. Congress, Senate Report No. 1237, 85th Cong., 2nd Sess., 1958, p. 15.

different legal forms (including Subchapter S status) instead of the former two.[8] Whether or not this is, or necessarily has to be, the case, it may be noted that compulsory partnership treatment fully accomplishes the neutrality objective. If a company is to be taxed as a partnership regardless of its legal form, form becomes a matter of tax indifference.

Tax Administration

Before dealing with detailed administrative problems of the partnership method and other methods of integration, it is well to consider some general factors affecting administrative feasibility and limitations on attempts to analyze them. It is easy to demonstrate that administrative feasibility is of great importance in deciding the merits of any major change in taxation, but it is difficult to analyze and evaluate the various kinds of administrative problems. The importance of administrative considerations to the question of integrating corporate and individual income taxation is illustrated by the fact that those who favor the partnership approach often have serious doubts as to its practicability when applied to large corporations. But these same writers have rarely carried their analysis further than

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[8] Mortimer M. Caplin, "Subchapter S--Election of Small Business Corporations," in Tax Revision Compendium, op. cit., p. 1711.

mentioning a few major problems that would have to be dealt with.[9]

It is hoped that a more detailed and systematic analysis of administrative problems will make a worthwhile contribution to our understanding of the possibilities of income tax integration. Final and exact answers are impossible without actual experience with a particular method, but it seems reasonable to expect a rather large amount of analytical effort to "pay for itself" by providing a better basis for weighing the relative importance of equity, economic, and administrative considerations, and by reducing unforseen problems of actual legislation.

Roy Blough has suggested that administrators and economists are frequently quilty of strong prejudice in opposite directions regarding administrative considerations. While administrators are "prone to view with alarm" and fear that new laws cannot be well administered, "economists and others proposing tax legislation are very prone to take

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[9]For example, the Haig Committee recommended (with two members dissenting) that "the use of the partnership method be extended to the limits of its legal and administrative possibilities . . . . The committee is of the opinion that the number of corporations to which the partnership method can be applied without involving formidable administrative difficulties is far greater than is generally realized and includes all but a few thousand, perhaps, of our larger corporations." This committee did not present a detailed analysis of administrative problems. "Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations," in Proceedings, National Tax Association, October 16-19, 1939 (Columbia, S. C.: National Tax Association, 1940), p. 555.

The most thorough available analysis of administrative problems of the partnership method is presented in approximately one printed page by Richard Goode in The Postwar Corporation Tax Structure, op. cit., p. 1155.

administration and compliance for granted and to recommend measures with little regard to the ease or possibility of their administration."[10] Insofar as there is truth in this view, the desirability of more careful analysis of administrative problems is supported. There is, perhaps, some basis for preferring the view of the administrator that new proposals are likely to be impractical. At least it is undoubtedly true that, other things being equal, it is better to retain existing methods than to change them. There are a number of reasons for this, including the inevitable uncertainties and inconveniences accompanying a change. There are also equity and economic reasons for favoring an "old tax" to a change. These center around the tendency of the market to adjust to taxes, so that major changes bring some inevitable disruption of economic relationships and some "windfall" gains and losses.

Administrative costs include government costs and taxpayer costs of compliance. As used in this study, administrative difficulties or problems also include non-monetary costs such as the time taken by an individual to prepare a return. In this study, rather than being classified according to whether they represent government or private costs or monetary or non-monetary costs, administrative problems will be classified according to certain major factors which influence them. These factors are: (a) the number of taxpayers affected, (b) the quantity and kinds of records required, (c) the complexity of the

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[10] Roy Blough, The Federal Taxing Process (New York: Prentice-Hall, Inc., 1952), p. 437.

law, and (d) the attitude of the taxpayers.[11] With the exception of the last of these four factors, it is possible to obtain data which make possible at least rough estimates of the severity of the administrative difficulties of various proposals. The statistics and other data available are far from entirely satisfactory, as will be seen, but are sufficient to repay careful analysis.

The fourth listed factor, the attitude of the taxpayers, is of obvious importance to the ease of administering a tax (especially a self-assessed tax), but is rather intangible. It is difficult to find data which would help in evaluating this inherently subjective factor. The difficulty is increased due to probable conflicts among different features of the law in this respect. For example, taxpayer cooperativeness would probably improve with improvements in equity and also with simplification of compliance requirements, but simplification often conflicts with improving equity. Conclusions about taxpayer attitudes and resulting administrative problems of various proposals must be based to a great extent on judgment.

The number of taxpayers affected by any integration proposal is approximately the number of taxpaying stockholders. Evaluating this factor, however, involves much more than obtaining this single

[11] In making this classification, the writer has gained much from Blough's discussion of tax administration (op. cit., Chap. XVII). This classification differs from Blough's in several respects, however. Other factors are important when considering certain aspects of taxation, but those listed cover the administrative problems likely to be significant in a plan of integration.

statistic. Various stockholders would be affected differently by different proposals and by specific features of any one proposal. For example, if a distinction is to be made between "public" and "private" corporations, it is important to know the numbers of stockholders of each.

Data as to numbers of taxpayers affected must be considered in relation to complexity and records required. A complex provision which requires detailed records that would not ordinarily be kept might be entirely feasible if only a few taxpayers (but substantial amounts of tax) were involved. Advances in data processing methods can be expected to continue to reduce the difficulty both of keeping necessary records and of auditing returns. The complexity of the law is perhaps the most difficult factor to evaluate. Simplification of one part or stage can lead to greater complexity elsewhere, and it is difficult to foresee and measure the seriousness of these effects. For example, we might try to avoid undue complexity in the law and regulations either by allowing more administrative discretion to the tax authority or by making rather arbitrary distinctions in the law. The first alternative is likely to place a heavy burden on the courts as taxpayers dispute the decisions of the collectors, while the second can lead to pressure for "loopholes" favoring those who fall close to borderlines.

In considering administrative problems of proposals for integration of corporate and individual income taxation, it is well to keep in mind that integration is only one aspect of the broad problem of more closely approximating the accretion concept of income. The question of the treatment of capital gains in general (including gains on assets other than stock) is important. If capital gains generally were taxed at ordinary income rates, rather substantial reductions in the complexity of the law could be made, though some new problems would arise. Also related is the question of permitting averaging of income. Averaging proposals are likely to add substantially to administrative difficulty. On the other hand, certain administrative problems of integration and the accretion concept in general, especially problems of timing of recognition of income, would be lessened by a system of averaging.

Administrative Difficulties of Changeover to a Partnership Method

If any of the proposals for integrating corporate and individual income taxation by the partnership approach were adopted, a number of special problems would arise in making the transition from the present system. Although these problems are temporary and would not exist if we had been using a partnership plan for some time, they cannot be ignored in considering a change. It is possible for the administrative difficulties of making a change to outweigh administrative and other advantages which might follow the change. This adds to the difficulty of evaluating the relative significance of equity, economic, and administrative considerations.

The seriousness of the problems of changeover from the present system of corporate taxation to a partnership method depends, in large part, on how exact we try to be in preventing inequities at the time of change or in correcting inequities of the former system. An example is the problem of establishing the taxpayer's basis at the time of beginning partnership treatment. If his basis is taken to be cost (as under present corporate treatment), no new administrative problem arises, but if it is felt that an adjustment of basis should be made to reflect his "share" of retained income on which corporate tax was paid, some serious complexities could result. If this basis adjustment were to be made, account would have to be taken of the length of time various numbers of shares were held, corporate earnings and losses during these periods, the rate of corporate tax paid (after application of carryovers and carrybacks), and the taxpayer's individual tax rates in various years.

On balance, the best approach to inequities arising from the change would seem to be to not try to do too much about them. This conclusion follows as much from uncertainties as to what the inequities are as from the administrative complexities that arise from trying to adjust for them. The uncertainties are due to a lack of knowledge of the incidence of the present corporation tax and of the extent to which anticipated taxes have been capitalized in the values of securities and other assets. Uncertainty about whether the transition achieves perfect equity is perhaps not a substantial argument against a change which might assure the avoidance of future inequities.

Those who have expressed concern over administrative difficulties of a partnership approach have not often mentioned problems of making the changeover from the present system to the new one. This, perhaps, supports the view that the problems of changeover would not be serious. In any event, it seems likely that these problems would be largely the broad ones associated with any major tax change (such as educating taxpayers to the new plan and building up satisfactory regulations and court precedents) rather than difficulties associated with trying to coordinate the old and new systems.

Administrative problems of the changeover might be lessened somewhat by instituting the new plan gradually. If a gradual change is considered desirable, it should probably not take the form of a gradual reduction of corporation tax rates combined with recognition of increasing amounts of income to stockholders. Such a plan of changeover would be difficult to justify on equity grounds and would probably raise unnecessarily serious administrative problems. Equity and administrative problems would stem from the impossibility of establishing a logical pattern of individual tax increases to correspond to a given schedule of corporate rate decreases. On the other hand, a gradual change might be practical if it takes the form of subjecting increasing numbers of corporations to the partnership method over a period of time. Presumably the partnership method would be required first of those corporations to which it can be most easily applied. This might help solve one of the most difficult problems mentioned in connection with the partnership approach; i. e., drawing a line between those corporations for which the method is practicable and those for which it is not. "Coverage" could be gradually extended until a point is reached where it is felt that further extensions would not be worthwhile.

The optional partnership treatment newly allowed by the 1958 tax revisions might be looked upon as a "foot in the door" for a gradual extension of application of a partnership method. This possibility will be examined in Chapter V, where this and other recent provisions are discussed in some detail.

There are many administrative problems already being faced in taxing the income of partners of existing partnerships. The partnership provisions of the Internal Revenue Code and the corresponding regulations have been criticized for their complexity.[12] A great deal, if not most, of this complexity is a direct result of the attempt to prevent the conversion of ordinary income into capital gains, and the law could be greatly simplified if capital gains were taxed at the same rates as other income. Compulsory partnership treatment of corporations,

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[12]See Arthur B. Willis, Handbook of Partnership Taxation (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1957), p. vi, and also his "Treatment of Partners and Partnerships" in Tax Revision Compendium, op. cit., pp. 1707-09. Willis indicates that the complexities appear less formidable once the over-all pattern is understood.

however, does not necessarily imply the elimination of special favorable rates for capital gains and so a study of administrative difficulties of integration proposals cannot ignore the complexities of present partnership taxation.

Numbers of Taxpayers Affected

The first of the four major factors affecting administrative difficulty of integration proposals is the number of taxpayers affected. Some useful data pertaining to this factor can be obtained, but more detailed studies of stockholdings than are available would add much to this analysis. Such studies would not only make possible more accurate assessment of the extent of administrative problems, but would also aid in judging the seriousness of inequities in the present tax structure.

Some rather good statistics on the number and characteristics of corporations and other business entities are available. Table 1 gives estimates of the business population between 1945 and 1959. As indicated, the breakdown between corporate and non-corporate firms for recent years is based on simplifying assumptions. This, however, does not appear to affect the general composition and trends shown by the data. Corporations make up a small but apparently increasing proportion of the total firms in operation. Of course, the importance of corporations is much greater in terms of business done than in terms of number of firms because large firms are more likely to be corporations than are small ones.

TABLE 1.--Number of firms in operation January 1, 1945-59 by form of organization (thousands of firms)[a]

Year	Total	Corporate	Non-corporate	Percent corporate
1959	4589	734[c]	3855[c]	16.0[c]
1958	4534	724[b]	3810[b]	16.0[b]
1957	4471	681[b]	3790[b]	15.2[b]
1956	4381	621[b]	3760[b]	14.2[b]
1955	4182	564	3618	13.5
1954	4185	551	3634	13.2
1953	4179	539	3640	12.9
1952	4121	526	3595	12.8
1951	4067	516	3551	12.7
1950	4009	495	3514	12.3
1949	3984	483	3501	12.1
1948	3873	459	3414	11.8
1947	3651	412	3239	11.3
1946	3242	350	2892	10.8
1945	2995	331	2664	11.1

[a]Sources: 1945-55, Betty C. Churchill, "Business Population by Legal Form of Organization," Survey of Current Business, XXXV (April, 1955), 14-20; 1956-59, Betty C. Churchill, "Rise in the Business Population," Survey of Current Business, XXXIX (May, 1959), 15-19.

[b]Breakdown between corporate and non-corporate firms for 1956-58 estimated by assuming that corporate firms equal 77% of total active corporation returns filed for corresponding years (See Table 2). The corresponding percentages for 1945-55 varied from 78.1% to 83.9%.

[c]Corporations are assumed to account for 16% of total firms as of January 1, 1959.

Table 2 gives estimates for 1947 of the numbers of firms of different sizes (measured by number of employees) employing various forms of organization. A further idea of the importance of corporations can be gotten from the following: In 1947 fewer than one percent of the firms in operation had 100 or more employees. These firms, however, accounted for approximately 60 percent of the paid employment, and 82.6 percent of these firms were corporations.[13]

TABLE 2.--Number of firms in operation January 1, 1947 by form of organization and employee size class (thousands of firms)[a]

Employee-size class	Form of organization: All firms	Corporate	Proprietor-ship	Partner-ship	Other
0-3	2683	99	2137	412	36
4-19	777	200	381	173	23
20-49	117	59	27	25	10[b]
50-999	71	51	6	9	--
1000 or more	3	3	---	---	--
Total	3651	412	2550	620	69

[a]Source: Betty C. Churchill, "Business Population by Legal Form of Organization," Survey of Current Business, XXXV (April, 1955), 19.

[b]Twenty or more employees.

[13]Betty C. Churchill, "Business Population by Legal Form of Organization," Survey of Current Business, XXXV (April, 1955), 19, and "Size of Business Firms," Survey of Current Business, XXXIX (September, 1959), 15.

Additional data concerning numbers of corporations of different sizes are given in Tables 3 and 4. From Table 3 it can be seen that most corporations are in the relatively small asset-size classes under $250, 000, while somewhat fewer than 10 percent have over $1, 000, 000 in assets. The number of returns in all size classes has been increasing in the postwar years, with the greatest proportional increase in the "middle size classes," $50, 000 to $1, 000, 000 of assets. At least some of this relatively large increase can be accounted for by the more or less automatic moving of corporations into higher asset classes as price levels have risen.

Table 4 reveals the striking contrast between the proportion of corporate tax returns in the smaller asset size classes and the proportion of assets, income, and tax represented by these returns. Roughly 90 percent of the returns filed covers only 10 percent of the tax paid, while the other 10 percent accounts for 90 percent of the tax. Total receipts are not as concentrated as are assets and income tax; the smaller corporations account for a somewhat higher fraction of receipts than of assets or income tax. This does not appear to substantially lessen the significance of the concentration indicated by the asset and income tax figures.

Tables 1-4 indicate the numbers of corporations that would be affected by various partnership approaches, but not the numbers of stockholders. Available data on stockholders and stockholdings are less satisfactory than the data on corporations, but some useful studies

TABLE 3.--Number of active corporation returns filed and number of active corporation returns with balance sheets by size of total assets, 1944-59 (thousands of returns)[a]

Year	All active corporations	Returns with balance sheets	Asset size class: Under $50,000	$50,000 under $250,000	$250,000 under $1,000,000	$1,000,000 under $50,000,000	$50,000,000 or more
1957-58	940	879[b]	...	...	...	..	...
1956-57	886	828	333	321	118	54	2.0
1955-56	807	747	300	282	110	54	1.9
1954-55	723	668	273	251	94	49	1.8
1953-54	698	640	262	244	87	45	1.7
1952-53	672	616	253	232	84	45	1.6
1950-51	629	570	237	213	79	40	1.3
1948-49	594	537	235	197	68	36	1.1
1946-47	491	441	199	153	55	32	1.0
1944-45	412	363	176	114	44	28	.9

[a]Source: U. S. Treasury Department, Internal Revenus Service, Statistics of Income, Corporation Income Tax Returns, various years.

[b]Breakdown by asset size class not available for 1957-58.

TABLE 4.--Total assets and total compiled receipts of active corporations filing returns with balance sheets by size of total assets, 1956-57[a]

Asset size class	Number of returns	Percent of returns	Total assets (billions)	Percent of assets	Total compiled receipts (billions)	Percent of receipts	Income tax (millions)	Percent of income tax
Under $50,000	333	40.2%	$ 7	0.7%	$18	2.7%	$115	0.5%
$50,000 under $250,000	321	38.8	38	4.0	76	11.3	724	3.4
$250,000 under $1,000,000	118	14.3	55	5.8	99	14.7	1,345	6.3
$1,000,000 under $50,000,000	54	6.5	272	28.7	219	32.5	6,621	31.2
$50,000,000 or more	2	.2	577	60.8	261	38.8	12,417	58.5
Totals	828	100.0%	$949	100.0%	$673	100.0%	$21,222	100.0%

[a]Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income, Corporation Income Tax Returns, 1956-57 (1959), pp. 33-34.

have been made in this area. The most detailed study of share ownership was made by Lewis H. Kimmel for the Brookings Institution at the request of the New York Stock Exchange.[14] Kimmel estimated that as of early 1952 there were about 27.4 million shareholdings in 13,650 publicly held common stocks and 2.8 million shareholdings in 3005 preferred stocks.[15] He estimates that 3 million persons in 2.3 million families own privately held stocks.[16] Some of these persons undoubtedly have more than one shareholding, but others likely hold only preferred stock. If we ignore these two factors, which at least partially offset each other, we may conclude that in 1952 there were approximately 30 million shareholdings of common stocks. Although this estimate is subject to a fairly wide margin of error and has probably increased since 1952, it is adequate for our purposes. This figure gives us an idea of the number of separate computations and records that would be necessary if full corporate income or loss were to be imputed to each stockholder of every corporation. If a very heavy burden of record-keeping or of complexities or uncertainties of computation attached to each shareholding, the total administrative burden would clearly be substantial.

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[14] Lewis H. Kimmel, Share Ownership in the United States (Washington: The Brookings Institution, 1952).

[15] Ibid., pp. 76, 77, 124.

[16] Ibid., p. 126.

There is evidence that the bulk of these shareholdings is concentrated in a relatively few large corporations. It follows that administrative burdens related to number of shareholdings would be greatly diminished if a partnership approach were confined to small, closely-held companies. Of 2932 common stock issues of reporting companies in the Kimmel survey, 107 issues of companies with assets of $500 million and over accounted for almost 35 percent of the total reported shareholdings; 1332 issues of companies with assets of $20 million and over accounted for approximately 88 percent of the total.[17] Of 2932 reported common stock issues, 72 percent of the shareholdings were in 357 issues with 10, 000 or more shareholdings per issue and 97 percent were in 1789 issues with 1000 or more shareholdings per issue.[18]

It is very likely that the number of shareholdings is substantially higher today than in 1952. This would be expected in view of the generally high levels of business activity, the favorable tax treatment of dividends, and state laws which have made it easier to make gifts of stock to minors. Also, the number of shareholdings can

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[17] Ibid., p. 24. The 2932 issues involved a total of 18.5 million shareholdings of record. Adjustment for beneficial holdings of shares registered in the names of nominees and brokers and dealers increased the number of common shareholdings accounted for by reporting companies to 22.8 of the 27.4 million estimated shareholdings of 13,650 publicly held common issues (p. 63). If an analysis of beneficial holdings by size of company were available it would probably increase rather than reduce the indicated degree of concentration.

[18] Ibid., p. 38.

be expected to increase as the number of individual stockholders increases, and more recent estimates of the Brookings Institution and the New York Stock Exchange indicate a substantial rise in the number of owners of stock of publicly held companies. Kimmel's 1952 estimate was 6.5 million shareholders; comparable estimates for 1954, 1956, and 1959 are 7.5, 8.6, and 12.5 million respectively.[19]

Administrative difficulty is related to the numbers of individual taxpayers involved as well as to the number of companies and shareholdings. The Brookings-NYSE figures given above are useful, and further information is provided by the Treasury Department's Statistics of Income series.[20] The following figures for 1957 individual returns are revealing: 5.1 million returns on form 1040 reported dividends received; of these, 4.4 million were taxable returns, and 3.6 million of these taxable returns had dividends in adjusted gross income.[21] Table 5 shows the distribution of the latter returns by adjusted gross income class, and shows the amount of dividends, after

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[19] Shown in Economic Report of the President, January, 1960 (Washington: U.S. Government Printing Office, 1960), Table C-21, p. 140.

[20] U.S. Treasury Department, Internal Revenue Service, Statistics of Income, issued annually, about two years after the period to which the tax returns apply. Separate reports are issued for corporation and individual returns. Reports on other returns, including partnerships and fiduciaries, are issued occasionally.

[21] U.S. Treasury Department, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1957. No figures are available on dividends received by those filing 14.2 million form 1040A returns.

exclusions, in each class. For comparison, the distribution of all returns with adjusted gross income is shown. This table reveals the considerable concentration of dividend income among those with high incomes. More than half of the taxable dividends were received by taxpayers with adjusted gross incomes over $25,000, while less than 1 percent of all returns were filed at these levels of adjusted gross income. As might be expected, the proportion of returns with dividends in adjusted gross income varies directly with the level of adjusted gross income.

Table 4 revealed a high concentration of corporation income tax among relatively few large corporations. The concentration of dividends among high income taxpayers, shown by Table 5, has different implications for administrative problems of integration. While it might be possible to achieve reasonable complete integration while treating large corporations (or holdings in them) differently from small corporations, there does not appear to be any way to similarly distinguish high from low and middle income taxpayers. A high income stockholder may hold stock in a number of small corporations and a low income stockholder may own stock of the largest companies. On the other hand, it may be possible to keep the numbers of taxpayers and returns affected at a minimum by an exclusion, or an arbitrary formula for treatment of, those with quite small stockholdings. Compulsory partnership treatment of all corporations would undoubtedly have affected more individuals and returns in 1957 than the 3.6 million

TABLE 5.--Dividends in adjusted gross income, taxable returns, by adjusted gross income class, 1957[a]

Adjusted gross income class	Taxable returns with dividends in adjusted gross income				All returns with adjusted gross income	
	Number of returns (thousands)	Percent	Amount of dividends after exclusions (millions)	Percent	Number of returns (thousands)	Percent
Under $600	.....	.....	.....	.....	3,833	6.5
$600 under $1,500	66	1.8	$31	0.4	7,168	12.0
$1,500 under $2,500	167	4.7	103	1.2	7,542	12.7
$2,500 under $5,000	666	18.6	471	5.4	19,476	32.7
$5,000 under $10,000	1,311	36.6	1,152	13.4	17,898	30.0
$10,000 under $25,000	1,012	28.3	2,143	24.8	3,008	5.0
$25,000 under $100,000	337	9.4	2,947	34.2	460	0.8
$100,000 under $500,000	21	0.6	1,321	15.3	22	0.04
$500,000 or more	0.8	0.03	459	5.3	0.8	0.001
Totals	3,581	100.0	$8,627	100.0	59,407	100.0

[a]Source: U. S. Treasury Department, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1957 (1959), Table B, p. 4, and Table 1, p. 20.

of Table 5. The total number of returns on form 1040 reporting dividends received was 5.1 million; the proportion of these that would be taxable and have "dividends" in adjusted gross income would be higher if "dividends" included the stockholder's full share of a corporation income. Others who would be affected include those who own only stock on which no dividends were paid, those who filed on form 1040A but who own stock, and, perhaps, those who received the approximately $1 billion of dividends not reported in 1957.[22]

Sometimes cited as a serious administrative problem of the partnership method is the difficulty to corporations of making the allocation of earnings to hundreds, or even hundreds of thousands, of shareholders.[23] But, once the amount of earnings per share is known, allocation is a mechanical problem which even the larger corporations could handle without great difficulty or expense. The process would be much simpler than that of paying a dividend, which is typically done quarterly, since the company would not have to take account of the number of shares in each shareholding, but could merely give notice to the stockholders of the amount of earnings per share to be taken into account. This problem also seems small when compared with the proposal for withholding individual tax on dividends, which would require

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[22] Joseph H. Pechman, "What Would a Comprehensive Individual Income Tax Yield," in Tax Revision Compendium, op. cit., p. 278.

[23] See, for example, J. Keith Butters, "Should the Profits of Small Corporations Be Taxed like Partnership Earnings?" in How Should Corporations Be Taxed, Symposium conducted by the Tax Institute, December 6-7, 1946 (New York: Tax Institute, Inc., 1947), p. 78, and Richard B. Goode, The Postwar Corporation Tax Structure, op. cit., p. 1155.

the corporation to take account of the tax status of the recipient.

Much more serious than problems resulting from the existence of large numbers of shareholdings in some corporations are problems relating to changes in stock ownership. Unfortunately, very little data is available that would indicate the extent to which stockholders tend to keep holdings unchanged for periods of time. Such data would be helpful in evaluating possible methods of allocating corporate income to short-term stockholders or of excluding them from such allocation. Kimmel estimates that as of early 1952 about two-thirds of the owners of shares of publicly owned stocks had held some kind of stock since 1944 or earlier.[24] This, of course, gives no hint of the extent of trading, but does indicate a considerable continuity within the stockholder group. Another study indicated that "traded stocks sold during 1949 represented only about 7 percent of the average total value of such stocks held by Wisconsin individuals filing tax returns for that year."[25] The same study revealed that about one-third of the value of traded stocks sold was comprised of stocks which had been held less than one year, and about one-sixth over 5 years.[26]

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[24] Lewis H. Kimmel, op. cit., p. 115.

[25] Thomas R. Atkinson, The Pattern of Financial Asset Ownership, Wisconsin Individuals, 1949, A study by the National Bureau of Economic Research (Princeton: Princeton University Press, 1956), p. 132.

[26] Ibid., p. 133.

Some idea of the extent to which stockholders vary their holdings can be gotten from data on the value and numbers of shares traded. The New York Stock Exchange dominates trading in stock in the United States. For 1949, Friend estimated over-the-counter sales of outstanding corporate stock at $5.0 billion, whereas stock exchange sales totalled $10.7 billion.[27] Of the total exchange sales, $9.0 billion were on the New York Stock Exchange.[28] Recent figures show similar dominance of exchange trading by the NYSE. In 1958, this exchange accounted for $32.8 billion of total exchange stock sales of $38.3 billion, and 921 million of 1,307 million shares sold.[29] The turnover of shares listed on the NYSE varied between about 10-25 percent between 1940 and 1954.[30] The turnover rate had been much higher in earlier years (e.g., 132 percent in 1928 and even higher in several years prior to 1920), but these figures may perhaps be considered irrelevant to today's market.

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[27] Irwin Friend and others, The Over-the-Counter Securities Markets (New York: McGraw-Hill Book Company, Inc., 1958), p. 109.

[28] U. S., Securities and Exchange Commission, Statistical Bulletin, IX, No. 2 (February, 1950, 20. The New York Stock Exchange will be referred to hereafter as the NYSE.

[29] U. S., Securities and Exchange Commission, 25th Annual Report (Washington: U. S. Government Printing Office, 1960), Table 13, p. 246.

[30] New York Stock Exchange Yearbook, 1955. Turnover is computed by dividing the average number of shares listed for the year by the reported stock volume.

The number of shares listed on the New York Stock Exchange, at the total market value at year end, and the number of shares traded for selected years, are given in Table 6.

TABLE 6.--Number of shares listed, market value, and shares traded, New York Stock Exchange, 1940-59[a]

Year	Number of shares listed at year-end (billions)	Market value of shares listed at year-end (billions of dollars)	Reported stock volume for year (millions of shares)
1959	5.8	$308	820
1955	3.8	208	650
1950	2.4	94	525
1940	1.5	42	208

[a]Sources: The Exchange (published by the NYSE), XXI, No.2 (February, 1960), 17; The Commercial and Financial Chronical, January 4, 1960, p. 31; and The New York Stock Exchange Yearbook, 1955, p. 33.

The figures indicate that the number of shares traded in the course of a year is only a fraction of the total shares outstanding. When it is considered that a small number of shares may change hands many times in the course of a year, it is clear that a large proportion of shares must remain untraded for long periods of time. These figures do not disclose that some stocks are more actively traded than others and that certain stockholders turn over their holdings rapidly. On the whole, the evidence indicates that most stockholdings are retained by the owner for a fairly long time. To the extent that this is the case, both the appropriateness and the practicability of the partnership approach are enhanced. Any major change in methods of taxing corporate income could be expected to result in substantial shifts in holdings by stockholders whose tax position is affected, but the long-term pattern of trading would not necessarily be affected. Some long-term increase in trading would probably result from adoption of partnership treatment because the present "locked-in" effect would be greatly reduced. The "locked-in" effect results from the possibility of postponing tax until the time of realization at sale. To the extent that appreciation in a stock's value is not in excess of retained earnings, this effect will disappear under a partnership approach since the stockholder's basis will not be below selling price and there will be no gain to be taxed. It is not possible to predict the extent to which trading would be increased by this factor.

The data on stockholders and stockholdings surveyed above make possible some tentative generalizations about administrative difficulties of plans for integration of corporate and individual income taxation, though more detailed studies would be valuable for this purpose and also for evaluating other tax proposals. It is clear that very large numbers of taxpayers would be affected by a compulsory partnership plan applied to all corporations. The Internal Revenue Service figures indicate that something like 1,000,000 corporation returns are being filed annually, and in 1957 3.6 million individual taxable returns had dividends included in adjusted gross income. The estimates of numbers of shareowners indicate the likelihood that this figure has since increased.[31] In any event, somewhat larger numbers of taxpayers would be affected than are now taxed on dividends because every stockholder would have to take account of his share of corporate income (whether or not distributed) or loss. The 3.6 million can be looked upon as a lower limit to the number of taxpayers affected, while the 12.5 million estimate of the total number of shareholders as of 1959 may be considered an upper limit.

The number of individual taxpayers affected would be sharply reduced if the partnership method were applied only to small, closely held corporations. Such a plan could be expected to include the great majority of corporations but only a fraction of total corporate income and shareholdings.

Quantity and Kinds of Records

Administration of any tax is rendered much easier if it can be done with a minimum of record keeping on the part of both the government and the taxpayers. Record keeping problems can be an especially serious hindrance to the effectiveness of a tax if large numbers of "small" taxpayers are required to keep special records,

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[31] Gifts of stock to children, though increasing the number of individual shareowners, could conceivably reduce this figure if the child does not have a taxable return and if dividends are thereby eliminated from the parent's adjusted gross income. An over-all increase would appear likely, however.

even seemingly simple ones. A partnership method of integrating corporate and individual income taxation would give rise to some record keeping problems. An attempt to appraise the seriousness of record keeping problems under partnership methods of integration is made in this section.

The most important record keeping problems of partnership approaches are related to the basis of stock and to different types of income. The present system of corporate taxation has considerably simplified record keeping problems in both these areas in contrast to partnership taxation. The basis of a partner's equity in a partnership changes with each period's income or loss and with each investment or distribution of profit. In a corporation as presently treated, however, the stockholder's basis is generally equal to his original cost and is unchanged by corporate income, loss, or income (dividend) distributions. A partnership method of taxing corporations would obviously add to the problems of each stockholder in keeping track of his basis and to the problems of the government in verifying basis.

Partnerships are treated as a "conduit" through which income passes to the partners. Particular kinds of income earned by the partnership (e.g., rent, fees for services, capital gains) continue to be distinguished as such when allocated as income to the partners who gain the benefits or suffer the disadvantages of special treatment given to different kinds of income. Income earned by a corporation, however, generally loses any special characteristics, and is simply "dividend income" when passed on to the stockholders. If this "conduit" treatment were applied to corporations, record-keeping problems would be more serious than if no distinction among kinds of income and loss were made.

It might appear that it would be impossible to determine basis for a stockholder unless he maintained records of corporate income and distributions for each year he held the stock. If this were the case, the practicability of the proposal would be doubtful because substantial numbers of stockholders would fail to keep the necessary records and because of the burden of keeping such records. It would be possible, however, to compute basis with no more taxpayer records than must now be kept. Given the date of acquisition and cost of the shares, the necessary adjustment to give current basis could be obtained from the corporation records of retained earnings per share. This would involve more work than the present method of simply taking cost as basis, but would not be as serious a problem as it would be if the computation could not be made unless the taxpayer himself hept the relevant records. The difficulty of computing basis would increase somewhat with the length of time shares are held, since basis would essentially equal original cost plus corporate earnings and less dividends during the period held. But, disregarding differences between taxable and accounting income, the computation could be made using book value per share without having to add up earnings and dividends of each year. This computation would require knowing only cost, book value at time of acquisition, and book value at time of computing basis. For example, if book value were $10 per share less than cost at time of acquisition it will be $10 less than basis at any future date since book value and basis are both increased by earnings and reduced by dividends. Stock dividends and splits would not complicate the computation of basis any more than they do at present. Possible differences between taxable and accounting or "book" income, however, would require that book value be determined using taxable rather than accounting income.

If a compulsory partnership method of integration were applied to all corporations it would probably be desirable for the government to publish annual "taxable book value" figures for the more widely held corporations. If the partnership method were applied only to private corporations while stockholders in public corporations were taxed on the change in market value, then basis computations for the latter would require cost and market value figures rather than cost and taxable book value. In this case, since cost presumably equals market value at time of purchase, basis would simply be the most recent market figure which had been used for recognition of income.

A special basis and taxable income problem arises from the possibility of adjustments to reported corporate income as a result of audits in later years by the Internal Revenue Service. It would be nearly impossible to attempt to reopen and adjust the returns of hundreds of thousands of stockholders of a large corporation. This would not be so serious a problem if there were no distinction between capital gains and ordinary income and if a system of averaging were in effect. Since, under these circimstances, the timing of income would lose much of its significance and offsetting adjustments of capital gains and other income would have no tax effect, adjustments of prior years' corporate income could be reflected in current stockholder returns without inequity. The taxes of those who had sold stock in the interim would not require adjustment. Another way of considerably diminishing the seriousness of this problem would be to use the market value method for public corporations. Since stockholders would be taxed on the change in market value rather than book value, an adjustment of corporate profits would have no tax effect.

Stockholders and corporations would face a substantial record-keeping problem if a partnership method involved treating the corporation as a conduit for various special types of income and deductions. Under present law the earnings and deductions of partnerships are allocated separately to partners and retain their original character whenever doing so has any tax significance. For example, gains and losses on property used in a business (section 1231) are allocated to the partners who must combine them with any other section 1231 gains and losses. If a compulsory partnership method were applied to all corporations, practical difficulties would require modification of this conduit approach, at least for public corporations. A company with several thousand stockholders would have to make an allocation of a considerable number of special types of income and deductions to each of its stockholders, or at least would have to present a detailed breakdown of its earnings per share into its components. This problem would largely disappear if the major types of special treatment were eliminated.

Another possible method of reducing the difficulties of allocation would be to disregard individual items of less than a certain amount. This would be similar to provisions now in the law such as the provision that self-employment income amounting to less than $400 is not subject to self-employment tax. The law could provide minimum amounts of each special treatment item which would be allocated. To illustrate, a corporation might have $20,000 of long-term capital gains, which amounts to 5 cents per share. If a minimum amount were set at $50, then only shareholders owning at least 1000 shares would pick up the capital gain as a separate item. This simplifying procedure would favor large shareholders when favorable treatment items were involved.

The distinction between public and private corporations is important in considering the appropriateness as well as the practicability of the conduit treatment of income items. Conduit treatment would be at least as appropriate for many closely held corporations as it is for partnerships, and the record-keeping problems of this treatment would tend to be relatively small in private corporations because of the smaller number of stockholders. If the items subject to conduit treatment in partnerships are sufficiently meritorious to justify the present administrative burden of conduit treatment, then similar treatment for at least large numbers of corporations is surely also justified. This conclusion, however, does not necessarily extend to the public corporation. It was pointed out above that, conceptually, the income of the small stockholder in a public corporation is probably better determined by reference to dividends plus change in market value than by imputing a share of the corporation's earnings. It follows that it would make little sense to break down imputed earnings into components. Since the larger, widely held, corporations account for most shareholdings and since conduit treatment would appear to be generally inappropriate to these companies, the record-keeping problems of conduit treatment are much less serious than they might appear to be.

In considering administrative difficulties related to the quantity and kinds of records that must be kept, account should be taken of recent and prospective advances in data processing methods. The increasing use of electronic computers by industry and government, including the Internal Revenue Service,[32] can be expected to make

[32]See Thomas C. Atkeson, "Recent Developments of a Planning and Research Nature in the Field of Tax Administration," in Proceedings, National Tax Association, October 27-31, 1958 (Harrisburg, Pa.: National Tax Association, 1959), pp. 181-88.

record-keeping problems less of a hindrance to otherwise desirable tax changes.

Complexity of the Law

The phrase "complexity of the law" is used here in a broad sense. This section consists of a discussion of a number of circumstances and situations which appear likely to complicate an attempt at a partnership approach to integration of corporate and individual income taxation. Complexity in taxation can result from large numbers of special provisions, ambiguities in the law, or uncertainties to the taxpayer because of either administrative discretion or determinations, such as property valuations, required.

One of the more obvious situations which would tend to complicate an attempt to tax corporations as partnerships is that in which a corporation has more than one class of outstanding security. Where this is the case, there will sometimes be problems in allocating the corporate earnings among these securities.[33] The complexities are similar to those involved in computations of book value and are most serious when there are many or unusual classes of securities, when the corporation is financially insecure, or when there are changes in outstanding securities. Certain bond, as well as stock, issues must be taken into account.

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[33] Simons considered this the most serious administrative difficulty of partnership treatment of corporations. Henry Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938), p. 190.

It should be emphasized that the partnership approach does not necessarily require the "valuation" of securities. Although corporate earnings may have the effect of increasing the market values of various classes of securities, this would not be a factor in allocating earnings to these securities. Earnings would be allocated according to the legal interest of each class of security in the earnings. This involves a departure from a strict adherence to the accretion concept of income, under which an individual would show income or loss as the values of his assets, including securities, changed. As was pointed out in Chapter II of this study, the partnership approach is based on the belief that allocating corporate earnings to shareholders results in a close approximation to accretion income. When shares are sold or otherwise disposed of, differences between market and book valuations would result in taxable income adjustments. Such adjustments could be expected to be generally small compared with those which are necessary under present taxation.

When a corporation has several classes of outstanding securities, there are likely to be problems in allocating earnings and losses among them. It would be difficult to attempt to set up detailed rules for allocation in the law and regulations, because of the tremendous variety of security provisions in existence. The considerable freedom of corporations in setting security provisions could conceivably lead to a situation where "loopholes" are sought by setting up special classes of stock or bonds and where the law is made more and more complex in an effort to close the loopholes. These loopholes would probably be cases of postponing recognition of income and/or converting ordinary income into capital gains by taking advantage of situations where market value can be expected to change differently from earnings allocated. The tax value of such loopholes would be greatly diminished if capital gains were taxed at ordinary rates.

Sizable differences between changes in book value and changes in market value are most likely to arise in financially insecure companies. A corporation with large cumulative preferred dividends in arrears or with a large deficit which has substantial current earnings would be an example. If there is a possibility of forced liquidation or reorganization, market values are likely to be highly uncertain, depending on prospects of the various classes of securities. These prospects would likely be quite different if continued profitable operations were foreseen.

Special problems arise when there are changes in outstanding securities and stock options. Even if there is only one class of stock and no income bonds, there is likely to be a problem when stock is issued or retired. Transaction prices are likely to differ from book value per share and thus will change the book value of previously outstanding shares. Since under the partnership method stockholders are taxed on changes in the book value of their shares resulting from earnings, it would seem necessary to take account of an increase in or dilution of that book value resulting from changes in outstanding stock. An extreme example would be a case of a growing company with 10,000 shares of outstanding stock having a book value of $10 per share. If, because of favorable earnings prospects, the company is able to issue 10,000 additional shares to new investors at $50 per share, the new book value will be $30 per share. The new investors have not suffered a loss, since presumably all shares are worth $50 at this point. It appears that the old stockholders have income equal to the difference between their cost (including any retained earnings previously taxed to them) and the current value of $50 per share. The question is whether, under the partnership approach, the old stockholders should be subject to tax at this point, on the increase in book value to $30 per share. Here we are faced with an administrative dilemma. We can avoid a problem at this point if income is not recognized to the old stockholders, but this will increase the difficulty of computing their basis when they dispose of the stock because the relative amounts of cost, book value, and basis have been changed. The extent of the problem is greater than indicated by the simplified example because a similar situation arises whenever even a small quantity of stock is issued, retired, etc. If income or loss were recognized to old stockholders when such changes occur, basis at disposition could be computed without referring to dividends received and undistributed earnings accrued to the shares during the period held. Basis would differ from current book value by the same amount it did at acquisition. A choice must be made between ease of determining basis and ease of handling changes in outstanding stock. Like many other administrative problems of the partnership approach, this would present greatest difficulties in connection with public corporations, which are likely to have more classes of securities, more changes in them, and more stockholders than smaller companies.

Stock options and participating and convertible securities present similar problems of allocating income. If stockholders in public corporations were taxed on a market value basis, these problems would only affect those holding securities in smaller companies. Even for just these smaller companies, it would be necessary to establish fairly complex rules to govern the allocations of income.

Another type of difficulty of a partnership approach relates to intercorporate stockholdings. There is no great conceptual problem involved as each corporation should reflect its full share of the earnings of other corporations in which it holds stock. Nevertheless, problems of timing and computation could be important. A stockholding corporation would not be able finally to determine its income for a given period until it knew the earnings of the companies in which it holds stock. These companies, in turn, might have to await the determination of income of other firms. Exact computations of income where there were circular stockholdings would be conceptually possible, but obviously difficult in practice. These difficulties would be minor where the corporations concerned are on different fiscal years and the stockholding company accrues income as of the latest accounting period of the company whose stock is owned. Where the firms have the same fiscal period it would probably be necessary to permit accruing income as of the prior year.

The fact that some stockholders are religious, charitable, or otherwise nontaxable entities would not create significant problems. Partnership treatment would have the effect of giving them a further tax benefit, since they are, in a sense, now taxed by the corporation income tax on companies in which they hold stock. There is little logical justification for the present partial taxation. If it is felt that the income involved should be taxed as "business" income, then the present exemption of dividends should be eliminated. On the other hand, if the exemption is continued, it appears proper to apply it to all the income, not just the distributed portion.

Complexities might be introduced into the law if it is felt that special provisions are needed where the taxpayer has difficulty raising cash to pay taxes under a partnership approach. Such cases could arise either where stockholder income is computed on a market value basis or where it includes undistributed earnings. Both the seriousness and possible inequities of this type of problem are easily exaggerated. Although many cases might arise where the cash flow from a particular investment, or even all investments, would be inadequate to pay the tax liability, relatively few instances of insufficient cash flow from other sources or lack of liquid assets could be expected. If the accretion concept is accepted, the man who has an income of

$100, 000 from an investment in a corporation with high earnings but paying no dividends should be taxed as much as his neighbor who has the same income in cash. Only in the relatively rare instances where partial liquidation is necessary and is likely to cause a loss does special tax treatment seem justified. Even in these cases, postponement of payment would be more equitable than tax reduction. Provisions for postponement of tax payments would add to the complexity of the law. It might be difficult to establish simple, objective standards which would permit these provisions to work effectively without the necessity for making numerous rulings for particular cases. A solution to the problem could involve a compromise under which simplicity would be achieved without too great a loss of revenue by being rather liberal in allowing tax postponement.

The question of how to treat short-term holders of stock is important. This could be handled rather easily if capital gains were not taxed differently from other income. A corporation's income for a given fiscal year would be accrued to those who own stock as of the end of the year. Those who sold stock during the year would properly disregard undistributed current income because to allocate this income to them would merely increase the basis of their stock and reduce the capital gain (or increase the loss). If capital gains were taxed like other income, the allocation would be cancelled out. Allocating a full year's income to those who acquire stock near the end of a year would, however, be somewhat inequitable in extreme cases because of timing of the tax. An investor who acquired a large proportion of a company's stock near the end of a highly profitable year would be justified in objecting to paying an immediate tax on undistributed earnings of the entire year even though his taxes later would be reduced because these current earnings would be added to his basis.

From the above discussion, it is apparent that it would be desirable, if only for administrative reasons, to have some differences of treatment for public as opposed to private corporations under a partnership approach. Differences might be found worthwhile even if partnership treatment were applied to all corporations and would be necessary under a partial partnership approach or where stockholders in public corporations were to be taxed on a market value basis. This raises the troublesome question of how a line can be drawn that will satisfactorily separate corporations into two classes. It is easy to point out examples of giant public companies and of small private companies, but there is a sizable group of in-between firms for which classification is difficult. Drawing such a line would also create problems in treatment of stockholders of companies which change their status.

It would be difficult to treat public corporations differently from private corporations without introducing complexities into the law. Complexities could result from dividing corporations into a number of classes or from using several bases for classifying companies. Yet to divide all corporations into two classes on the basis of one criterion, such as number of stockholders, would inevitably lead to arbitrary and often undesirable results near the borderline. A number of criteria for distinguishing different classes of corporations could be considered relevant. As a measure of size, total assets or total net worth might be used. As a measure of marketability of stock, one or more of the following would be appropriate: number of stockholders, number of shares outstanding, listing on an exchange, and volume and frequency of over-the-counter trading. Another possible important factor would be complexity of capital structure. A possible way of avoiding a single arbitrary borderline between public and private corporations would be to draw two borderlines; one of these would set off those corporations which should clearly be considered public and the other private corporations. If partnership treatment were compulsory for the latter and market-value treatment required for the former, an option could be allowed for corporations falling in-between. It would not be necessary that all stockholders of a given corporation make the same election, though some simplicity would be gained if this were required.

Legal complexities could arise from attempts to make detailed adjustments for special types of income, revenue agents' changes of corporate returns, and stockholder basis computations. These items were discussed above in the section "Quantity and Kinds of Records To Be Kept." Problems of legal complexity as well as of record-keeping would be minor for these items under a market value

method of taxing stockholder income. The more serious problems under partnership treatment could be substantially reduced by eliminating special treatment of certain types of income and by disregarding small items.

A final source of complexities in the law under a partnership approach to integration would be attempts to prevent or minimize windfalls at the time of change. It would be impossible to make a basic change such as the partnership method without some unintended benefits or losses at the time of change. The market values of securities are inevitably affected by present and prospective taxation. Many investments are made with an eye to peculiarities of the tax structure. A major revision in the taxation of corporate income is sure to affect prospective rates of return and market values, and it is impossible to predict exactly what these effects will be. For example, insofar as high bracket taxpayers have tended to invest in companies with low dividend payout, the values of such stocks would be adversely affected by a partnership method of taxation since the advantage to these investors would largely disappear. But this adverse effect would be offset to some unknown extent by a greater attractiveness of these stocks to those in low tax brackets who would now, in effect, avoid the burden of the separate corporate tax.

Because of the uncertainty as to the amount and impact of windfalls, there would probably be little benefit in attempting to alleviate them through detailed special provisions. There is a possibility that a gradual change may minimize the impact of windfalls, although "announcement effects" could defeat this. If a compulsory partnership method is ever established it will likely be after an extended legislative process and a gradual adjustment to the new tax method may well take place in the securities markets during this process.

Taxpayer Attitudes

Whether or not a partnership approach to integration of corporation and individual income taxation would be administratively feasible depends in part on taxpayer attitudes. The American income system is largely based on voluntary self-assessment and reporting by the taxpayers. Although every taxpayer is under a threat of legal penalties in case of tax evasion, administration of the income taxes would be vastly more difficult if the great majority of taxpayers did not voluntarily cooperate. A partnership approach to corporate income taxation could conceivably have either a favorable or an unfavorable effect on taxpayer attitudes. It is very possible that the increased equity of the partnership approach, including the elimination of some major opportunities for tax avoidance by high income taxpayers, would have a favorable effect on attitudes that would outweigh possible unfavorable effects. The most likely source of adverse taxpayer reaction would be the taxation of income that has not been realized in cash. Even if provision is made to permit tax postponement in extreme cases, this factor will carry some weight. Another possible source of adverse taxpayer attitudes would be increased complexity in the law.

A somewhat controversial question involving taxpayer attitudes centers around "tax consciousness." Individuals who bear the burden of taxes are much less conscious of this burden for some taxes than for others. The personal income tax, especially when the individual must write a check to the government, creates a relatively high degree of tax consciousness. Many excise taxes appear to rank low in this regard, while the present corporation income tax probably falls somewhere between the extremes. Besides being often more feasible politically, taxes with low taxpayer consciousness are likely to involve fewer attempts at evasion and thus can be easier to enforce. Such factors might explain, but do not appear to justify, major departures from tax equity. Depending on a person's attitude toward proper levels of government expenditure, an increase in tax consciousness might be advocated on the grounds that it will tend to promote pressure for governmental economy.

Administrative Advantages of Partnership Methods

A partnership approach to integration of corporate and individual income taxation would eliminate several important administrative problems of the present tax system. The administrative advantages would not be likely to outweigh the difficulties discussed in the preceding sections of this chapter, but would be quite significant. Even more important administrative savings would result from the elimination of special tax rates for capital gains, but these will not be taken up here.

Taxation of corporations as partnerships automatically eliminates the necessity for the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code. The difficulty of determining what are "reasonable" accumulations and the resulting tax uncertainties are well known. Elimination of this problem would be an important administrative advantage. Present problems of taxing personal holding companies would be similarly eliminated since there would be no opportunity to avoid tax through undistributed income.

Under a partnership approach there would be no need to establish the reasonableness of compensation of stockholder employees, as no corporate tax would be avoided when profits are distributed as "salary." Borderline cases where it is not clear whether a payment is interest or a dividend (including cases of "thin capitalization") or where a company might or might not be considered a corporation would no longer be a problem. Shifting of income among commonly controlled corporations and setting up multiple corporations to take advantage of the lower corporate tax rate on the first $25, 000 of earnings would not offer opportunities for tax avoidance under partnership treatment.

Even if favorable tax rates on capital gains are retained, a partnership method would greatly reduce the significance of problems of controlled and collapsible corporations since it would no longer be possible to get capital gains treatment on retained corporate earnings.

The analysis in this chapter of administrative aspects of a partnership approach to integration indicates that public corporations could not simply be taxed as partnerships are at present, but that private corporations probably could without undue difficulty. Both conceptual and practical considerations support the possibility of taxing stockholders in public corporations on the change in market value of their stock rather than on their imputed share of corporation income.

CHAPTER IV

OTHER APPROACHES TO INTEGRATION

In addition to the partnership methods discussed in the preceding chapter, there are several other methods of taxing corporate income which would achieve some of the objectives of integration of corporate and individual income taxation and which therefore can be termed approaches to integration. These approaches can be classified as follows:

a. Imposition of an undistributed profits tax or allowance of a dividends paid credit to corporations

b. Treatment of the corporation tax as a withholding tax

c. Allowance of a dividends received exclusion or credit against tax

d. Elimination of the corporation tax and taxation of capital gains at ordinary rates.

As will be seen, the first three of these approaches all involve the elimination of at least some of the "double taxation" of distributed corporate income while retaining a flat-rate tax on undistributed profits. Relief is given at the corporate level under approach (a) and at the individual level under (b) and (c). Each of these three approaches could be set up so as to have the effect of partially or entirely eliminating the corporation tax on distributed income (dividends)

while retaining the tax on undistributed income (retained earnings). In effect, integration would be partially or entirely achieved for distributed but not undistributed corporate income. Approach (d) involves an attempt to integrate undistributed profits indirectly by taxing them as capital gains either when realized upon disposition of stock or periodically. The equity, economic effects, and administrative problems of each of these four approaches will be discussed in the sections which follow.

Imposition of an Undistributed Profits Tax or Allowance of a Dividends Paid Credit to Corporations

Imposition of an undistributed profits tax would, by itself, result in a tax increase while a dividends paid credit would decrease taxes. These appear to be two different approaches to integration of corporate and individual income taxation, but once we allow changes in corporate tax rates the difference is seen to be superficial. Both types of provisions have the effect of taxing corporations more heavily on undistributed than on distributed income and either could involve eliminating the corporate tax on distributed income entirely while imposing a more or less severe tax on retained earnings. To the extent that distributed profits continue to be taxed at the corporate level under a plan of this type, integration would be incomplete, even for the distributed portion of corporate income. For this reason, and to simplify the discussion, we shall only deal with the case where a corporate tax is not imposed on distributed profits. Thus, in speaking of a dividends paid credit plan, it will be understood that dividends are fully deductible in computing corporate tax liability or, what amounts to the same thing, the only corporate income tax is a tax on undistributed current profits.

A dividends paid credit plan would be, at best, only a partial remedy for present inequities in the taxation of stockholder income. The "double taxation" of distributed profits would be eliminated, but relative under and overtaxation of undistributed profits would remain. Corporate income paid out in dividends would be subject to the same schedule of progressive individual tax rates as are other types of income. But any tax on undistributed income would inevitably be too high for taxpayers who, for any reason, are not subject to income tax, while any such tax at a rate below the highest individual rate would still leave opportunities for tax avoidance by high income stockholders.

If adoption of this plan results in a revenue loss, then presumably this loss would have to be made up by increases in rates or by other taxes. An evaluation of equity must take into account whatever tax increases accompany the plan. Eliminating the corporate tax on distributed profits would almost certainly cause a loss of revenue, but the amount of loss would be less than might be expected, because the plan would increase the percentage of corporate income that is paid out in dividends, thus subjecting more corporate income to the individual income tax. In general, the higher the rate of tax on undistributed profits, the higher would be the proportion of profits distributed, and the closer this plan would come to accomplishing full integration of corporate and individual income taxes. Probably the over-all loss from exempting distributed profits from corporate tax would vary inversely with the rate of tax on undistributed profits. The yield of this tax, however, could be expected to decline as rates rise beyond a certain point. Total revenues would increase with an increase in the undistributed profits tax rate if the resulting increase in the yield of the individual tax is greater than the decline in the yield of the undistributed profits tax. It is clear that the maximum yield of a corporate tax which exempts distributed profits would be at some "middle" rate of tax, since a rate close to zero could not yield much and a rate close to 100 percent would cause distribution of substantially all profits. It is not so obvious that the smaller yield of the undistributed profits tax at high rates would be more than offset by a larger individual tax yield, but there would be at least a substantial offset. In the extreme case where nearly all corporate profits are distributed, it is likely that there would be little, if any, over-all revenue loss. This situation would approximate a compulsory partnership plan in its tax effects. As was indicated in Chapter II, there would likely be little or no revenue loss if all corporations were taxed as partnerships.

From the point of view of equity, then, the dividends paid credit plan would be highly satisfactory only if it resulted in forcing the distribution of nearly all corporate profits. A relatively small increase in the proportion of corporate income distributed would indicate continuing or increased opportunities for tax postponement or avoidance by high income taxpayers, continued overtaxation of those with low incomes, and a substantial revenue loss which would have to be made up by other taxes of possibly questionable equity.

There is no general agreement as to whether favorable economic effects would result from exerting tax pressure on corporations to distribute a greater proportion of profits.[1] This reflects both uncertainty as to what effects would result from such pressure and disagreement as to the desirability of certain possible effects. For example, it is not clear whether a dividends paid credit plan would tend to favor greater saving and investment or greater consumption, and there are differences of opinion as to which would be desirable. If the only change from present law were to make dividends deductible in computing corporation tax liability, the net effect would likely be to stimulate savings and investment. Since lower taxes would be paid by corporations, both investment by corporations and investment in stock by individuals could be expected to be stimulated. The reduced importance of retained earnings as a source of self-financing for corporate expansion might be offset by the ability to raise funds more easily by selling new stock. The effect on investment would also depend on the results of new taxes or increases in individual tax

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[1]See Goode, The Postwar Corporation Tax Structure, op. cit., pp. 1162-63.

rates employed to offset revenue losses. If the rate of tax on undistributed profits were set high enough to cause distribution of substantially all corporation earnings, there would be relatively little loss of tax revenue, but saving and investment would almost certainly be adversely affected to a substantial extent. The revenue loss is minimized because the reduction in tax burden on non-taxable and low income stockholders is largely offset by a greater burden (high individual rates) on high income stockholders. Higher taxes on those with large incomes would undoubtedly discourage saving to some extent and corporations would, by assumption, have little ability to finance expansion with retained earnings.

A dividends paid credit plan would to some extent increase the economic neutrality of the tax system. Unneutralities resulting from treating interest, but not dividends, as a deduction from taxable income and from taxing corporations more heavily than other business forms would either be eliminated or substantially lessened.

Administrative problems of a dividends paid credit plan would be relatively minor compared with those of a partnership method of integrating corporate and individual income taxation.[2] If the tax on undistributed profits is at a high rate so as to cause distribution of a very high proportion of corporate earnings, then some present problems,

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[2]Goode feels that such problems "do not seem grave enough to be an important factor in evaluating the plan." Ibid., p. 1163. As the discussion which follows shows, however, there could be some significant problems.

such as those related to unreasonable accumulations of earnings and personal holding companies, would be eliminated or minimized. On the other hand, a high tax rate on undistributed profits would require careful framing of details of the law and regulations to prevent avoidance of the tax and also to prevent possible inequities. A low rate of tax would ease administration in that less concern with these matters would be necessary, but present problems relating to undistributed profits would not be lessened.

The major administrative problems of a dividends paid credit play would likely be related to legal and other restrictions on dividend payments and to situations in which dividends are paid in years other than when the income is earned. These administrative problems would consist mainly of legal complexities resulting from attempts to prevent both avoidance of taxes and undue hardship. There are a number of possible limitations on the ability of a corporation to pay out all of its current income in dividends. These include legal or contractual limitations and cases of "business necessity." Special provisions to give relief in these situations would appear to be necessary. The undistributed profits tax of 1936-37 contained relief provisions for some cases where dividends were limited by contract or because of receivership or bankruptcy but no relief was given where state law prohibited dividends in excess of retained earnings.[3]

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[3]These provisions and the reactions of corporations to them are discussed in George E. Lent, The Impact of the Undistributed Profits Tax, 1936-1937 (New York: Columbia University Press, 1948), pp. 82-97.

Most legal and contractual dividend limitations are aimed at the protection of holders of senior securities by preventing impairment of the cushion provided by the capital investment of the common stockholder. A tax which penalizes earnings retention appears to be in conflict with laws aimed at safeguarding creditors. A possible way to permit corporate tax minimization without harming creditors would be to permit stock dividends to be considered distributions entitled to the dividends paid credit and also subject to individual income tax.

There is somewhat more stability from year to year in dividend payments than in corporation earnings. This is to a large extent a result of deliberate corporate policy, and the economic effects of this are good---at least from a contracyclical point of view. To minimize interference with dividend stabilization, it might be desirable to allow a carryover or carryback of dividends paid in excess of earnings. Both equity and administrative considerations indicate the desirability of limiting the time period of such carryovers. If dividends in excess of earnings were allowed to be carried forward or back without time limitation, some serious record-keeping problems would arise. An example of doubtful equity of such long time periods would be a case where a corporation paid a tax on undistributed profits and then distributed the remaining profits many years later to new stockholders. When earnings are distributed after having been retained for many years, there is little reason for associating the current distributions with the earlier corporate taxes paid. A more logical adjustment in cases where the distribution reduces the value of the stock would be to exclude all or part of the dividend from income of the recipient. Formulating and administering tax rules which would bring about approximate equity in all the kinds of situations that would arise under a dividends paid credit plan would require such complexity as to be quite impractical. Allowing a carryover or carryback of a few years would not pose such serious difficulties and would eliminate some of the worst inequities.

In summary, a dividends paid credit plan would compare favorably with a partnership plan with regard to administrative difficulty but unfavorably with regard to equity. A dividends paid credit plan would likely result in a substantial over-all improvement in equity of taxation, since distributed profits would be integrated and distribution encouraged, but considerably less of an improvement than would follow establishment of a partnership plan which would integrate undistributed profits as well. It is not clear whether the economic effects of a dividends paid credit plan would be desirable ones nor whether the effects would be better than those of a partnership method.

Treatment of the Corporation Tax as a Withholding Tax

A withholding approach would achieve about the same degree of integration of corporate and individual income taxation as would a dividends paid credit plan. Both would, in general, integrate distributed but not undistributed corporate income. With liberal provisions for carryovers, each of these approaches would have the effect of subjecting only permanently retained corporate earnings to a corporation income tax while taxing distributed earnings to individuals at the time of distribution. As will be seen, the differences between these approaches are quite significant with respect to administrative difficulty and perhaps also in their effects on the attitudes of businessmen and investors.

In its simplest form, the withholding approach involves imposing a flat-rate tax on the entire income of corporations and then treating this tax as a withholding of individual tax when the income is distributed. For example, if the corporate tax rate is 40 percent, a corporation earning $100, 000 would pay a $40, 000 tax. Distribution of half the corporate income will result in dividends of $30, 000. The individuals receiving the $30, 000 will report an aggregate dividend income of $50, 000 and take credit for $20, 000 tax withheld. Thus, an individual receiving a net dividend of $300 and subject to a marginal tax rate of 20 percent would be entitled to a refund of $100, the excess of the $200 of tax "withheld" over his $100 individual tax liability on $500 of distributed corporate earnings. Similarly, an individual in the 60 percent bracket would be required to pay $100--the excess of his individual liability over the amount withheld. The similarity of the tax results of this plan with a dividends paid credit plan can be

illustrated by extending this example. With the same corporate tax rate and dividends, the total revenue under a dividends paid credit plan would be the same as under the withholding plan illustrated. Instead of collecting $40, 000 fromthe corporation and allowing $20, 000 of this as a reduction of individual tax liability on $50, 000 of dividend income, the government would collect $20, 000 (40 percent of undistributed income) from the corporation and collect the full individual tax on $50, 000 of dividends actually paid. If we further assume that in the second year the corporation has no income or loss but wishes to distribute the income retained in the first year, total tax revenues are still the same for the two plans. Under the withholding approach $30, 000 net dividends would be paid to the stockholders, who would be taxed on $50, 000 of dividend income and credited with $20, 000 "withheld" tax. Under the dividends paid credit plan the stockholders would receive and pay tax on $50, 000 of dividends. Under the latter plan it would be necessary for the corporation to receive (and pay out to stockholders) a refund of the $20, 000 tax it had paid in the preceding year.

It is clear that with similar rates and carryover provisions the tax burdens of these two approaches to integration are approximately the same. It follows that they are about equally satisfactory or unsatisfactory on grounds of equity. Some minor differences in tax burden could be expected as a result of differences in timing and source of tax payments and because of possible differences in the amounts of dividends paid. The tax would be collected more quickly after the income was earned under the withholding plan, and a larger proportion of total income tax payments would be made by corporations under this plan. If there is underreporting of dividend income by taxpayers, the withholding plan would reduce the amount of taxes evaded.[4] It is possible that those who make corporate dividend policy would make larger dividend payments under a dividends paid credit plan than under a withholding plan at the same rate of tax. Although the amount of cash paid to stockholders would have to be larger to give an equivalent dividend after individual taxes, psychological reactions might be such as to favor relatively larger distributions under a dividends paid credit plan.[5] Boards of directors might be influenced by the fact that the amount the corporation pays to the government is reduced by increasing dividends under a dividends paid credit plan but not under a withholding plan.

Economic effects of a withholding approach should not differ much from those of a dividends paid credit plan, assuming equivalent rates and dividend policies. Both plans would, by integrating the distributed portion of corporate income, lessen the discrimination

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[4]It should be noted that it is not necessary to adopt the withholding approach to achieve this result. Withholding of individual income taxes on dividend payments could be instituted without any other change in the tax structure or in conjunction with any of the approaches to integration discussed in this study. Such withholding, however, would not in itself in any way integrate corporate and individual income taxation.

[5]This possibility is suggested by Goode in The Corporation Income Tax, op. cit., p. 195.

against the corporate form of business and against stock as opposed to bond financing. Since the withholding approach would involve larger tax collections from corporations (offsetting smaller individual tax payments), any shifting of taxes to consumers and factor suppliers would tend to be greater under this plan.

Administratively, the withholding approach is likely to be somewhat more complicated and difficult than the dividends paid credit plan, but it would be much easier to administer than a partnership approach. Making refunds to individuals would be a problem. Refunds would be necessary to those whose exemptions exceed income or to non-taxable entities even if the corporate rate were at the lowest individual rate, and a higher corporate rate would require substantially more refunds. Every dividend recipient would face at least a minor complication in computing his income and tax. Whereas income of the shareholder would equal dividends received under the dividends paid credit approach, it would be necessary for the shareholder to add the "withheld" tax to dividends to arrive at income under the withholding approach. This complication might be considered serious by large numbers of taxpayers.

Especially difficult administrative problems could arise as a result of special treatment of certain kinds of income. Inter-corporate dividends would be somewhat difficult to handle under a withholding approach. They would be deductible by the paying corporation under a dividends paid credit plan and should logically be income in full (and deductible if redistributed) by the receiving corporation. Carrying a "withheld tax" credit through several "layers" of corporations would be relatively difficult. Administration of both plans would be somewhat simplified by continuing the present practice of generally treating dividends as ordinary taxable income even when the corresponding income to the corporation was given special treatment, such as that given capital gains or tax exempt income. However, the illogic of this would be especially apparent under the withholding approach because individuals would be taking credit for "withheld" taxes which had never been paid to the government insofar as the distributed income was not fully taxed to the corporation. An attempt to refine the withholding approach so as to permit capital gains, tax exempt interest and other specially treated types of income to be carried through to dividend recipients would present formidable administrative difficulties.[6]

Attempts to adjust for fluctuations in the corporate tax rate would cause more serious administrative problems under the withholding than the dividends paid credit plan because of the larger number of (individual) returns involved.[7] For the latter, carryovers

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[6]Goode discusses in some detail possible methods by which this might be attempted and concludes that administrative problems would be serious. The Postwar Corporation Tax Structure, op. cit., pp. 1167-69.

[7]In the British withholding system, the tax is assumed to have been withheld at the rate current at the time of the distribution. This simplifies administration but results in some loss of equity.

or carrybacks would relate only to corporation tax returns. Problems of transition from the present system to the withholding plan would be increased if dividends paid out of retained income accumulated prior to establishing the plan were treated differently from dividends out of current earnings.

Allowance of a Dividends Received Exclusion or Credit

A dividends received excludion will not be discussed in detail in this study because such a plan is at best only a poor approximation to integration of corporate and individual income taxation. An exclusion of either a flat dollar amount[8] or a percentage of dividends received does not integrate even the distributed portion of corporate profits, but only removes the excluded dividends from individual taxation. The relief afforded by an exclusion is too little for low income stockholders, who will still be bearing the burden of the corporate tax on all distributed and undistributed profits, and too much for high income stockholders, who escape progressive taxation of some of the distributed as well as undistributed profits. To exclude all dividends from individual income taxation would, in a sense, be the opposite of integration.

See Walter W. Brudno and Frank Bower, Taxation in the United Kingdom (World Tax Series, Harvard Law School, Boston: Little, Brown and Company, 1957), pp. 257-58.

[8] The $50 exclusion permitted by the 1954 Internal Revenue Code is discussed briefly in Chapter V.

The result would be a complete separation of corporate from other types of income, with taxation of the former at a flat rate.

A dividends received credit against tax would partially integrate distributed, but not undistributed, corporate profits. As will be seen, the credit could be computed so as to approximate the withholding or dividends paid credit plans in fully integrating distributed corporate income. However, if this credit is computed at a percentage of dividends received equal to the percentage corporate rate, it would over-adjust individual taxes for high income taxpayers (causing dividend income to be undertaxed relative to other forms of income) and would fail to remove all the overtaxation of dividends for low income taxpayers. This is because individuals would include in taxable income only the amount of dividend received rather than the dividend plus the corresponding corporation tax paid. For example, with a corporate tax of 40 percent, a tax credit of 40 percent of dividends (and assuming refunds are made when the credit exceeds individual tax liability), $100 of corporate income would result in total tax revenues of $16 if paid to a non-taxable stockholder, $28 if paid to someone taxed at 20 percent and $64 if paid to someone taxed at 80 percent. These total revenue figures are computed as follows:

Individual tax rate	0	20 percent	80 percent
Corporate income	$100	$100	$100
Corporate tax	40	40	40
Dividend (taxable to shareholder)	$60	$60	$60
Shareholder individend tax	$0	$12	$48
Tax credit (40 percent of dividend)	24	24	24
Individual tax payment (refund)	($24)	($12)	$24
Total tax revenue (corporate tax plus individual tax)	$16	$28	$64

The result is that, in effect, 60 percent of distributed profits are taxed at progressive individual rates while the remaining 40 percent of distributed profits and the undistributed profits are taxed at a flat rate of 40 percent. Thus part of distributed, as well as undistributed, profits are still subject to under and overtaxation. This under and overtaxation of part of the distributed profits could be eliminated by subjecting the "gross" dividend (before applicable corporate tax) to progressive individual rates and giving a credit equal to the applicable corporate tax, but this would be simply the withholding approach.

In order for the amount of dividends received credit to equal the amount of corporate tax paid on distributed profits, the percentage rate of credit would have to be higher than the percentage rate of corporate tax if the credit is computed as a percentage of dividends received rather than as a percentage of dividends and related corporate tax. If the corporate tax rate is 20 percent, a dividends received credit of 25 percent will make the amount of credit equal to the amount of corporate tax paid, while a corporate tax rate of 50 percent would require a credit rate of 100 percent to equalize the amounts of tax and credit. Although equalizing comparable dollar amounts under the withholding approach results in complete integration of the distributed portion of corporate income, this is not true under this approach because the individual tax liability is computed on the net dividend paid out of corporate income left after corporate tax. Equalizing the dollar amounts of credit and corporate tax paid in this manner would result in greater inequities than equalizing the rate of credit and the rate of corporate tax. The effect is to subject only actual dividend payments to individual taxation while that portion of distributed corporate income which was paid in corporate tax is relieved from both corporate and individual tax. For example, with a corporate tax of 20 percent and a dividends received credit of 25 percent, \$100 of corporate earnings for distribution would result in \$20 of corporate tax and a \$20 credit to the shareholder (25 percent of the \$80 dividend). But since the shareholder includes only the \$80 dividend in computing his tax liability before credit, the \$20 of corporate income which was originally paid as corporate tax in effect escapes taxation. This method would eliminate all overtaxation of distributed corporate profits (assuming refunds are given), but there would be undertaxation of all income from dividends except where the recipient is not subject to taxation.

It may be noted that prior to 1936 the United States income tax included what amounted to a partial dividends received credit. This was accomplished by exempting dividends received from the individual normal tax.[9] The benefit was not large since the individual normal tax was at low rates, never exceeding 8 percent except in 1918.[10] At the same time, corporate rates prior to 1936 were relatively low, varying between 10 and 13 3/4 percent between 1918 and 1934 and graduated from 12 1/2 to 15 percent in 1935.[11]

Unless a dividends received credit plan were modified so as to be equivalent to a withholding plan, it would less completely integrate corporate and individual income taxation than either the withholding or the dividends paid credit approaches and thus has less merit on grounds of equity. Actually, it is not clear that a dividends received credit plan would represent an improvement over the present system of taxation. Because of the manner of computing the credit,

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[9] Section 25 (a) (1), Revenue Act of 1934, 48 U. S. Statutes at Large 692.

[10] Roy G. and Gladys C. Blakey, The Federal Income Tax (New York: Longmans, Green and Co., 1940), p. 512.

[11] Ibid., p. 524.

it is relatively more valuable to high income taxpayers. With a corporate tax rate of 50 percent and individual rates ranging from 20 to 90 percent, the effective rates on distributed corporate income range from 60 to 95 percent. Allowing a dividends received credit of 50 percent would result in a range of effective rates of 35 to 70 percent--high income taxpayers being relatively undertaxed on distributed as well as undistributed corporate income. At the 20 percent individual rate the total tax is $60 per $100 of corporate income--$50 of corporate tax plus $10 individual tax on $50 of dividends. The individual tax is $45 at the 90 percent individual tax level. The 50 percent credit amounts to $25 per $100 of corporate income distributed ($50 of dividends). With a corporate tax rate of 50 percent and a top individual rate of 90 percent, any dividends received credit in excess of 10 percent would result in relative undertaxation of some distributed corporate income--a 10 percent credit would just eliminate the overtaxation at the 90 percent bracket; the total tax on $100 of distributed corporate income would be $90, consisting of $50 corporate tax plus $40 ($45 less $5 dividend received credit) individual tax. Lower bracket taxpayers would, of course, still be overtaxed if allowed only a 10 percent credit.

From the point of view of economic effects, the strongest argument for a dividends received credit plan is that it would encourage saving and investment by lessening the tax burden on high income taxpayers. It would also remove (or more than remove) some of the tax discrimination against the corporate form of business. These arguments are far from convincing, however. It is not universally agreed that encouraging saving is a desirable long-run economic objective, and this plan is considerably less effective than either the withholding or the dividends paid credit plan in eliminating over and undertaxation of distributed corporate income. If encouraging saving by high income individuals is considered desirable, this could be accomplished much more directly and equitably by adjusting the higher progressive tax rates downward and adopting a more logically consistent approach to integration.

Administration of a dividends received credit does not pose especially serious problems. Although a substantial number of individual taxpayers would be affected, computations would be simple, compared to the withholding approach because it would not be necessary to add corporate tax to arrive at individual income before credit. If the plan provides for paying refunds to those whose credit exceeds individual tax liability, some additional administrative effort would be required, but this would probably not be excessive in view of the inequity to low income stockholders of not making refunds under such a plan.

Some of the administrative problems of the withholding and dividends paid credit approaches would not arise under a dividends received credit. This is partly because a dividends received credit is a device which is farther removed from the ideal of completely integrating taxation of corporate and other forms of income.

Because a dividends received credit does not result in consistently treating the corporate tax as a prepayment of individual tax, as do the withholding and dividends paid credit approaches (for distributed profits), there is less likelihood that refinements of the plan would be considered necessary. For example, under the withholding approach changes in the corporate rate would logically require corresponding adjustments in individual withholding allowances and special computations when dividends are paid out of earnings taxed at different rates. A dividends received credit, on the other hand, inasmuch as it gives a benefit to the individual which is not equal to the effective corporate tax, would not appear to demand such adjustments. The same is true of making adjustments at the individual level for specially treated income earned at the corporate level, such as intercorporate dividends, capital gains, and tax exempt income.

The administrative ease of a simple dividends received credit plan, under which no refunds are paid, is indicated by the apparent lack of serious problems in administering the 4 percent credit allowed in the 1954 Internal Revenue Code.[12] The number of tax returns affected was reduced about one million by granting an exclusion from taxation of $50 of dividends.[13] The 4 percent credit

[12]The credit is limited to the lesser of (a) the total income tax or (b) 4 percent of taxable income. Sec. 34, IRC.

[13]From 4.96 million returns showing dividends eligible for exclusion to 3.97 million with dividends eligible for tax credit; only 2.99 million returns actually involved use of the credit. U.S. Treasury Department, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1957, Table B, p. 4.

was used for the bulk of dividends. This is indicated by the fact that the total tax credit amounted to $300 million, which is 3.4 percent of the $8.95 billion of dividends eligible for the 4 percent credit. The $8.95 billion of eligible dividends was a strikingly high proportion of the $9.43 billion of foreign and domestic dividends received reported by individuals.[14]

The Capital Gains Approach

The last type of approach to integration to be considered here can be called the capital gains approach. Essentially this approach integrates distributed corporate profits by eliminating the corporation income tax and integrates undistributed profits insofar as they eventually are taxed as capital gains to shareholders at full progressive rates. This approach is associated with Henry Simons, who argued forcefully that it would achieve the best obtainable balance among the objectives of fairness, economic effects, and administrative feasibility.[15] An important feature of Simons' proposal is that he would not tax undistributed profits until they are realized--he would consider any disposition of stock, including gifts or bequests, to constitute realization. An alternative capital gains approach would be to tax capital gains on stock periodically whether realized or not. The necessary stock

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[14] Ibid.

[15] Simons, Personal Income Taxation, op. cit., and Federal Tax Reform, op. cit.

valuations could be required annually or less frequently. For simplicity of presentation, the terms "realized capital gains approach" and "accrued capital gains approach" will be used in this paper to refer to plans under which capital gains on stock would be taxed (a) only when realized and (b) annually based on stock values, respectively.

Of the approaches to integration discussed in this study, only the partnership and the capital gains approaches result in integration of undistributed as well as distributed corporate profits. From the point of view of the accretion concept of income,[16] undistributed profits would be satisfactorily integrated by the accrued capital gains approach. This approach would be conceptually superior to the partnersnip approach insofar as the effective income of a stockholder of a large corporation is better measured by changes in the stock's market value than by changes in its book value. It would also be conceptually somewhat superior to a realized capital gains approach (Simons' proposal) since large time differences between earning of income and payment of tax arise under the latter. It is difficult to evaluate the relative merits as to equity of the realized capital gains approach and the partnership approach. The partnership approach gives questionable results when changes in book values of stock differ from changes in market values. When such differences are cumulative (e.g., market value increasing at some fraction of the

[16] See the discussion of this concept in Chapter II.

increase in book value) or very large, a substantial capital gain or loss will often eventually result even though the stockholder's basis has been adjusted for his share of corporation earnings and losses. The realized capital gains approach would be unsatisfactory if it permitted postponement of tax to stockholders but not to partners and others who might be very similarly situated. As Goode points out, even if a similar postponement were permitted to partners and all businessmen, there would still be an element of discrimination against other savers including those saving in order to go into business.[17] Simons advocated extending to businessmen generally the privilege of carrying reinvested earnings forward untaxed.[18]

The loss of revenue from abolishing the corporation income tax would be more or less offset by an increase in individual tax revenues. The accrued capital gains approach would increase individual tax revenues by taxing corporate income in full to individuals insofar as retained income increases stock values. The realized capital gains approach would ultimately have much the same effect except that the timing of recognition of income to individuals would differ and there would be differences in total tax depending on tax rates and tax brackets of individuals when the income is recognized and on the extent to which losses offset unrecognized prior earnings. Both these approaches

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[17] Goode, The Postwar Corporation Tax Structure, op. cit. p. 1153.

[18] Simons, Federal Tax Reform, op. cit., p. 56.

would increase revenues by taxing all capital gains, including those not related to corporate stock, at ordinary income rates, and both would offset this increase somewhat by allowing the full deduction of capital losses against ordinary income.

The accrued capital gains approach would probably not differ much in its effects on investment and employment from the partnership approach. Both would entirely eliminate the corporation income tax and would have the effect of taxing corporate income currently to individuals. As indicated in Chapter III this could be expected to stimulate investment in some respects and discourage it in others. The net effect on employment and income would probably not be especially great in either direction. The accrued capital gains approach would also yield about the same benefits as the partnership approach in increasing the economic neutrality of income taxation. Both approaches would eliminate the present discrimination against financing with stock as opposed to bonds and would put corporations on about the same tax basis as other forms of business organization. They would also tend to reduce the significance of tax factors in business decisions. Examples of this include eliminating the incentive to setup multiple corporations to take advantage of progression in the corporate tax rate and largely eliminating the "locked in" effect which arises when the taxpayer's basis is substantially less than market value.

The realized capital gains approach, on the other hand, would have rather drastic economic effects, some of which might be unfavorable. This approach would, by permitting postponement of all tax liability on retained earnings, strongly favor investment and stimulate incentives. This, in itself, would be favorable to economic growth and employment, but the failure to tax currently a sizeable portion of income might require either higher tax rates on remaining income or reliance on other forms of taxation. Either alternative would tend to offset the employment stimulating effects of the tax postponement. Goode concludes that the net result would be that taxes "would have to fall more heavily on consumption and investment not financed out of retained corporate profits" and this would likely "make maintenance of a high level of national income and employment more difficult."[19] This conclusion is not unchallengeable. In the long-run, no income escapes taxation under the realized capital gains approach, except to the extent that losses offset untaxed gains. It would even be difficult to predict that total tax revenues for <u>any given period</u> of time would be lessened by the postponement of tax on retained corporate earnings because postponement would never be possible beyond the date of death of the person earning income and thus, even if maximum postponement were always availed of, there would be a more or less continuous realization in the aggregate. This prospect is strengthened

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[19]Goode, <u>The Postwar Corporation Tax Structure</u>, <u>op. cit.</u>, p. 1153.

by the fact that the realized capital gains approach would subject to taxation, at full progressive rates, much income which at present is either taxed at low capital gains rates or escapes individual income taxation entirely. Perhaps then, the most significant revenue effect of this approach would be fluctuations of revenue due to a degree of taxpayer control over the timing of realization. It is difficult to predict the pattern of collections over the course of a business cycle, but there would be some tendency for tax revenues to fluctuate less than income. It is fairly certain that as income rises in a prosperous period the proportion of income retained by corporations would also rise. Also tending to level collections would be the postponement of realization until death, resulting in only random fluctuations. Whatever the net effects on incentives, investment, and employment, it appears likely that the realized capital gains approach would have somewhat more drastic economic effects than the partnership or accrued capital gains approaches.

The realized capital gains approach is less satisfactory from the point of view of economic neutrality than the partnership or accrued capital gains approaches. The relative tax advantages of debt financing would be eliminated, but this approach would not achieve tax neutrality between corporations and other forms of business organization, unless all businesses were given the privilege of postponing taxation of undistributed profits. Even in this event, there would be unneutrality in the form of discrimination in favor of certain forms of savings. The logical result of attempting to keep the realized capital gains approach but eliminate these unneutralities would be to tax consumption and exempt all savings. The realized capital gains approach would, on balance, probably accentuate the "locked in" effect of present tax methods. Eliminating all immediate taxes on undistributed corporate profits and taxing gains on disposition of stock at full ordinary rates would increase the pressure to retain income in corporations and to hold onto stock rather than realize gains. This would, at best, be only partially offset by the eventual taxation of all gains at full rates and permitting averaging of income. The likelihood of fluctuations in tax rates from year to year increases the extent to which this approach will affect purchases and sales of stock. Thus, expectations of falling tax rates would cause postponement of realization of gains and acceleration of realization of losses.

Administrative difficulties would be serious if either the accrued or the realized capital gains approach were adopted. The accrued capital gains approach would be rejected by many as hopelessly impractical because of the difficulty of satisfactorily valuing stock which is not actively traded and because there would be some cases where tax postponement would appear justified for owners of such stock who have large unrealized gains. This approach, especially by eliminating special treatment for income from capital gains, would make it possible to greatly simplify the law and regulations, but this advantage is probably small compared with the difficulty of satisfactorily determining market values for closely held stock. This market value problem applies similarly to assets other than stock; the accretion concept would suggest taxing the owner of any asset on an increase in its market value. The fact that market values are readily determinable for some stock issues suggests the possible practicability of a combination of the accrued capital gains approach (for holders of actively traded stocks) with some other approach to integration (for holders of other stocks).

The accrued capital gains approach, even if applied only to corporations with actively traded stock, would have the advantage of somewhat lessening the need for a system of averaging of incomes. This may be considered an administrative advantage in view of the administrative problems usually associated with averaging proposals.[20] A major argument for averaging is the fact that income which accrues over a period of years is sometimes realized all at once, subjecting the taxpayer to very high progressive rates in that year. This situation would occur much less frequently if appreciation in stock values were taxed currently.

The realized capital gains approach would present administrative problems strikingly different from those of the accrued

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[20] One of the best known averaging proposals and a detailed discussion of administrative problems of averaging are to be found in Vickrey, Agenda for Progressive Taxation, op. cit.

capital gains approach, but perhaps nearly as serious. Whereas the accrued capital gains approach would lessen the necessity for permitting averaging of income, the realized capital gains approach would make averaging almost imperative. Without averaging, this approach would include a strong incentive to postpone realization of gains but also a severe penalty if gains are bunched into one year so as to subject the taxpayer to unusually high progressive rates. The taxpayer would have to be an adroit planner and have some good luck in order to minimize taxes. The necessity for luck as well as planning is due to the fact that realization may be outside the taxpayer's control or due to pressing business or personal necessity. In any event, all gains would be treated as realized as of the owner's death. Even with averaging there would be both opportunity and incentive for tax planning which would be troublesome to the taxpayer and the Internal Revenue Service and of doubtful merit from the point of view of equity and economic effects. For example, it would generally be in the interest of the taxpayer to postpone realization and payment of tax and to arrange transactions in such form that realization is not recognized under whatever rules are in effect. The tax planning problem is made considerably more serious by the combination of relative taxpayer freedom to determine the time of realization of gains (especially distributions of corporate profits) with changes in tax rates from year to year.

It can be argued that averaging would be desirable even under the present tax structure and that therefore a realized capital gains approach to integration should not be criticized because of the administrative problems of a system of averaging of income. However, the fact that the realized capital gains approach would make averaging more necessary than at present indicates that an averaging system in conjunction with this approach would probably have to be somewhat more refined in order to achieve a given level of success in avoiding undue hardships. It would be that much less possible to arbitrarily simplify the averaging computations.

None of the approaches discussed in this chapter would achieve full integration of corporate and individual income taxation except the accrued capital gains approach. This approach conforms very well to the accretion concept of income but faces an especially serious difficulty in the necessity to establish values for closely held stock. Either the dividends paid credit or the withholding approach would integrate the distributed portion of corporate income. These two approaches would probably have about the same economic effects, while the dividends paid credit plan would appear slightly less difficult to administer. A dividends received exclusion or credit would not fully integrate even distributed profits, but these proposals would involve relatively little administrative difficulty. The realized capital gains approach would integrate distributed profits but would discourage distribution and would integrate undistributed profits only when and if they are eventually realized. Economic effects of this approach would be at least partially undesirable in that the tax system would be somewhat less than neutral in important respects and this approach would present quite serious administrative problems.

CHAPTER V

RELATED PROVISIONS OF THE 1954 INTERNAL REVENUE CODE AND PROSPECTS FOR INTEGRATION

There are at present (June, 1960) four provisions in the Internal Revenue Code which are related to the question of integration of corporate and individual income taxation. These provisions might be considered a step in the direction of integration but, as will be seen, their total effect is far from complete integration. This chapter contains a summary of these provisions, some background on their enactment, and a discussion of their effects. The chapter concludes with a discussion of the prospects for achieving some degree of integration, either by building on the 1954 code provisions or by more drastic changes in the tax structure.

Dividends Received Excludion and Credit

Code section 116[1] permits individuals to exclude from taxable income up to $50 of dividends received from taxable domestic corporations.[2] Section 34 grants individuals a credit against tax of 4 percent of dividends received in excess of the exclusion. The

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[1] All references to code sections in this chapter are to the 1954 Internal Revenue Code unless otherwise indicated.

[2] Since we are concerned here with the over-all effects of these code sections as related to integration, no attempt is made to point out details of the law and regulations. These are often, of course, important to taxpayers.

exclusion simplifies administration of the credit by making the computation of credit unnecessary for taxpayers who receive small amounts of dividends. Neither the exclusion nor the credit are of benefit to taxpayers who have such low incomes that they would not be subject to tax in any event. No refunds are paid to individuals, as might be done under a withholding approach to integration, as discussed in Chapter IV. The exclusion results in a tax benefit the amount of which depends on the marginal tax rate paid by the dividend recipient. Thus a taxpayer in the lowest (20 percent) individual tax bracket who receives $50 or more of eligible dividends has his tax reduced by $10, while a taxpayer in the highest (91 percent) bracket saves $45.50. The dividends received credit against tax, on the other hand, gives a tax benefit which is not affected by the individual's tax bracket; $100 of eligible dividends will reduce tax by $4 for both high and low bracket taxpayers. Because a large proportion of dividends is paid to high income stockholders, the tax credit benefits high bracket taxpayers more than does the small $50 exclusion. In 1957, 64 percent of individual returns with adjusted gross income had adjusted gross income under $5000 and accounted for 34 percent of total adjusted gross income.[3] In the same year, 34 percent of dividend exclusions applied to returns with adjusted gross income under $5000 while only 11 percent of dividends

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[3] U.S. Treasury Department, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns 1957, p. 20.

eligible for tax credit applied to such returns.[4]

Both the exclusion and credit represent rather small steps in the direction of integrating corporate and individual income taxation. Even if the amounts were substantially increased, these methods would result in a rather poor approximation to integration, as was indicated in the discussion of these methods in the preceding chapter. Neither the exclusion nor the credit integrates undistributed corporate income at all, and neither would completely integrate distributed profits even if the amount of exclusion or rate of credit were higher than at present.

The exclusion and credit of code sections 116 and 34 were enacted in 1954. There was a great partisan controversy at the time, with many Democrats insisting these provisions represented "rich man's" tax relief and Republicans pointing to the desirability of encouraging investment and wide ownership of stocks.

As finally enacted in August, 1954, the provisions are much less generous to stockholders than when they started in the legislative process. The _New York Times_ reported on January 3, 1954, that "more than a score of experts from the Treasury and from Congressional committees" who had been "laboring privately . . . for more than a year" had agreed on major points for tax revision, including a proposal to allow a 5 percent dividend credit against tax and a higher percentage in future years.[5] On January 13 the House Ways and Means Committee

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[4] _Ibid._, p. 4.

[5] _New York Times_, January 3, 1954, p. 1.

went into executive session to work on the new code, issuing releases on certain items from time to time.[6] A January 14 release indicated committee agreement on dividend exclusion and credit provisions which appear to be those agreed to earlier by the staff experts. The exclusion was to be $50, increasing to $100 after August 1, 1955. The credit was to increase from 5 percent to 15 percent over a three year period.[7] On January 21, President Eisenhower delivered his Budget Message to Congress and included these same provisions among a number of recommendations for tax changes. The House Committee modified its proposal on February 19 by limiting the credit to a maximum of 10 percent.[8] The Senate amended the house bill to eliminate the credit entirely and to limit the exclusion to $50.[9] The credit was restored in conference but limited to an eventual 4 percent and the exclusion was left at $50.[10] These provisions are still in the law in this form (as of early 1960) and they are still controversial, with some favoring elimination of the provisions and others favoring increasing their benefits to stockholders.

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[6] See Prentice-Hall, Federal Taxes, 1954, paragraph 66, 511 ff.

[7] Ibid., paragraph 66, 515.

[8] Ibid., paragraph 66, 673. Also see New York Times, February 20, 1954, p. 1.

[9] Senate amendment No. 10 as reported in House (Conference) Report No. 2543, 83rd Congress, 2nd Session, 1954, p. 22.

[10] Ibid.

While the dividend exclusion and credit have been the center of much political controversy, they have not been the subject of a large literature for the tax practitioner. Although the exclusion and credit affect a rather large number of taxpayers, they present few computational problems for the taxpayer, relatively little opportunity for tax planning, and are, in general, easy for the government to administer.

Elections under Subchapters R and S

Two other code provisions, in addition to the dividend exclusion and credit, are related to integration of corporate and individual income taxation. These are Subchapter R[11] which permits certain proprietorships and partnerships to elect to be taxed as corporations and Subchapter S[12] which permits certain corporations to elect to be taxed somewhat similarly to partnerships. Subchapter R became law in 1954, but Subchapter S was not enacted until 1958. These provisions, especially Subchapter S, are complex and present many opportunities for taxpayer planning (or make planning necessary), so that they have been the subject of an unusually large amount of discussion by tax practitioners.

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[11] Section 1361.

[12] Sections 1371-7.

Essentially, a partnership or proprietorship may elect to be taxed as a corporation under Subchapter R if there are no more than 50 owners and if capital is a material income-producing factor or 50 percent or more of gross income is derived from trading or buying or selling for the account of others. Personal holding company income (dividends, interest, etc.) is taxed as if no election were made.

Subchapter S is considerably more complex. The basic objective is to permit closely held corporations to elect to be taxed as partnerships, but the resulting taxation is unlike that of partnerships in a number of important ways. In order to be eligible to make an election under Subchapter S a corporation must meet a number of requirements, and an election can be terminated in a number of ways, voluntarily or involuntarily. To be eligible a corporation must be a "small business corporation." Such a corporation is defined[13] as a domestic corporation which is not a member of an affiliated group, which has ten or fewer shareholders (who are all individuals or estates and not nonresident aliens), and which has only one class of stock. An election will be terminated[14] if a new shareholder does not consent to the election, if all shareholders agree to revocation, if eligibility is lost (such as by having more than 10 shareholders), if gross receipts from outside the United States exceed 80 percent, or if income from certain sources (including dividends, rent, and gain on securities)

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[13] Section 1371 (a).

[14] Section 1372 (e).

exceeds 20 percent. Once an election is terminated, a new election cannot ordinarily be made within five years. A Subchapter S corporation is taxed like a partnership in that no corporate tax is imposed and the entire earnings are taxed to the shareholders whether distributed or not. However, whereas partnerships generally pass through to the partners any special tax characteristics of income, this is true only of long-term capital gains for Subchapter S corporations. Furthermore, there are a number of complications in the tax treatment of distributions, especially where the electing corporation has earnings accumulated while it was taxed as a corporation.

Subchapter R does not actually represent a step in the direction of integration of corporate and individual income taxation. On the contrary, it makes separate corporate taxation available to proprietorships and partnerships where this is advantageous to the taxpayers involved. It is, however, a logical counterpart of Subchapter S in permitting the most lenient taxation of business income where non-tax factors determine the form of business organization. Administrative complications and uncertainties limit the effectiveness of the provision in this regard.

Subchapter S can be considered to provide for optional integration. The fact that is is optional rather than compulsory and the restrictions on eligibility for the election make it a limited approach to integration. A very large proportion of business income is earned by (and dividends paid by) a relatively few large corporations for whom the option is not available. Probably most of the large number of relatively small businesses do not have pressing non-tax considerations dictating the choice of form of organization and so have, in effect, already made an election by choosing whether or not to incorporate. Thus, only a rather small proportion of the overtaxation of corporate income (and hardly any of the undertaxation) can be expected to be eliminated by Subchapter S.

The elections permitted by Subchapters R and S have not been involved in much political controversy. President Eisenhower's January, 1954 budget message recommended that "corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations."[15] He stated that "small business should be able to operate under whatever form of organization is desirable . . . without . . . tax penalties."[16] In the Ways and Means Committee releases in January and February, 1954, on the bill (HR 8300) which was to become the 1954 Code, the only mention of the option proposals was on January 29, when it was noted that the Committee had not yet considered the President's budget message recommendations for such options.[17] On March 7, 1954, the Committee reported out the

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[15]U. S. Government, Budget for the Fiscal Year ending June 30, 1955 (Washington: U. S. Government Printing Office, 1954), p. M20.

[16]Ibid.

[17]Prentice-Hall, Federal Taxes, 1954, paragraph 66, 570.

bill with no option provisions. On June 18, 1954, the bill was reported to the Senate by the Finance Committee, which had added section 1361 (Subchapter R) and a section 1351 which would have permitted certain closely held corporations to elect to be taxed as partnerships under Subchapter K.[18] This election, however, could only have been made in the corporation's first taxable year, in order to avoid the complications of earnings accumulated prior to election. In conference, the House accepted the section 1361 election but rejected section 1351, the result being that some firms could elect to be taxed as corporations but not the other way around.[19]

In July, 1956, the House Committee on Ways and Means established a Subcommittee on Internal Revenue Taxation which proceeded to consider various tax revision possibilities. In October and November, 1956 this Subcommittee released some material[20] prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department, which included a proposed Technical Amendments Bill of 1957 (after modification this later became the Technical Amendments Act of 1958). The only reference in this material to elections as to form of taxation was a recommendation that a Treasury Decision which

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[18]U.S. Senate, Report No. 1622, 83rd Cong., 2nd Sess., June 18, 1954, pp. 452-58.

[19]U.S. House, Report No. 2543, 83rd Cong., 2nd Sess., July 26, 1954, p. 72.

[20]Reprinted in Prentice-Hall, Federal Taxes, 1956, paragraphs 28, 902-4.

had permitted "tentative" Subchapter R elections (pending final regulations) be formalized in the law.[21]

The bill which later became the Technical Amendments Act of 1958 (HR 8381) was introduced in the House on June 26, 1957, and reported by the Ways and Means Committee on July 9, 1957.[22] This bill provided for the repeal of Subchapter R because of difficulties of administration.[23]

On August 7, 1956, the President's Cabinet Committee on Small Business had made a number of recommendations, including that, "corporations with, say, ten or fewer stockholders be given the option of being taxed as if they were partnerships.[24] The President included this among four recommendations for tax changes in a letter to the chairman of the Ways and Means Committee on July 15, 1957.[25]

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[21] Ibid., paragraph 28, 904, item 5.

[22] U.S. Congress, House Report No. 775, 85th Cong., 1st Sess., July 9, 1957.

[23] Ibid., pp. 35, 92. The Committee noted: "This provision has proved to be difficult to apply in actual practice because of the complexities which can arise in such problems as how to treat undistributed earnings and profits after a proprietorship or partnership . . . subsequently becomes taxable as such again. In fact, it has not been possible as yet to prepare either final or tentative regulations on section 1361." p. 35.

[24] U.S., President, Progress Report by the Cabinet Committee on Small Business (Washington: U.S. Government Printing Office, 1956), p. 5.

[25] Referred to in U.S., Economic Report of the President, January, 1958 (Washington: U.S. Government Printing Office, 1958), p. 63.

These recommendations were again made to Congress in the January, 1958 Economic Report of the President.[26]

In 1958 the Senate Finance Committee restored Subchapter R, which the House had voted to repeal, and added Subchapter S, permitting certain corporations to elect to have their income taxed directly to shareholders.[27] The bill became law with these provisions as added by the Senate Finance Committee. Senator Paul H. Douglas submitted individual views which were printed with the Finance Committee report,[28] in which he proposed repeal of the dividend exclusion and credit and objected to Subchapter S as an "attempt at piecemeal solution of [a] general problem."[29] Professor Anthoine reports that the Finance Committee built upon a Treasury Staff draft of Subchapter S which had been prepared earlier in 1958 for the Ways and Means Committee and criticizes the haste with which the provision was considered and enacted.[30] He recommends repeal, prospectively, of Subchapter S.[31]

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[26] Ibid.

[27] U.S. Congress Senate Report 1983, 85th Cong., 2nd Sess., July 28, 1958.

[28] Ibid., pp. 255-66.

[29] Ibid., p. 265.

[30] Robert Anthoine, "Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment," Columbia Law Review LVIII (December, 1958), pp. 1146-95.

[31] Ibid., p. 1175.

A large number of articles on the subject have appeared since the enactment of Subchapter S and probably none of the many tax institutes failed to include a discussion of this provision. Nearly all of these articles and papers deal with the subchapter from a technical point of view, pointing out tax saving opportunities and taxpayer hazards without commenting on the broader merits of the legislation. It is beyond the scope of this study to deal with these detailed aspects of the law.

Prospects for Integration

The political controversy surrounding the dividend exclusion and credit indicates that coming closer to integration by increasing the amount of exclusion or rate of credit would be difficult. In any event, these provisions can, at best, only poorly approximate integration and are open to serious criticism on grounds of equity, as was seen in Chapter IV. The relatively small controversy over Subchapters R and S, on the other hand, indicates that it might be feasible to come closer to integration by increasing the "coverage" of Subchapter S. There would be practical obstacles, however, to making Subchapter S treatment compulsory rather than optional, and undoubtedly there would be political obstacles too. A compulsory approach would be essential to eliminating undertaxation of corporate income, but the eligibility requirements would have to be changed somewhat to prevent corporations from disqualifying themselves by such expedients as issuing a second class of stock.

On the whole, the 1954 code provisions are not a very promising start towards integration, since they fail to eliminate, even in part, the relative undertaxation of some corporation derived income. Subchapter S elections result in taxation significantly different from partnership taxation but do have the general effect of taxing both distributed and undistributed corporate income to shareholders. To make Subchapter S treatment compulsory for even a limited number of corporations would be an important step towards integration.

There would clearly be important improvements in tax equity if more complete integration could be achieved. As shown in this study, the most serious obstacle, other than pressures of vested interests, to achieving fairly complete integration is the administrative difficulty involved. Administrative problems would be greatly reduced, and the prospects for integration correspondingly increased, if special treatment of certain "kinds" of income (such as capital gains and tax exempt interest) were eliminated. It is perhaps too much to hope that such elimination would be politically feasible, but this may well be a prerequisite for achieving a substantial degree of integration.

An approach which would, at the same time, eliminate some of the most serious administrative problems and conform well to the accretion concept of income would be to apply the accrued capital gains method to "public" corporations and the partnership method to "private" corporations. The difficulties of assigning a value to closely held stock would be avoided as would many conceptual and practical problems of allocating income to shareholders of large corporations.

CHAPTER VI

SUMMARY

Federal corporate and individual income taxation in the United States is not at present integrated because the corporation pays a tax, essentially at a flat rate, on its entire income, while the shareholders are taxed only on the distributed corporate income, largely without regard to the corporate tax paid. There is disagreement as to whether or not a result of this is "double taxation" of distributed corporate income, but it is clear that corporate income is likely to be subject to total income taxes that are either greater or smaller than would have been paid if the same amounts of income had been taxed directly to the shareholders. Integration involves eliminating the major differences of tax treatment between the income individuals derive from corporations and their other income.

The principal factors that must be considered in deciding whether or not, or to what extent, integration is desirable are equity, economic effects, and administrative feasibility. Analysis of these factors is difficult because each involves conceptual problems, complexities, and shortages of data on which to base conclusions. Although particular attention is given in this study to administrative problems, it is not felt that administration is the most important factor. An attempt is made to demonstrate that it is possible and desirable to go farther in analyzing administrative problems of integration than is usually done.

There is little doubt that integration would substantially improve the equity of Federal income taxation. There has been some disagreement whether the ideal basis for tax equity is property, consumption, or government benefits received rather than income, but the conceptual arguments for income are very strong and widely accepted. Given income as a tax base, integration would result in a closer approximation to "equal treatment of equals" (horizontal equity) and would make more explicit the degree of differentiation among unequals (vertical equity). Horizontal equity would be improved, because persons who earn a given amount of income through corporations would no longer be subject to substantially greater or smaller taxes than persons who have the same amount of income from other sources. Vertical equity, which involves chiefly the degree of progression of tax rates, could not be said to be improved by integration without making a value judgment as to how much progression is desirable. With integration, the degree of progression indicated by the schedule of individual tax rates (which, of course, could be changed) would be more nearly approximated by the taxes actually paid by individuals.

The concept of the corporation as an "entity" is useful and important in law and accounting, but this does not appear to justify the failure to subject some corporate income to progressive individual income taxes. Economists are uncertain about the incidence of the corporation income tax. The equity arguments for integration are changed somewhat, but not eliminated, if it is believed that some or all of the tax is shifted by the corporation to customers or suppliers rather than resting on the shareholders. To the extent the tax is shifted it is equivalent to a selective excise tax (of doubtful equity) and to the same extent it would appear that undistributed corporate earnings escape income taxation entirely. Other factors to be considered in connection with equity include "windfall" gains and losses resulting from major tax changes, the place of income taxation in the over-all tax structure, and voluntary compliance with tax laws.

Integration could have economic effects in such areas as prices, investment and incentives, and tax neutrality. While economic effects might be important, it is not clear that, as a whole, they would be strongly favorable or unfavorable. For example, in some respects integration would encourage saving and investment while in other respects they would be hindered.

Administrative problems, including difficulties of compliance by taxpayers, vary greatly among the different methods which might be used to attain some degree of integration. A close approximation to complete integration would substantially increase tax administration problems, although certain present problems might be reduced. Administrative difficulties of integration must be weighed against gains in tax equity. One's opinion as to the desirability of a given method of integration depends significantly on the relative importance attached to equity as opposed to administrative considerations.

Fundamental to any consideration of income tax revision is the question of what concept of income is appropriate for tax purposes. An answer to this question requires a consideration of economic, accounting, and legal points of view. The necessity for making value judgments precludes finding a universally acceptable concept of income, but there is much merit in what is termed the "accretion concept." This concept, which is consistent with the objectives of integration, can be valuable as an ideal or directional guide in taxation and in accounting. Briefly, this concept views income as any accretion to economic power or, equivalently, as equal to consumption plus the increase (or less the decrease) in net worth. Under this concept, net worth would be increased or decreased by reasonably measurable changes in market values. This is in contrast to the emphasis on "realization" in the present income tax structure and in accounting. There are conceptual as well as practical problems in implementing this concept, but it appears that both accounting and taxation could be substantially improved if the accretion concept were to receive greater emphasis as a directional guide. Conceptual difficulties include distinguishing economic from non-economic items, determining whether or not gifts are income to the recipient (or reductions of income for the donor), and defining the proper tax paying unit--for example, the family or the individual.

It is also necessary to decide when a change in market value is "reasonably measurable." Because of these problems, the accretion concept does not provide precise answers to all questions in taxation or accounting; but if the main features of the concept were accepted as an ideal, the prospects for improving tax equity and settling accounting theoretical controversies would be greatly improved.

Substantially complete integration of the taxation of corporate and individual income could be accomplished by the "partnership approach." This involves taxing corporate income in the same manner as partnerships and proprietorships are now taxed; that is, there is no tax on the business income as such, but the income (whether distributed or not) is taxed directly to the owners. Complete integration would result from making the partnership method compulsory for all corporations. Partial use of this approach could involve compulsory or optional use of the method by some corporations, possibly with another method required of the remaining corporations. A different method, which would be particularly appropriate for large, widely held, corporations, would be to tax shareholders on dividends received plus the change in market value of the stock. This is a variation of the "capital gains approach," which, alternatively, could involve recognizing gain or loss only upon disposition (including gifts and bequests) of stock, rather than on the annual change in market value. Still other approaches, which would accomplish at least some of the objectives of integration, are: (a) taxing corporations only on undistributed income, (b) treating the corporation tax as a withholding of individual tax, (c) excluding a portion of dividends from taxable individual income, and (d) allowing individuals a credit against tax based on dividends received.

Integration results in improved tax equity primarily by eliminating relative overtaxation and undertaxation of income derived from corporations. Different approaches to integration vary considerably in the extent to which they accomplish this. Compulsory use of the partnership approach or the capital gains approach could effectively achieve this objective. Such treatment on an optional basis, however, would eliminate little, if any, of the relative undertaxation because high income stockholders would continue to take advantage of relatively low corporate and capital gains tax rates. Taxing corporations only on undistributed income or treating the corporation tax as a withholding of individual tax would, in general, eliminate overtaxation of distributed, but not undistributed corporate income and would eliminate undertaxation only to the extent that these methods result in larger distributions of corporate income. A dividends received exclusion or credit against tax would not eliminate undertaxation and would be likely to more than eliminate overtaxation. Thus an exclusion of any amount has the effect of exempting a portion of corporate earnings from the individual income tax and a credit against tax of more than 10 percent of dividends received would result in distributed corporate income being taxed less heavily than other income of taxpayers who are subject to a marginal individual rate of 90 percent. Nearly complete integration would result in much greater improvements in tax equity than would most of the approaches which result in only partial integration.

As indicated earlier in this chapter, it is not clear whether the economic effects of integration, especially effects on saving and investment, would be favorable or unfavorable as a whole. It might be thought that complete integration would result in a large loss of tax revenue (because of eliminating the corporation income tax) which would have to be made up through other taxes. However, a large part, if not all, of this revenue loss would be made up by the individual taxes on distributed and undistributed corporate income. Integration would be likely to improve tax neutrality; decisions as to form of organization and stock or bond financing would no longer be importantly affected by tax considerations. There would also be greater certainty as to the incidence of taxes if corporate and individual income taxation were integrated.

Administrative problems of major tax changes are determined by a number of factors, including the number of taxpayers affected, the quantity and kinds of records required, the complexity of the law, and the attitudes of the taxpayers. An evaluation of the seriousness of administrative difficulties of a given approach to integration requires consideration of available information regarding these factors. Shortages of available data, the impossibility of foreseeing all problems that might arise, and the necessity to exercise judgment in comparing difficulties of one approach with those of another prevent arriving at precise appraisals of the seriousness of administrative problems. However, careful study of these problems appears justified.

The administrative feasibility of nearly complete integration would be considerably enhanced if the special treatment now given to certain income items (such as long-term capital gains, resource depletion, and state and local bond interest) were eliminated. Even without integration, tax administration would be greatly simplified by such a step. Temporary administrative difficulties of making the changeover to a new method of taxation could be important. The seriousness of such problems would depend largely on the extent to which detailed adjustments of tax liabilities are made in an attempt to prevent windfall gains or losses and to correct for inequities of prior taxation. A gradual change in the direction of integration might help to minimize this type of problem if "announcement effects" could be minimized.

Available data on corporations, other forms of businesses, shareholders, and shareholdings is helpful in analyzing likely administrative problems of integration, though more detailed studies would be valuable. For example, relatively little is known about the pattern of shareholdings by corporation size and shareholder income level. Only a small proportion of business firms are organized as corporations, but they account for the bulk of business receipts. Most corporate receipts, income, and shareholdings can be traced to a relatively few large corporations. The numbers of shareholders and shareholdings has been increasing in recent years.

A partnership approach to integration would result in certain administrative advantages as well as disadvantages. Significant advantages include eliminating most problems of unreasonable accumulations of earnings and personal holding companies. Approaches which result in only partial integration would be relatively easy to administer.

There are strong arguments, on grounds of both equity and administrative feasibility, for taxing stockholders of small, closely held ("private") corporations differently from stockholders of large, widely held ("public") corporations. The differences between public and private corporations appear more significant than those between private corporations and other forms of businesses. A combination of two methods may be the most satisfactory way to achieve nearly complete integration. The conceptual and administrative difficulties of attributing public corporation income to individual shareholders argue against use of the partnership approach for these companies.

On the other hand, the existence of fairly definite market values for the shares of "public" corporations supports the view that their shareholders might be taxed on dividends received plus the change in market value of the stock. Somewhat the opposite situation exists in the case of "private" corporations--market values of shares of stock are typically very uncertain, but corporate earnings can more easily and more appropriately be attributed to the shareholders. This combination approach would be much more appealing were it not for the fact that many corporations fall in between the "public" and "private" categories and it is difficult to establish criteria for drawing lines between groups of companies. A possibility which deserves consideration is to give companies which are not clearly either "public" or "private" a choice of either the partnership method or the capital gains method.

In 1954, Congress enacted a dividend exclusion of $50, a dividends received credit of 4 percent, and a provision permitting certain proprietorships and partnerships to elect to be taxed as corporations. In 1958, another option was added (Subchapter S), permitting certain closely held corporations to elect to be taxed somewhat like partnerships. A consideration of the legislative background of these provisions is helpful in ascertaining the prospects for integration. As a whole, these provisions accomplish little towards integration, only partially and imperfectly correct the relative overtaxation of income derived from corporations, and do not eliminate any of the relative undertaxation. The Subchapter S election could conceivably become a starting point for coming closer to integration. This would require easing the restrictions on eligibility and, more importantly, making the election compulsory for at least some corporations.

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