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Double Jeopardy of Corporate Profits, The

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THE DOUBLE JEOPARDY OF CORPORATE PROFITS

CONSTANTINE N. KATSORIS*

INTRODUCTION

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us . . . . It was the year of Our Lord one thousand seven hundred and seventy-five.¹

Nineteen hundred and seventy-nine was also a year of great expectations² and unsettling turmoil.³ It was a year in which our national will was tested in the most direct manner.⁴ The unchallengeable concept of diplomatic immunity was breached.⁵ The threat of an oil cutoff was used to change national policies and affect vital interests.⁶ We experienced double-digit inflation,⁷ an economic slowdown,⁸ and soaring interest rates.⁹ Foreign investors in-

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2. See, e.g., Treaty of Peace, Mar. 26, 1979, Egypt-Israel, 18 Int'l Legal Materials No. 2.
7. See Rattner, '79 Prices Up 13.3% In Biggest Increase For A Year Since '46, N.Y. Times, Jan. 26, 1980, § A, at 1, col. 6.
8. Although there is some disagreement as to whether an actual “recession” commenced
creasingly acquired American assets, while many prominent companies closed plants, idled capacity, and laid off employees. As we enter the 1980's, the problems of the world seem insurmountable. This article will not dwell on our future involvement in world affairs, except to state that isolation and retrenchment would be unthinkable, if not impossible. Whatever our role, we must have the capability of acting quickly and decisively: a goal requiring independence and great moral, economic and military strength.

The more one reads about our economy, the more one is baffled and alarmed. Permanent solutions to economic problems are


13. In a recent speech before the Foreign Policy Association in New York the Prime Minister of Great Britian, Margaret Thatcher, referring to the eighties as the dangerous decade, cautioned:

The last 10 years have not been a happy period for the Western democracies, domestically or internationally . . . . Self questioning is essential to the health of any society. But we have perhaps carried it too far—and, carried to extremes, it causes paralysis. The time has come when the West—above all Europe and the United States—must begin to substitute action for introspection.

Let us go down in history as the generation which not only understood what needed to be done but again had the strength, the self-discipline and the resolve to see it through. That is our generation, that is our task for the Eighties.

Address by Prime Minister Thatcher, quoted in Reston, id. See also Naylor, The U.S. Needs Strategic Planning, BUSINESS WEEK, Dec. 17, 1979, at 18.

elusive. Treating one financial malaise often aggravates another sector of the economy, necessitating a delicate balancing of conflicting interests. Furthermore, the problems are complicated by the constant influence of foreign forces. Nevertheless, most economists agree that any solution will require enormous funding.

Among the most effective inducements to the commitment of private capital and action are our tax laws. At present, tax credits are used to encourage a wide range of activities, from energy conservation to hiring and training the unskilled, disadvantaged and unemployed. More important in this context, the investment credit and accelerated depreciation options have already stimulated billions in new investments. The list of tax incentives is almost endless. When tax law is an inducement for economic activity, it must be used innovatively and fairly. Unfortunately, the arena of tax reform is often charged with emotion and fraught with self-interest. Understandably, differences exist among lawmakers; however, our legislators should not support proposals that are made solely for elective purposes. They should seek long range solutions and not merely stop gap measures. Moreover, in charting our economic course they cannot ignore the realities of the marketplace.

Unfortunately, the public has little, if any, confidence in our

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Dec. 20, 1979, § D, at 1, col. 6; The Decade Ahead: More Inflation Is Seen, But Many Economists Voice Optimism on 80's, Wall St. J., Dec. 21, 1979, at 1, col. 1; The Petro-Crash of the '80s, BUSINESS WEEK, Nov. 19, 1979, at 176. Indeed, a recent poll indicated that respect for economic forecasters was "only marginally ahead of stockbrokers and astrologers, and well behind such categories as plumbers and sportscasters." Evans, Confessions of an Economic Forecaster, N.Y. Times, Feb. 17, 1980, § 3, at 16, col. 3.


17. I.R.C. §§ 44C, 46(a)(10), 48(e).
18. I.R.C. §§ 40, 44B.

21. A credit is also used to induce broad-based support for political candidates, I.R.C. § 41, and tax dollars can be directed toward the funding of presidential elections, I.R.C. § 6096. Furthermore, we use the tax laws to fund retirement pensions, I.R.C. §§ 401-407, and to provide life and health insurance for employees, I.R.C. §§ 79, 106.

22. See Kingon, "To Hell with business!", FINANCIAL WORLD, Dec. 15, 1979, at 11.
tax system. Indeed, some tax laws and proposals have been referred to as "obscene" and a "disgrace to the human race." Few quarrel with the aptness of such general descriptions; however, there is much disagreement over which specific tax provisions warrant such criticism. In this author's opinion, one of the most excusable anomalies of our income tax laws is the double tax on corporate profits that arises from taxing the same income as it is earned by a corporation and again when it is distributed to its shareholders.

This article will discuss the merits of double taxation of corporate profits. This discussion may appear to be of minor importance in comparison with the enormous economic challenges we face in the next decade. The topic assumes major significance, however, when one considers that increased equity investment is a cornerstone of capital formation, which to a great extent, can provide the economic stimulus essential to our national survival.

I. UNFAIRNESS OF DOUBLE TAXATION

The computation of income tax begins with a compilation of gross income, broadly defined as "all income from whatever source derived," including amounts received as compensation for services, and amounts derived from business, dealings in property, or other investments such as interest, rents, royalties and dividends. The taxpayer subtracts his allowable deductions from this figure to arrive at his taxable income.

24. See, e.g., An Obscene Tax, Wall St. J., Nov. 12, 1979, at 26, col. 1, where the proposed windfall profit tax was referred to as obscene.
27. I.R.C. § 61(a)(7). Because a corporate shareholder is not the ultimate owner of the shares, the I.R.C. grants a partial or total exclusion for dividends received by corporations. I.R.C. § 243. See also Committee on Affiliated and Related Corporations, American Bar Ass'n, Legislative Recommendation to Amend the Internal Revenue Code of 1954 to apply a 100 Percent Dividends-Received Deduction to all Dividends Received by a Corporation from a Domestic Corporation, 32 TAX LAW. 883 (1979).
30. Id.
The tax imposed on a specific amount of taxable income varies according to the nature of the gain\textsuperscript{32} and the identity of the taxpayer. A partnership, for example, is not taxed. Instead, it files an information return, and its partners report the income, whether actually distributed or not, on their individual returns.\textsuperscript{35} Special items of income and deduction retain their character as they pass through to the partners.\textsuperscript{34} Similarly, a corporation electing under Subchapter S of the Internal Revenue Code (hereinafter referred to as subchapter S corporation) generally has its income taxed only to its shareholders.\textsuperscript{35} On the other hand, estates and ordinary trusts\textsuperscript{36} are taxed on their income. To the extent the income is distributable or distributed, however, it is deducted by the trust or estate and taxed to the beneficiaries.\textsuperscript{37} If it is taxed to the estate or trust, those entities generally are treated the same as individuals, and are taxed at similar rates.\textsuperscript{38} Similarly, income earned or received by individuals, other than corporate dividends, is taxed only once.

In contrast to the tax treatment of all other entities, the income of a regular corporation is taxed twice. It is taxed to the corporation as it is earned and is taxed again when distributed to the shareholders, either as ordinary income\textsuperscript{39} or capital gain.\textsuperscript{40} In fact, a tax on the accumulated earnings of closely held corporations en-

\textsuperscript{32} See, e.g., I.R.C. § 1201(a) (alternate tax treatment provided for the net capital gains of corporations).

\textsuperscript{33} See I.R.C. § 702(a).

\textsuperscript{34} See I.R.C. § 702(b).


\textsuperscript{36} Generally, an "ordinary trust" is one other than a "grantor trust" (where because of retained dominion or control the income remains taxable to the grantor) or "special trusts," i.e., trusts used in special situations such as pension trust, common trust funds, alimony trusts and trusts taxable as corporations. For a more detailed distinction between ordinary trusts, grantor trusts and special trusts, see A. Michaelson & J. Blattmachr, Income Taxation of Estates and Trusts 1-3 (10th ed. 1978).

\textsuperscript{37} Id. at 5.

\textsuperscript{38} I.R.C. § 1(e). The maximum tax rate, however, on personal service income of an individual is 50%. I.R.C. § 1348.

\textsuperscript{39} Corporate distributions are dividends to the extent of earnings and profits and dividends are ordinary income to the shareholder. I.R.C. §§ 301(c)(1), 316. For a discussion of earnings and profits see B. Bittker & J. Eustice, Federal Taxation of Corporations and Shareholders § 7.03 (4th ed. 1979).

\textsuperscript{40} A shareholder will have capital gain when he sells his stock, I.R.C. § 1221, and may have capital gain on a redemption, I.R.C. § 302, or liquidation, I.R.C. §§ 331-333.
courages such corporations to distribute their earnings, which thus results in a double tax.\textsuperscript{41} As for publicly held corporations, which are generally immune from such dividend-forcing taxes, market investor expectations often require payment of at least a reasonable dividend, which again results in a double tax.

Furthermore, profits generated by lending funds to corporations are taxed differently from those generated by equity financings of the same corporation. The cost of borrowed money, interest, is tax deductible by the corporation before the remainder is taxed twice.\textsuperscript{42} The cost of equity financing, dividends, is not deductible. Why do we allow creditor-investors to take out income from a corporation, which is not taxed to the corporate debtor, while equity-investors' income is subjected to a double tax?\textsuperscript{43}

In addition, it may be shown that the income taxation of dividend income does not favorably compare with that of income from wages. First, the former income is taxed twice,\textsuperscript{44} while the latter is taxed only once. Moreover, dividend income can be taxed up to a 70\% rate\textsuperscript{45} while income from wages is protected by a 50\% ceiling.\textsuperscript{46} We seem to recognize that a 70\% tax discourages income earned from labor, but ignore its effect on income earned from capital. In addition, wages are supplemented by many other forms of non-taxable compensation such as employer-financed life insurance, medical insurance, and pension plans,\textsuperscript{47} which are unavailable to the equity investor.

\textsuperscript{41} I.R.C. § 531. This tax varies between 27\(\frac{1}{2}\)\% to 38\(\frac{1}{2}\)\%. For a general introduction to the accumulated earnings tax, see B. Brrtkekr & J. Eustice, supra note 39, at ¶ 8.01.

\textsuperscript{42} I.R.C. § 163. It may be true that profits exceeding the cost of borrowing inures to the benefit of the equity investor; however, at today's interest rates, 10-12\% returns on newly issued bonds are not uncommon. Thus, a significant part of the profits generated go to the creditor-investor. For additional discussion of the problems of raising capital see text accompanying notes 78-87 infra.

\textsuperscript{43} In addition, to the extent of his basis, the creditor-investor is not taxed on the withdrawal of his investment when the corporation repays the debt. On the other hand, in a close corporation the stockholder, often unable to sell his shares to anyone but the corporation itself, would likely be taxed upon such redemption as ordinary income. See I.R.C. § 302.

\textsuperscript{44} First to the corporation as it is earned and then to the shareholder as it is distributed. See text accompanying notes 39-40 supra.

\textsuperscript{45} See I.R.C. § 1(a)-(d).

\textsuperscript{46} I.R.C. § 1348.

Why is income earned by a corporation taxed twice, whereas income earned by other legal entities is taxed once? Perhaps this discriminatory treatment arose by chance, convenience, or compromise. Regardless of its origin, however, its existence does not jus-

48. For the origin and development of corporate taxation in this country, see D. KAHN & P. GANN, supra note 35, at 1-6:

Congress first enacted a tax on corporate income in 1894 as part of a federal income tax which imposed a tax of two percent on both individual and corporate income. Less than a year later, in Pollock v. Farmer's Loan & Trust Company, the Supreme Court held that the federal tax on income from real estate and personal property was a "direct" tax and, therefore, unconstitutional since not apportioned among the states in proportion to population. Since the particular unconstitutional provisions were part of one unseverable scheme of taxation (including the tax on corporate income), the entire 1894 income tax was held to be unconstitutional.

Demands for a new income tax arose less than fifteen years after Pollock from Western Republicans and from Democrats. A compromise was reached between this coalition and conservative Republicans who were opposed to the tax: an income tax would be imposed on corporations but an individual income tax would not be passed until the ratification of a constitutional amendment permitting its imposition on all types of income without regard to source. The conservative Republicans thus hoped to delay the enactment of a general income tax by making it contingent upon a constitutional amendment. This approach also avoided the passage of a general income tax which could be upheld constitutionally only if the Supreme Court reversed itself. As a result of this compromise, a corporate tax of one percent on corporate net income over $5,000 was passed in 1909 as part of the Payne-Aldrich Tariff Act. It preceded the date of the adoption of the Sixteenth Amendment by four years. The Supreme Court in Flint v. Stone Tracy Company upheld the constitutionality of the corporate income tax, stating that it was not a direct tax but an excise tax on the privilege of conducting business in the corporate form.

A corporate income tax has been in continuous existence since 1909.

Prior to the adoption of the Revenue Act of 1978, the corporate tax was a three-tier structure, which had been scheduled to return to a two-tier structure in 1979. The corporate tax consisted of a normal tax and a surtax, but the first $50,000 of taxable income was exempt from the surtax. The normal tax was 20% of taxable income in excess of $25,000 of taxable income and 22% of taxable income in excess of $50,000. Thus, for a corporation's taxable year beginning prior to January 1, 1979, taxable income in excess of the $50,000 surtax exemption was taxed at a 48% rate (22% normal tax plus a 26% surtax).

The 1978 Act reduced corporate tax rates. In so doing, the 1978 Act eliminated the surtax concept and substituted a five-tier graduated rate structure. For taxable years beginning after 1978, § 11(b) establishes the following rate schedule for corporate taxable income: the first $25,000 of taxable income is taxed at a 17% rate; the next $25,000 is taxed at a 20% rate; the next $25,000 is taxed at a 30% rate; the next $25,000 is taxed at a 40% rate; and taxable income in excess of $100,000 is taxed at a 46% rate. The maximum rate was thus reduced from 48% to 46%. The net capital gain of a corporation is taxed at a
tify its continuance. A corporation and its shareholders are two separate entities, but there is only one profit. In fact, "the corporation is simply the aggregate of its owners and can best be characterized as a 'conduit' through which income earned in the corporation is passed to the shareholders as dividends or retained earnings." Although the privilege of incorporation and its umbrella of limited liability allow businesses to raise large amounts of capital and thus conduct large-scale operations, this benefit hardly justifies the punitive effect of the double tax. This "benefit" argument is deficient in several respects.

Most obviously, it is the states, rather than the federal government, that allow firms to incorporate under their laws. Second, the entire public cost of the legal machinery necessary for the advantages of incorporation is miniscule in comparison to the forty billion dollars in revenue collected through the federal corporation income tax. Collecting sufficient revenue to cover that cost is, after all, the most that could be justified under most reasonable interpretations of the benefit principle. Finally, even if the taxation of corporations were justified on the ground that incorporation provides substantial benefits, it is far from obvious that a profits tax would be indicated. After all, the advantages of incorporation (especially limited liability) are often more relevant for the firm with losses than for the healthy and profitable firm.5

maximum rate of 28% (§ 1201(a)) plus a minimum tax of 15% on tax preference in excess of the corporation's total normal tax. Approximately 39% of a corporation's net capital gain constitutes a tax preference item.


50. McLure, supra note 49, at 536. It has been suggested that the present system is particularly inequitable in the case of low-income shareholders:

[B]ecause low-income shareholders probably bear, at least in part, the burden of a proportional corporate tax rate which may be substantially higher than their individual marginal rates. All shareholders incur the individual tax on distributions they receive, resulting in a combined corporate and individual tax burden substantially heavier than their individual marginal rates would produce with respect to other income. Equity is also adversely affected because high-income shareholders may avoid the effect of progressive individual rates by causing their corporations to retain earnings. This effect is compounded by the special tax provisions reducing the effective corporate rate and by the treatment of gain on the sale of stock or liquidation of the corporation as capital gain, even if such gain is attributable to retained earnings.

It has been suggested that a separate corporate tax is justified because (1) it is a means of improving the allocation of social costs; (2) it is based upon an ability to pay; and (3) it is helpful as a means of social control. Assuming the validity of these social arguments, it would be fairer to tax all business similarly (albeit at slightly higher rates) rather than differently on the basis of operational form. In fact, the progressive individual income tax rates seem to satisfy such social needs. Why, therefore, must we add a layer of taxation at the corporate level to these already steep individual rates? Social goals would be better served by a productive and expanding economy, rather than by one stifled by excessive taxation. Indeed, if carried to an extreme, this social philosophy could justify a 100% tax on corporate profits.

Opponents to easing the tax on dividend income might further argue that the present system of corporate taxation is already integrated into the current prices of corporate stock; therefore, removal of double taxation should increase stock prices, resulting in windfall gains to present shareholders. Higher stock prices, however, would also benefit millions of employees and their families by increasing the investment portfolios of their retirement plans.

52. The rates range from 0-70%. I.R.C. § 1(a)-(d).
53. For a related example of the counterproductive effects of excessive taxation based largely upon social needs, see Katsoris, City’s Death Tax and Its Possible Effects, N.Y.L.J., Jan. 29, 1976, at 1, col. 2.

Admittedly, no tax is popular. When government reaches its tax saturation point—as New York City has—then choosing among levies still yet to be imposed becomes quite difficult. Understandably, political expediency usually dictates the imposition of the least unpopular tax. Such expediency, however, often becomes counterproductive.

The City death tax is retrogressive and self-defeating. It will trigger the final exodus of its more affluent citizens to suburban tax havens outside the City, thereby further eroding its already deteriorating tax base.

Id. at 4.
55. It should be noted that many pensions are presently underfunded. See J. Flint, The old folks, Forbes, Feb. 18, 1980, at 51, 54:

On page 68 of Gulf & Western Corp.’s last annual report there is a little footnote about $160 million—“the amount by which vested benefits under our pension plans exceed market value of assets in the funds, plus balance sheet liabilities.” At AT&T a footnote for 1979 will mention $239 million. At General Motors Corp., another footnote casually mentions $3.9 billion.

Among all businesses, these liabilities run into the tens of billions of dollars,
Similarly, charitable and foundation portfolios would benefit. Moreover, windfall gains to present shareholders are offset by investment losses in the past that resulted from such double taxation. Furthermore, an increase in stock prices might encourage firms to more frequently satisfy their capital needs through equity financings; higher prices of equity offerings result in a lower cost to the corporation of such funds.\footnote{56}

Finally, let us examine the net effect of this double taxation on individuals. Although the top corporate rate of 46%\footnote{57} is substantially less than the 70% ceiling applicable to the high levels of an individual’s unearned income, the combination is severe. A corporate tax rate of 46% followed by an individual tax on dividends at a rate of 70% results in an aggregate rate of 83.8%, leaving an after-tax profit of 16.2%. This is roughly one-half of the after-tax profit of 30% on noncorporate profits.\footnote{58} Such an inconsistency is hardly insignificant.

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\footnote{56}{As to the need to increase equity financings see text accompanying notes 82-126 infra.}
\footnote{57}{I.R.C. § 11(b)(5).}
\footnote{58}{Although the imposition of local income taxes on these profits would require some adjustment to these figures, the resulting disparity between the after-tax profits would still be grossly disproportionate.}
II. UNSOUNDNESS OF DOUBLE TAXATION

A large amount of capital is necessary to build factories and machinery that will increase productivity, thus moderating inflation during this decade. Vast sums are needed for technological research and to make American products more competitive in the international and national marketplaces. The increased dependence on foreign oil necessitates additional capital for added oil exploration and the development of synthetic fuels.

What will be the source of this capital? Government cannot directly furnish the capital because its income is largely derived from taxes on the profits sought to be encouraged. Even if govern-

59. Poor progress on productivity—output per man-hour of work—is one reason for the shortages and rising costs that have plagued this country in recent times. Productivity is a measure of how efficiently we produce goods and services. Gains provide more supplies at lower cost. Declines make costs go up.

Stone, Don’t Prime the Pump This Time, Fix It, U.S. News & World Rep., Oct. 1, 1979, at 80. Weil Management’s Drag On Productivity, Business Week, Dec. 3, 1979 at 14, discusses the decline of the rate of productivity growth in the U.S. “We cannot ignore startling figures such as the fact that the average Japanese auto worker makes 48 to 50 cars per year compared with 25 for the U.S. worker. The average Japanese steelworker produces 421 tons vs. 250 in the U.S.” Id. (emphasis added). This decline is attributed, in part, to a decrease in the amount of capital equipment available to American workers. See Hogan, What’s Wrong With Our Steel Industry?, N.Y. Daily News, Dec. 28, 1979, at 28, col. 1. For an example of this decrease see Stone, supra this note at 79:

Technological advances are meaningless unless put to work. Many American industries are burdened by aging and outmoded facilities and are hard pressed to compete with foreign producers who have more modern plants.

In the last 15 years, Japanese steelmakers have constructed nine ‘supermills,’ while U.S. industry has built only one. Our companies can produce no more steel today than they could 10 years ago. Our consumption of steel has increased, but the additional supplies we are using are coming from abroad....


60. Our technological advantage over other countries is broadly eroding. See R. Reinhold, New President Is Chosen at M.I.T.; He Warns of U.S. Technology Lag, N.Y. Times, Oct. 6, 1979, at 1, col. 5. This can partly be attributed to the fact that expenditures for research and development, which amounted to 3% of the gross national product in the mid-1960’s, has decreased to a little more than 2%. Stone, supra note 59, at 79. See also Better Prospects for Our Ailing Productivity, Fortune, Dec. 3, 1979, at 68.

61. Moreover, the true cost of oil dependency is not necessarily limited to economic cost. See, e.g., Burt, Iraq Said To Get A-Bomb Ability With Italy’s Aid, N.Y. Times, Mar. 18, 1980, at 1, col. 6; The Mideast Arms Race Is Turning Nuclear, Business Week, Apr. 14, 1980 at 55.
ment could provide the capital directly, it should not generally do so.\textsuperscript{62} Therefore, the needed capital must be derived from the private sector through such devices as the reinvestment of corporate profits, and debt and equity financing.\textsuperscript{63} This raises the issue of whether we have a sufficient rate of capital formation\textsuperscript{64} to satisfy our needs. The consensus is that we do not.\textsuperscript{65} The influential Joint Economic Committee of Congress\textsuperscript{66} noted that "if no new steps are taken to address the problem of structural unemployment, lagging capital formation and a slow-down in productivity, then the American economy faces a bleak future."\textsuperscript{67} All these problems are related; increased investment improves productivity, thus lowering costs, slowing inflation and making our goods more competitive.\textsuperscript{68}

\textsuperscript{62} It is likely that direct governmental contribution would involve the creation of additional federal bureaucracy. It is generally felt that government is less efficient and achieves poorer results than private industry. See generally Comment, \textit{Providing Municipal Services in New York State: The "Private Contract" Alternative}, 28 \textit{Buffalo L. Rev.} 589 (1979); \textit{Private Service of Public Needs Sought in Cities}, \textit{N.Y. Times}, Nov. 23, 1979, § A, at 1, col. 1. Government could provide capital indirectly, either through tax incentives or by insuring the development of projects such as the synthetic fuel program. It is felt that private companies would refuse to risk the required billions on untried technology, and that without a guaranteed price, their infant industry could be eliminated by world wide market forces. See generally \textit{Fuels for America's Future}, \textit{U.S. News & World Rep.} Aug. 13, 1979, at 32. Whether the government should assist troubled companies is beyond the scope of this article. For two different views, see \textit{Pro and Con, Should Taxpayers Bail out Chrysler?}, \textit{U.S. News & World Rep.}, Nov. 26, 1979, at 99.

\textsuperscript{63} \textit{Office of Economic Research, The New York Stock Exchange, Building a Better Future: Economic Choices for the 1980s} at 26 (Dec. 1979) [hereinafter cited as \textit{Exchange Study}]. This study is an analysis of the economy of the 1980s that is based on a sophisticated mathematical model of the economy developed by the Wharton Econometric Forecasting Associates, Inc., under the direction of Professor Lawrence Klein. It develops projections of the likely overall consequences of three alternative courses national economic policy could take in the decade ahead—"pessimistic," "status quo" and "optimistic."

\textsuperscript{64} "In its simplest terms, capital formation means the creation of productive capacity from funds built up by businesses and individuals." \textit{Worry for Industry: Where To Get Money to Keep Growing}, \textit{U.S. News & World Rep.}, July 14, 1975, at 23.


\textsuperscript{67} \textit{Joint Economic Committee, Congress of the United States, Outlook 1980's} 2 (Aug., 1979) (Summary of Midyear Report & Staff Study) [hereinafter cited as \textit{Outlook}].

\textsuperscript{68} \textit{See Shabecoff, Mr. Productivity}, \textit{N.Y. Times}, Feb. 17, 1980, § 3 at 9, col. 1.

Mr. Grayson, former chairman of President Nixon's Price Commission and former dean of the Tulane and Southern Methodist University schools of business, turned his back on government and academia several years ago to carry the
Indeed, the Committee referred to productivity as the "linchpin" of economic progress in the 1980's.\textsuperscript{69} It is estimated that for the economy "to perform at even minimally acceptable levels in the 1980's, U.S. capital requirements will be enormous—$1.8 trillion (in 1972 dollars)."\textsuperscript{70} This is significantly higher than capital requirements in the 1970's,\textsuperscript{71} due in part to an

word of economic salvation around the country. That word was productivity. At first, few listened. But now Mr. Grayson finds that his mission is no longer regarded as quixotic.

\textit{\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots}\n
Productivity—or output per worker—is a key measure of economic health. When it grows, the economy grows in real terms and so do standards of living. When it goes down, real economic growth slows or stagnates.

\textit{\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots}\n
To ask Mr. Grayson why productivity is so important is to open a floodgate. "It is a key variable at work in reducing — or increasing — inflation," he said. "To increase productivity is the best way to fight unemployment. We have the statistics to show that higher productivity produces more jobs. The higher the growth of productivity the more resources there are for health services, education and fighting pollution."

Mr. Grayson added that sustained productivity growth is necessary for United States' industry to meet rising foreign competition. "If we don't improve our growth rate we will lose jobs and market positions to other countries."

\textit{\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots}\n
Whatever the reasons for the decline, there is much to be done to improve productivity, Mr. Grayson said. Government "must remove disincentives" to investment and to research and development.

It must also take steps to stimulate capital investment and savings. Costs and benefits of regulation must improve productivity in its own operations."

\textit{Id.} at col. 1, 2, 3.


We don't see how anyone can quarrel with the JEC's conclusions. The facts and figures certainly don't. Productivity growth in the private business sector was three times greater over the 1947-65 period than during 1973-78. There's no mystery about the reason for the shocking decline. Economists have traditionally stressed the importance of capital investment to increasing productivity, and "in recent years capital investment has not kept pace with employment." Inflation and regulation have eaten up a sizeable chunk of investment capital and reduced after-tax rates of return."

\textit{Id.}

70. \textit{Exchange Study, supra} note 63, at 3. "The 'base case' projects non-residential fixed investment at a staggering $1.8 trillion (in 1972 dollars) in the decade of the 1980s. This is what corporations will have to spend on replacement, modernization and expansion of the productive capital stock." \textit{Id.} at 26. "The 'optimistic' scenario points to even higher needs—$120 billion of net new equity financing and $1.1 trillion of new debt financing." \textit{Id.} at 26 n. 27. \textit{See also Worry for Industry: Where to Get Money to Keep Growing, supra} note 64, at 23, where estimates ranging from 3.8 trillion to 4.5 trillion dollars were reported.

71. \textit{Exchange Study, supra} note 63, at 26, which estimates a 50% increase in capital requirements, in constant dollars, for the eighties over the seventies.
expanded population, inflation,\textsuperscript{72} and the antiquated condition of much of our plant and equipment, which must be replaced or repaired.\textsuperscript{73} The costs of environmental and pollution control standards\textsuperscript{74} also significantly contribute to this increase.\textsuperscript{75}

Historically, 48\% of all outlays for plant and equipment in the United States has been financed from retained earnings, with the remaining 52\% from debt and equity financing.\textsuperscript{76} Of the 52\% from debt/equity financing, approximately 90\% has been derived from debt offerings.\textsuperscript{77} Assuming that the $1.8 trillion in fixed investment is adequate and the historical rates continue, the capital needs of the 1980's will be approximately financed as follows:

<table>
<thead>
<tr>
<th>Source of New Capital</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained Earnings</td>
<td>864 billion</td>
<td>48.0%</td>
</tr>
<tr>
<td>Debt Financings</td>
<td>842 billion</td>
<td>46.8%</td>
</tr>
<tr>
<td>Equity Financings</td>
<td>94 billion</td>
<td>5.2%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>1.8 trillion</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Of course, a more optimistic outlook would require even greater amounts of capital from these three sources. Aided by these statistics, let us examine each source to see whether it will meet the demands of the near future.

Whether retained earnings will continue to satisfy its historical contribution of 48\% of the capital requirements of the 1980's is

\textsuperscript{72} Inflation adds to the increase because to replace tomorrow the same item purchased yesterday costs more.

\textsuperscript{73} See "The net effect of takeovers is positive", \textit{Forbes}, June 11, 1979, at 65. "The average age of all U.S. plant and equipment is $17\frac{1}{2}$ years vs. under 12 years for West Germany and under 10 years for Japan. Nearly two-thirds of our factories are 28 years old or more. Only British plants are older, among major developed economies." \textit{Id.} at 66. Indeed, "[o]ver the past ten years the U.S. spent 13.5\% of GDP on plant and equipment while Britain spent 14.9\%, France 16.7\%, West Germany 17.4\% and Japan 26.4%." \textit{Id.}

\textsuperscript{74} See Stone, \textit{supra} note 59, at 79: It has been estimated that "10 percent of the funds that are being spent for new plant and equipment are required simply to meet new pollution-control standards." See also Quarles, \textit{A Thicket of Environmental Laws}, \textit{Wall St. J.}, Aug. 24, 1979, at 10, col. 4; Brody, \textit{Orphan Ante: Cleaning Up Abandoned Chemical Dumps Will Cost Billions}, \textit{Barron's}, Jan. 28, 1980, at 4, col. 1.

\textsuperscript{75} Furthermore, developing new energy sources, including synthetic energy, will add billions to the capital requirements of the past. \textit{See Fuels for America's Future, supra note} 62, at 32. See also Lyons, \textit{U.S. Details Gasahol Program}, \textit{N.Y. Times}, Jan. 12, 1980, at 27, col. 6. "The Carter program, which has taken 18 months to draft, envisions the use of between $8.5 billion and $13 billion over 11 years to spur production of ethanol with the aim that by the mid 1980s about 2 billion gallons of ethanol a year will be produced." \textit{Id.}

\textsuperscript{76} \textit{See Exchange Study, supra} note 63, at 26.

\textsuperscript{77} \textit{Id.}
speculative. If slippage should occur in retained earnings, either because of lower earnings or a higher payout ratio, then an even greater contribution must be made by new equity investment.\textsuperscript{78} Such slippage is indeed a possibility.\textsuperscript{79} Furthermore, a greater proportionate contribution from retained earnings may not be desirable. By encouraging equity buildup through retained earnings (which avoids the double taxation of dividends) rather than by new issues of stock, our present tax system biases "the allocation of capital in favor of those firms that are already earning income and against new businesses."\textsuperscript{80} Moreover, favorable tax treatment of retained earnings "may also be a major cause of corporate mergers and takeovers."\textsuperscript{81}

In examining the historical 52\% capital contribution furnished by debt/equity funding, we find that choosing between the two alternatives, a corporation invariably prefers to incur new debt. The existing financial ratios indicate that new debt is favored nine to one over equity financing.\textsuperscript{82} This situation exists because borrowed capital is cheaper, since the interest cost is tax deductible, and because the leveraged profits resulting from low equity capitalization are shared by fewer shareholders, thus maximizing earnings per share. Conversely, dividends are not tax deductible\textsuperscript{83} and addi-
ational common stock often results in a diminution of earnings per share.

Why, therefore, doesn't industry borrow all of its capital needs not satisfied by retained earnings? The answer lies in a common sense rule of the marketplace that a reasonable amount of equity (the aggregate of invested capital and retained earnings) is required for each new layer of debt. The rationale behind this unwritten rule is that the prospective lender, who receives only a fixed rate of return, will insist that expansion also be funded by equity money. Thus if the projected profits do not materialize, shareholders' contributions will support the loan. Otherwise the lender would be foolishly assuming all the risk.

Capitalization ratios vary. When the proportion of debt rela-

§ 247 grants a limited deduction for dividends paid by public utility corporations on certain preferred stock. This exception to the general rule that dividends are not deductible by the paying corporation was enacted in 1942, in response to testimony that regulatory restrictions on the issuance of debt by public utilities would make expansion to meet war demands difficult, and that a deduction for dividends paid on preferred stock would make it easier to attract equity capital.

Id.

84. Capitalization consists of the long term capital for each company, namely, long term borrowings, common and preferred stock. See Independent Appraisals, FINANCIAL WORLD, Jan. 1, 1980, at 61. Capitalization ratios, therefore, reflect the proportionate part of a company's capitalization that is contributed by each of these three components. For example:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Capitalization Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds $3,000,000</td>
<td>30%</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>6,000,000</td>
</tr>
<tr>
<td>(including capital surplus and retained earnings)</td>
<td></td>
</tr>
<tr>
<td>TOTAL $10,000,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

Desirable capitalization ratios are well known and fairly standard. Generally speaking, it is considered desirable for an industrial company to have no more than a 25% bond ratio, and for the common stock ratio to be at least as much as the total of the bond and preferred stock ratios. If these proportions are not maintained, a company may find it difficult to raise new capital.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC., HOW TO READ A FINANCIAL REPORT 24 (New ed. Dec., 1964). Moreover:

A one-stock capitalization may be attractive because there are no prior claims ahead of the common stock. But there may be an advantage in using senior securities provided the funds borrowed can earn more than is needed to pay the interest on debt or dividends on the preferred stock. Long-term debt and preferred stock add what is called "leverage" to a company's capital structure. The degree of leverage is the percentage of the common stock and surplus
tive to equity increases, borrowing costs are higher and credit is less available. As a practical matter, therefore, this is why companies, although mindful of the leverage and tax benefits of debt financing, repeatedly seek more expensive equity capital before floating additional debt financings. This has been particularly true in the utility industry, which annually requires vast sums of money to finance expansion and has often issued common stock below its historical book value.

Equity funding's historical 5.2% share of newly raised capital may seem unimportant. Yet, it assumes enormous significance when one considers its irreplaceable contribution to overall shareholders' equity, essential in maintaining healthy capitalization ratios in financing future growth. Indeed, equity funding's share should be increased, for American industry is already too heavily committed to debt financings with its burdensome and inflexible fixed charges continuing to accrue even during recessionary peri-

to the total capitalization. After paying fixed charges and preferred dividends, increased earnings benefit the common stock. Therefore, leverage is an advantage to the common stockholders while earnings are increasing. But a high degree of leverage may be dangerous if a company's earnings are irregular or it is engaged in a cyclical industry. For industrial companies, a rough maximum for bonds and preferred stocks is that they should not exceed 50% of the total capitalization.

The smaller the year-to-year fluctuations in earnings, the larger the amount of senior securities outstanding may be without incurring danger. That is why electric and gas utility companies may properly have a 25-30% common-stock equity (ratio of common stock and surplus to total capitalization) whereas this would be considered undesirable for a meatpacking or steel company, or a railroad. A 50% common-stock equity is generally regarded as a minimum for a manufacturing or retail business.


85. See Elia, New Debt Needed to Fuel Economy Is So Vast, Study Says, It Will Crowd Out Equity Market, Wall St. J., Feb. 9, 1979, at 39, col. 3. It has been noted that the increasing debt to equity ratios of United States corporations have resulted in "increased risk and decreased flexibility in the course of business cycles." Evaluaton, supra note 50, at 597.

86. The companies today selling at below book value and far below replacement value are far too numerous to mention. See, e.g., Norman Weinger's triple sixes, FORBES, Dec. 10, 1979, at 129. See also The Return of Benjamin Graham, FORBES, Oct. 15, 1979, at 158.


88. See notes 76-77 supra and accompanying text.

89. See note 84 supra and accompanying text.

90. See notes 78-81 supra and accompanying text.
odds. A balance sheet too severely leveraged in favor of debt often leads to illiquidity and ultimately bankruptcy. 91

The next issue to consider, therefore, is who will supply approximately $94 billion (5.2% of $1.8 trillion) of new equity financing that is required to sustain minimal growth in the 1980's. 92 The origin of this new equity capital is as essential to future economic growth as the capital itself: it could determine who gains control of various corporate enterprises. In recent times, ownership of American companies has been shifting from individual nationals to institutions and foreigners, a trend that portends special dangers and problems. 93 There are many reasons for the burgeoning of foreign investment in the United States. 94 For example, the weakness of the dollar in comparison to foreign currencies 95 has made our securities inexpensive to foreign investors. Our nation also offers political stability and thus is a safe haven for vast amounts of funds. Moreover, many of our securities are presently selling below their historical book value and far below replacement costs. 96 In summary, buying depressed American securities with deflated dollars is viewed as a very inexpensive entry into the American marketplace. 97 This influx of foreign funds into United States equity securities has been across-the-board, and more recently it has resulted in actual takeovers of American companies. 98

92. See, text accompanying notes 76-80 supra.
94. See Who Owns American Industry? The Big Shifts Under Way, supra note 93, at 70: "Foreign ownership of American stocks has also increased dramatically, from only 3.1 percent of the total value of shares outstanding in 1970 to 6.4 percent."
95. In recent months, the dollar has been temporarily strengthening in world markets, principally because of the exorbitant heights to which interest rates have risen in the United States as a result of the government's attempt to arrest inflation. See, e.g., Dollar Reaches 2¼ - Year High; Gold's Price Slips, Wall St. J., Mar. 25, 1980, at 2, col. 2.
96. See notes 86-87 supra.
97. An additional attraction is that non-resident aliens are often not taxed on their capital gains. See I.R.C. § 871(a)(2), which provides for taxation of non-resident alien individuals who are "present in the United States for a period or periods aggregating 183 days or more during the taxable year. . . ." Id.
98. Foreign Investments Up in U.S., N.Y. Times, July 30, 1979, § 4 at 1, col. 6; Rout,
Although foreign investment on a limited scale should be encouraged, our nation must become increasingly sensitive to its presence.\textsuperscript{99} While United States investment overseas is nearly four times as great as direct foreign investment in this country, the latter is growing at a much faster rate.\textsuperscript{100} We should carefully monitor the growth of foreign investment.\textsuperscript{101} This is particularly true when one considers the great increase of federal debt in foreign hands. In 1970, 5\% of the publicly held federal debt was held by foreigners. This amount has risen to 20\%, approximately $121 billion.\textsuperscript{102} In fact, “[a]lmost half of all the new federal debt to have gone into private hands in the last decade has gone to foreigners.”

As equally disturbing as foreign investment is the vast concentration of American equity securities in the hands of institutions such as banks, trust companies, insurance companies, pensions and

\textsuperscript{99} See Stone, supra note 93.
\textsuperscript{100} See Address by Harold M. Williams, Chairman of the Securities and Exchange Commission, \textit{quoted in The Week In Review}, June 22, 1979, at 4.
\textsuperscript{101} See \textit{Who Owns American Industry? The Big Shifts Under Way}, supra note 93.
\textsuperscript{102} See \textit{Why Foreign Investors Put Their Money on U.S.}, supra note 98.
foundations. This raises concerns about the potential dominance of some of the largest companies in America. In addition, such a concentration creates a problem of illiquidity in the marketplace.


In a few cases, holdings of foundations distort the picture. For example, 71.4% of the stock of Kellogg is in institutional hands but a large portion of this is foundation-held.

But the same can't be said for some other stocks largely held by the reporting institutions. For example, a surprisingly high 71.2% of Digital Equipment stock is held by these institutional investors; the stock was in 153 portfolios at year-end.

International Business Machines, the most widely held issue, was held by 363 institutions at year-end. They accounted for $19.1 billion, or 43.9% of the stock outstanding in the giant computer manufacturer.

The nine next largest dollar holdings were Exxon, 36.5% by 344 institutions; American Telephone & Telegraph, 18.7% by 342; General Electric, 37.6% by 309; Minnesota Mining 54.4% by 265; Eastman Kodak, 35.6% by 303; General Motors, 21.3% by 288; Schlumberger, 39.2% by 253; Standard Oil (Calif.), 36% by 264; and Atlantic Richfield, 48.6% by 274.

Among other major stocks owned 50% or more by the institutions were Philip Morris, Xerox, Eli Lilly (includes a foundation), Halliburton, Burroughs, Smith-Kline, Avon, K-mart, Deere, McDonald's, American Express, Texas Instruments, Revlon, Alcoa, Schering-Plough, Raytheon, General Mills, Baxter-Travenol, Travelers, Upjohn, Motorola, General Reinsurance, Anheuser-Busch, AMP and American Broadcasting.

Id., col. 4. See also *Trust-Busting?*, FORBES, July 1, 1974, at 54; *Who Owns American Industry? The Big Shifts Under Way*, supra note 93.


To many businessmen the stock market this year has seemed inexplicable, about as bizarre, say, as Watergate. The market has ignored the large, and often sensational, earnings gains being reported by corporations, and has gone relentlessly down. More than that, it has gone down with a great unevenness, much as a giant popover might lose steam.

On the one hand, the prices and price-earnings ratios of a few dozen institutional favorites—known around as "the Vestal Virgins"—have fallen only moderately .... In contrast, the great majority of stocks have sunk to levels that suggest they have become virtual pariahs. In the early months of this year, Wall Street was already talking about a "two-tier market" of remarkable proportions. By May, stocks that had seemed cheap at March prices had collapsed still further—many to levels of four or five times expected 1973 earnings—and the situation was being described as unique in stockmarket history.
Thus, when the large sums of equity capital are raised in the next decade, steps must be taken to insure that the role of individual citizens of the United States is increased.\textsuperscript{108} The problem is how to encourage such individuals to make equity commitments. Part of the reason for the lack of equity investments by individuals is that personal savings in the United States "are falling short of past performance, and are well below what the U.S. principal Free World competitors—Japan, West Germany, Canada and the U.K.—are saving now."\textsuperscript{109} Several reasons have been advanced for this lack of frugality,\textsuperscript{110} but the principal culprit is lack of tax incentives.\textsuperscript{111} The United States is a nation where consumption in-

\ldots 

\ldots The basic questions concern the country's capital markets, which have in the past demonstrated an outstanding ability to deliver equity capital to a broad range of companies. The two-tier market suggests, however, that the range is narrowing and the universe in which investors are willing to sink their money is shrinking. If this situation persists, how are the great majority of companies to raise the equity capital they may need? Beyond that, what happens to the new company seeking equity capital the first time? Optimistic answers to these questions are hard to come by. 

\textit{Id.} at 82-83. For further discussion about the impact of institutional investments on the securities market, see Russo & Wang, \textit{The Structure of the Securities Market—Past and Future}, 41 \textit{Fordham L. Rev.} 1, 1-2 (1972).

\textsuperscript{108} See \textit{The Death of Equities}, supra note 79.

At least 7 million shareholders have defected from the stock market since 1970, leaving equities more and more than ever the province of giant institutional investors. And now the institutions have been given the go-ahead to shift more of their money from stocks—and bonds—into other investments. If the institutions, who control the bulk of the nation's wealth, now withdraw billions from both the stock and bond markets, the implications for the U.S. economy could not be worse. Says Robert S. Salomon Jr., a general partner in Salomon Bros.: "We are running the risk of immobilizing a substantial portion of the world's wealth in someone's stamp collection."

\textit{Id.} at 54.

\textsuperscript{109} \textit{Showdown}, supra note 65. \textit{See also The net effect of takeovers is positive}, supra note 73, at 65 ("[T]he U.S. savings rate is dangerously low: 6.7\% over the past five years vs. 14.1\% for Britain, 15.2\% for West Germany and 24.9\% for Japan."); Allan, \textit{Thrift Adrift: Why Nobody Saves}, N.Y. Times, Feb. 17, 1980, \S\ 3, at 1, col. 5.

\textsuperscript{110} One of the reasons is the expectations that old age benefits such as social security and pensions will make savings unnecessary. See Felstein & Griffin, supra note 104. \textit{See also Showdown}, supra note 65, at 41.

\textsuperscript{111} \textit{See Showdown}, supra note 65 at 39:

In the U.S. there is no tax break on savings account interest and only a modest break on dividend income—there is a $200 exclusion on a joint return. In Japan, interest on up to $32,000 of savings is exempt and dividends are taxed at a reduced rate. In West Germany, most dividends and $300 of interest (on a joint return) are tax free. Canada exempts the first $2,000 of interest and divi-
stead of savings is encouraged.

In the 1960s the question was whether America could afford both Vietnam and the Great Society—guns or butter. We chose to have guns and butter, and wound up with guns, butter and inflation. As we enter the 1980s, we're told we need more capital for industry. But that capital will have to come from somewhere, meaning someone will have to sacrifice something. As we found in the Sixties, there is no free lunch—or a free war. Just as we couldn't really have guns and butter, neither can we have both more investment and a continuation of the consumer spending spree that has marked the past few years.\textsuperscript{112}

This situation will recur in the 1980's because the "cold war" possibilities require increases in defense expenditures.\textsuperscript{113} This in turn will increase the federal deficit, straining our credit markets, and further aggravating inflation. Productivity gains achieved through increased investment, however, will decrease these inflationary pressures.\textsuperscript{114}

dends (on a joint return). Even in the U.K., not known for encouraging capital formation, interest on savings certificates is exempt, as is the first $140 of interest from National Savings Bank accounts.

The antisavings bias in the U.S. tax code is bad enough, but the pro-consumption bias is even worse. The consumption incentive is so deeply ingrained that no one seems to notice it anymore. The incentive is allowing people filing itemized returns to deduct from taxable income every penny of interest paid. Our competitors penalize wealth by assessing wealth taxes, but none of our competitors subsidizes consumer spending by allowing individuals to deduct all their interest expense. In West Germany and Canada, no interest deductions are allowed to individuals. Japan and the U.K. have only limited deductions for mortgage interest. None of these countries allows consumer loan interest to be deducted.

\textsuperscript{112} Id. at 43. The Joint Economic Committee, in its midyear review of the economy, beckons Americans to shift attention to the supply side of the economy, to save more, invest more, and train more of the disadvantaged to assume their rightful roles in the workplaces of America. See \textit{Outlook, supra} note 67. See also \textit{Stone, supra} note 59, at 80.


\textsuperscript{114} For the relationship between capital formation, productivity and inflation, see notes 59 & 69 \textit{supra} and accompanying text. See also \textit{Productivity: Only Real Cure for Inflation?}, U.S. News & World Rep., Mar. 12, 1979, at 80. Unfortunately, for the full year, productivity fell 9.3\% in 1979, making last year only the second time in thirty-two years that such a decline was registered, \textit{Productivity Off Again in 4th Quarter}, N.Y. Times, Jan. 29, 1980, § D, at 1, col. 3, and productivity is not expected to increase in 1980. See \textit{Productivity Fell At Rate of 1.6\% In The 4th Period}, Wall St. J., Jan. 29, 1980, at 2, col. 2.
An examination of the returns on other liquid investments illustrates a second reason why individuals do not purchase equity securities. Investors can receive double-digit returns on certificates of deposit, corporate bonds and Treasury issues. Holders of deep discount bonds can also reap significant capital gains profits if the bonds are held until maturity. Furthermore, the yield from Treasury issues is usually shielded from local income tax levies. Moreover, the record yields of municipal securities are attractive to tax conscious investors who realize that a secure 7½% yield is equivalent to a 15% taxable return to a 50% bracket taxpayer and a 25% taxable return to a 70% bracket taxpayer.

There is little wonder why investors shun equity investments. First of all, the average yield on common stock is significantly below both that of the pretax yield of the money instruments mentioned above and the posttax yield of municipal securities. In addition, unless an investment is substantial, bro-
kers’ commissions could virtually erase the current yield unless the stock appreciates in value.123

The ultimate question is whether tax incentives, such as the elimination of the double tax on dividends, will induce the additional commitment to equity investment that is essential to future growth. Logically, more persons will choose an investment if its after tax yield increases.124 In the meantime, while economists and

duction as is the case with interest expense. But see I.R.C. § 116(a), which offers up to a $100 exclusion ($200 on a joint return) for dividends received by an individual from a domestic corporation. This exclusion has been increased and amended to include interest income by Pub. L. No. 96-223 (1980). See note 178 infra.

123. Of course, there is always the fear that the stock value will fall. It should be noted that in the case of individual taxpayers, capital losses are generally limited to capital gains plus $3,000, I.R.C. § 1211(b), whereas capital gains are usually fully taxable when realized, I.R.C. § 451(a).

124. See generally text accompanying notes 129-134, infra concerning shareholder credit relief techniques. For an interesting observation of stockholder reaction to tax incentives, see Let Them Buy Stocks, FORBES, Dec. 25, 1978, at 32.

All over France, viewers tune in nightly at 8:30 for a prime-time adventure film. But first come the commercials, which run in a solid ten-minute block preceding the action. In the final spot, money rattles into a cash-box. A map of la patrie throbs to the sound of amplified heartbeats. “Invest in French industry,” the voice-over intones in a patriotic spiel aimed at selling common stocks.

This is the Gallic equivalent of Merrill Lynch’s thundering herd. The sponsor? The French government promoting “Shares—Today’s Way to Save.” A how-to mailing from the Treasury makes an even harder sell: “Pay less tax . . . by becoming a shareholder” is its message. A nationwide ad campaign by banks choruses the same line.

Behind all the hoopla is a new tax law enacted this July. It lets a Frenchman who buys up to 5,000 francs ($1,200) worth of stock in French companies each year for the next four years deduct that amount from his taxable income. For a businessman with a $30,000 annual salary, the potential tax reduction is $2,000 over the full period.

The objective is to entice France’s traditionally cautious small investors to take their savings out of bank accounts or real estate holdings and put them in common stocks. (Whereas 1 American in 9 is a shareholder, only 1 Frenchman in 35 is.) Investment professionals yawned when the government struck up this capitalist tune, but they were soon wide awake and taking orders. When 1978 ends, over 1.5 million Frenchmen will have invested $1.5 billion in common stocks through the plan. “Small investors who had never owned a share in their lives have come in,” says Jean-Jacques Netter of brokers Sellier, Suchet & Cie. “They realize that even if they lose 40% of their investment they still get a good deal because of the tax benefit.”

Id. A plan similar to France’s is being studied in the United Kingdom because of its success in France. See Ellington, Britons May Receive Tax Breaks To Boost Equities Investment, Wall St. J., Jan. 25, 1980, at 12, col. 3. In addition, significantly greater amounts of venture capital were raised following the reduction in capital gains tax contained in the Revenue Act of 1978. See notes 166 & 167 infra and accompanying text.
legislators fiddle with statistics, which are largely speculative or meaningless because of variable or external influences, the

125. See Committee on Corporations, Section of Taxation, New York State Bar Ass'n, Report on the Integration of Corporate and Individual Income Taxes, 31 TAX LAW. 37, 63 n.80 (1977) [hereinafter cited as Association Report], which discusses the lack of empirical evidence on the effect of integration of corporate and individual income taxes upon capital formation and equities. This is hardly surprising, because, except for a brief trial with integration, we have had unrelied double taxation of corporate profits since 1913. See note 48 supra. See also C. McLure, JR., MUST CORPORATE INCOME Be TAXED TWICE? 50-91 (1979), which discusses the foreign experience with integration.

The experience of France, Germany and the United Kingdom with their respective tax integration schemes suggests that partial tax integration may not be an effective mechanism for increasing the rate of capital accumulation by business. In France and the United Kingdom dividend rates were not increased, and in Germany, although the dividend rate seemingly was increased the proportion of corporate capital financed by sales of corporate stock actually decreased. It is true that in the United Kingdom potential dividend increases were held back by external factors, i.e., the government's anti-inflation policy, rather than any intrinsic flaw in the imputation system itself. But the British experience indicates that a policy to increase dividends may be viewed as inflationary or, at any rate, as incompatible with an anti-inflation policy.

Gourevitch, Corporate Tax Integration: The European Experience, 31 TAX LAW. 65, 82-83 (1977). On the other hand, even if dividends do not rise, the after-tax yield to the investor does rise if his aggregate tax is lowered on such income. Increasing the stockholder's after-tax yield might permit corporations to maintain dividends at their present levels, thus enabling a greater reinvestment of increasing corporate profits. Such reinvestment increases stockholder equity similarly to equity financings. Note, however, the warnings of Congressman Ullman that such retention may encourage mergers and takeovers. See note 81 supra and accompanying text. See also (1977) 64 STAND. FED. TAX REP. (CCH) 18 [hereinafter cited as TAX POLICY], which discusses, inter alia, the brief United States experience on integration.

U.S. Experience With Integration, 1936-38

1. In 1936 Congress enacted a split rate corporate income tax under which income paid out as dividends was taxed at normal tax rates between 8 and 15 percent and retained earnings were taxed under a surtax, whose rates ranged from 7 to 27 percent and were based on the fraction of earnings paid out as dividends.

2. As might be expected, the existence of an additional progressive tax on retained earnings encouraged a substantial increase in dividends. It has been estimated that during the two years in which this was in effect (1936 and 1937), dividend distributions were one-third greater as a result of this changed tax treatment. Substantial inter-industry differences in increased payout occurred. Manufacturing payout was 40 percent higher, while construction, forestry and fisheries and agriculture paid out 75 percent more. Small and medium corporations had higher payout rates of dividends than did the larger firms as measured by asset size. Apparently, the surtax on retained profits stimulated greater outlays to corporate employees and outlays for maintenance. Larger executive salaries and bonuses enabled owners of small businesses to reduce corporate normal taxes as well as to avoid the surtax.

3. In 1938 the undistributed profits surtax was repealed.
American investor—the key to a healthy investment climate—has emphatically delivered his message: present equity yields are inadequate to warrant his attention. Curiously, the United States is the only leading industrial nation that imposes unrelieved double taxation on corporate profits. The time has come to eliminate this dubious distinction.

III. FORM OF TAX RELIEF FOR CORPORATE PROFITS

Once a decision has been reached to alleviate the burden of the double tax on corporate profits, choosing the form of relief is no simple task. Although there are many possible ways to integrate corporate and individual income taxes, integration can basically be categorized as full or partial. Both methods will be briefly discussed.

A. Full Integration

Full integration essentially affords the tax treatment currently applicable to subchapter S corporations. The corporate tax is eliminated and corporate income is attributed directly to the shareholders, whether distributed or not. "Thus all corporate-source income would be taxed at the marginal tax rate applicable to the shareholder in question," and "[c]orporate losses would presumably also be attributed to the shareholders." Further-

Id. at 16.

126. See The Death of Equities, supra note 79, at 54-55, which discusses the significant decrease in the number of shareholders, particularly younger investors. During the period 1973-1978 the individual investor who has remained in the marketplace has shifted a significant portion of his investment funds away from equities to high yield, fixed income investment. According to data compiled by Salomon Brothers . . . individual households, have been the net sellers of approximately $25 billion in equity securities over the last six years. During this same period they have purchased over $216 billion in U.S. government and agency securities, issues of bonds and other fixed income securities.

REPORT OF THE JOINT INDUSTRY/GOVERNMENT COMMITTEE ON SMALL BUSINESS FINANCING, 22 (May 22, 1979).

127. See Tax Policy, supra note 125.

128. For more thorough discussions of integration techniques, see Gourevitch, supra note 125; McLure, supra note 49; Evaluation, supra note 50, at 595-620.

129. See note 35 supra and accompanying text.

130. See McLure, supra note 49, at 550; Gourevitch, supra note 125, at 85 ("Under full integration, the corporate tax can either be eliminated entirely or it can be retained as a withholding tax of shareholders' individual income tax liabilities.").

131. See Evaluation, supra note 50, at 598.
more, "the basis of corporate shares would be adjusted upward by the income attributed to the shareholders and downward by corporate losses allowed to them and by distributions made to them."\footnote{132} Full integration, therefore, would eliminate a large source of capital gains to shareholders by taxing retained earnings as ordinary income on an accrual rather than a realization basis.\footnote{133}

At first, full integration appears to be the simplest and most equitable method of undoing double taxation. Unfortunately, this is not true. For example, how are corporate preferences passed through to the shareholder? "The character of income (for example, tax exempt interest), accelerated depreciation, and an investment credit could not be passed on to millions of small shareholders of publicly-held corporations. The complexity of all of these items in the tax returns of millions of small shareholders would be overwhelming."\footnote{134} In addition, consider the unsettling administrative effect on millions of shareholders' income tax returns that

\footnotetext{132}{Id.} \footnotetext{133}{In the foreward to U.S. DEP'T. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter cited as BLUEPRINTS] former Secretary of the Treasury William Simon stated:}

I noted that we need to return to the basic principles upon which our income tax system was founded and the three cornerstones of its structure—equity, efficiency and simplicity. I said we need to wipe the slate clean of personal preferences, special deductions and credits, exclusions from income and the like, and impose a single, simple progressive tax on all individuals.

Comments on BLUEPRINTS, by the Special Committee on Simplification of the Section of Taxation of the American Bar Association were favorable.

The Committee recommends consideration of full integration only as an element of a massive revision of the United States income tax system, such as the comprehensive income tax proposed by BLUEPRINTS. Unless the special treatment of capital gains, the investment credit, accelerated depreciation, the exemption of state and local bond interest, and all other such provisions were eliminated at the same time, a fully integrated system would be more, rather than less, complex. The adoption of such a full integration system would require a transition period of ten years during which much of the complexity of existing law would remain. The Committee seriously doubts that it is feasible to make such a change in the United States and instead recommends that attention be focused on partial integration.

If, however, the United States were to adopt a comprehensive income tax base, low-rate system, as proposed by BLUEPRINTS, the Committee would favor adoption of full integration. Integration would greatly facilitate adoption of such a system, which would result in fundamental simplification of the income tax structure.

\textit{Evaluation, supra} note 50, at 604-05. See also, \textit{McLure, supra} note 47, at 568-69.

\footnote{134}{Evaluation, supra note 50, at 600.
would result from an audit of corporate profits. Moreover, full integration might be unmanageable for corporations with several types of stock, with different rights (for example, dividends, voting, liquidation, convertibility, warrants and redemption). Indeed, allocating corporate income among various shareholders could prove difficult if not impossible. Further complications arise in the case of a corporate shareholder who would be unable to calculate its own earnings and thus allocate them to its shareholders until it had been informed of its pro rata share of corporate profits. Such reporting delays would be unacceptable in today's time-oriented economy and tax structure.

This view on the administrative feasibility of the partnership method seems to have stood the test of time. In the one situation where the United States tax system provides for partnership treatment of corporate income, subchapter S for closely held corporations, administrability was preserved by the two requirements that only one class of stock be issued, and that all shareholders must be individuals.

Finally, consider corporations that retain a substantial part of their earnings. It is likely that its shareholders will not have the cash-flow necessary to meet personal tax liabilities on the portion of undistributed corporate-source income allocated to them. "This is particularly telling in the case of widely-held corporations; dividend policies are largely beyond the control of shareholders and would probably continue to be so . . . ."

B. Partial Integration

In contrast to full integration, partial integration can be applied at either the corporate or shareholder level. Both partial integration techniques reach only distributed earnings. Relief is

135. Id. at 603.
136. See McLure, supra note 49, at 563.
137. Evaluation, supra note 50, at 602. Obviously the problem would be further exacerbated for corporate stockholders.
138. McLure, supra note 49, at 564. The use of the term partnership in this quote is intended to describe the flow-through effects of full integration and, as such, is virtually synonymous with the tax treatment afforded to subchapter S corporations. See note 35 supra and accompanying text.
139. McLure, supra note 49, at 564.
140. See id. at 89.
141. McLure, supra, note 49, at 561, which, in discussing feasible integration methods rejects "those [techniques] that seem to be sufficiently defective from a conceptual standpoint not to merit further discussion of their administrative feasibility: the simple elimina-
granted at the corporate level either by allowing the corporation a
tax deduction for all or part of the dividends it pays, or by applying
a lower corporate rate [hereinafter referred to as "split rate"]
to distributed earnings. "The dividend deduction and split rate
systems are identical in effect; a full deduction for dividends
merely applies a zero rate to distributed earnings, and a partial
deduction is equivalent to a lower rate on distributed earnings
than on retained earnings."\(^{142}\) Partial integration at the share-
holder level [hereinafter referred to as "shareholder credit"] is
achieved by "treat[ing] all or part of the corporate tax deemed al-
locable to distributed earnings as an additional distribution for
which a credit is allowed against the shareholder's tax."\(^{143}\) This is
termed full credit and partial credit, respectively. The credit would
also be refundable, except possibly for tax exempt and foreign
shareholders.\(^{144}\)

Although there is some debate as to which partial integration
technique is preferable,\(^{145}\) a shareholder credit appears to be more
advantageous. "Most foreign countries with integration systems
have adopted the shareholder credit approach."\(^{146}\) For this reason

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\(^{142}\) See Evaluation, supra note 50, at 605.

\(^{143}\) Id.

\(^{144}\) See Tax Policy, supra note 125, at 11:

"Shareholders eligible for integration.—Another issue with significant reve-
nue effects is whether tax-exempt shareholders should be made eligible for inte-
gration. Tax-exempt organizations, pension funds and foreigners receive about
20 percent of all dividends (net of intercorporate dividends), but making them
eligible for integration would increase the revenue loss by about 50 percent (that
is, the tax-exempt shareholders would receive one-third of the tax reduction
from integration). The reason the tax-exempt shareholders benefit dispropor-
tionately from integration is that for taxable shareholders, some of the share-
holder credit is "recaptured" by the gross-up, but there would be no gross-up for
tax-exempt shareholders. However, excluding tax-exempt shareholders from in-
tegration would reduce the beneficial effects of integration on corporate financial
structures and resource allocation. Whether foreign shareholders in U.S. corpora-
rations should be eligible for integration is an appropriate subject for tax treaty
negotiations."

\(^{145}\) See generally Gourevitch, supra note 125, at 84-94; Evaluation, supra note 50, at

\(^{146}\) Evaluation, supra note 50, at 617. See also Gourevitch, supra note 125, at 89. The reason
for the preference for the shareholder credit system is explained in id. at 110-11.
("[U]nder such a system the tax credit granted to resident shareholders is automatically
denied to nonresident shareholders. This enables a tax credit country to negotiate from
strength if it is prepared to grant the tax credit to residents of another country through a
tax treaty.")
alone, a shareholder credit is advantageous because "international fiscal cooperation would be facilitated by our adoption of the same method."147 In addition, relief at the shareholder level would directly increase the after-tax yield of dividends, thus making equity investments more attractive.148

Under a full credit system, a shareholder's dividend plus the corporate tax allocable to the dividend (grossup) is included in his gross income. This combined figure, is taxed at the stockholder's marginal rate, which is 70% or less. Deducted from the resultant tax is a credit of 100% of the grossup. Since this 100% credit necessarily exceeds the individual's marginal tax rate on the identical grossup, the taxpayer's after tax yield is increased.149 Under a partial credit system, the amount grossed up and later credited is artificially fixed at a flat percentage (for example, 10% of the dividend), which bears no relation to the actual allocable taxes paid by the distributing corporation on the income being distributed as a dividend.

France, Germany, Japan and the United Kingdom have adopted a tax credit system.150 Of the four, however, only Germany

147. See McLure, supra note 49, at 582.
148. See notes 124-26 supra and accompanying text.
149. For an example of a full credit, see Tax Policy, supra note 125, at 14:

Consider a corporation with $300 of book income. Under existing law, assume its corporate tax liability is $100. Further assume that it now pays $150 in dividends out of its $200 in after-tax income and retains $50. If the shareholders are in the 40-percent bracket, they pay $60 in tax on their dividend so that the total tax burden—corporate plus individual—is $160 . . .

Assume that the corporation continues to pay a $150 dividend. Since this is three-fourths of after-tax income, the corporate tax attributable to the dividend would be $75 out of the $100 in overall corporate tax liability. The shareholders would report income of $225 (the $150 dividend “grossed up” by the $75 in corporate tax attributable to the dividend). The individual tax on this amount at a 40-percent rate is $90. The shareholders would claim a tax credit of $75 for the corporate tax attributable to the dividends, so that their net individual tax would be $15. The total tax burden would be $115 ($100 corporate tax plus $15 individual tax), a reduction of $45 from existing law.

Assume now that, in response to the elimination of the double tax on dividends, the corporation raises its dividend from $150 to $180, so that retained earnings fall to $20. Now, the corporate tax attributable to the dividend is $90. Shareholders would report income of $270 ($180 in dividends grossed up by $90 in corporate tax attributable to the dividends), on which the individual tax is $108. Since they would get a tax credit of $90, the net individual tax would be $18, and the total burden would be $118, a tax cut of $42 from present law.

150. Id. at 16.
gives resident shareholders a tax credit for the full amount of the corporate tax borne by distributed income. A partial credit system has recently been proposed in the United States. Such a system is easier to administer because the corporate tax paid does not have to be allocated to the dividend distributed. Nevertheless, from the perspective of inducing capital formation, a full credit would be more favorable than a nominal partial credit because it would make equity investments more attractive, at least initially, by further increasing the after tax yields of dividends.

IV. POLITICAL REALITIES

Understandably, because 1980 is an election year, tax revision proposals are a major topic of discussion. For the first time in decades, much attention is directed toward tax relief measures that induce production instead of consumption. Several proposals have been suggested, including slowing the escalation of social security taxes, indexing income tax rate brackets, liberalizing rules for depreciation deductions, extending the investment credit, reducing capital gain tax rates, reforming the disparate taxation of dividends, and granting limited exclusions for dividend and interest income.

151. Id. ("Japan uses a split corporate rate of 30 percent on dividends and 40 percent on retained earnings, and it allows shareholders a tax credit equal to 10 percent of their dividend income (with no gross up). The shareholder credit is 5 percent at higher income levels.")

152. See 124 Cong. Rec. H640 (daily ed. Feb. 2, 1978) (remarks of Rep. Ullman). [S]hareholders would receive a tax credit equal to a percentage of their dividend income—initially 10 percent but increasing over a 6 year period to 20 percent. They would include this credit in their gross income. This shareholder credit would, when fully phased-in eliminate almost 22 percent of the current double tax on dividends . . . I do not intend integration to be a substitute for other corporate tax reductions or to be contingent on enactment of any offsetting tax increases. My integration program is designed to have a modest initial revenue impact—about 1 1/2 billion—so there is no need for any trade-offs. Id. (emphasis added). See also 125 Cong. Rec. E70 (daily ed. Jan. 15, 1979) (remarks of Rep. Pickle); Rep. Pickle's proposal would defer the tax on dividends that are reinvested in a qualified investment plan. 125 Cong. Rec. E581 (daily ed. Jan. 21, 1979) (remarks of Rep. Pickle).

While each of these suggestions is intended to alleviate the problem of capital shortfall, the enactment of one or more does not render the others unnecessary; each serves capital formation in a different way. For example, the recent increases in social security taxes to both employer and employee, together with increases scheduled for the future, deprive business of capital that could be reinvested in expansion. Furthermore, these increases are particularly painful to employees, who pay the social security levy with after tax dollars—what is left over after the government has already withheld income taxes. These increasing social security taxes necessarily diminish savings, and inhibit the capital formation process. Accordingly, a moratorium on such increases has been proposed. Similarly, a combination of inflation and inflexible tax rate brackets has artificially subjected most Americans to higher income tax rates, leaving them with less real spendable income than in the past. This phenomenon of having less while making more is popularly referred to as the government’s “windfall tax,” which clearly erodes and discourages savings. For this reason, some form of adjustment and indexing of tax brackets has been suggested.

More liberal depreciation deduction and the extension of

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154. See Showdown, supra note 65, at 41. (“[O]ur Social Security system diverts money from savings into consumption. Americans will pay around $140 billion of Social Security taxes in 1980, vastly more than all personal savings combined.”)

155. I.R.C. § 275(a)(1)(A) specifically provides for the nondeductibility of Social Security contributions by employees.


159. Forbes, Jr., When The Irresponsible Becomes Responsible, Forbes, Aug. 20, 1979, at 31 (“A cut in marginal tax rates would not simply boost consumption; it would encourage people to save and invest and to work more productively. When personal rates were cut in 1964-65, total individual savings jumped nearly 40% in two years.” Id.)

160. See, e.g., Cowan, supra note 153.

161. See Hughey, 10-5-3 or fight, Forbes, Dec. 10, 1979, at 37.
the investment credit to research and experimental expenditures\footnote{162} have also been proposed, both of which will be beneficial to capital formation. The rationale behind such proposals is sound; both assist a business in financing capital expansion or in achieving technological advances. The investment credit directly reduces taxes by offering a bonus, thus inducing the desired investment towards research. The proposed Capital Cost Recovery Act of 1979\footnote{163} recognizes that existing tax rules discourage new capital investment. At present, firms must depreciate their plant and equipment on a historic cost basis over the “useful life” of such property, which averages about twenty-five years for structures and eleven years for equipment, even though inflation raises the replacement cost of the property.\footnote{164} The bill would allow companies to depreciate all structures over ten years, equipment over five years and light vehicles over three years—hence the popular designation of the bill as “10-5-3” depreciation. By materially accelerating depreciation allowances, corporate taxes are reduced, resulting at least temporarily in an improvement of corporate liquidity. This should lead to increased investment in capital facilities. It should be noted, however, that 10-5-3 does not basically increase the aggregate depreciation taken on an asset; it merely increases the rate of such deduction. Thus, although 10-5-3 will be a useful building block, it is hardly a panacea to our capital formation short fall.

The Revenue Act of 1978 included provisions for reducing the tax on capital gains.\footnote{165} It is likely that there will be some opposition to alleviation of the double tax on dividends on the ground that it is no longer essential to capital formation needs because of

\footnotesize{\begin{itemize}
  \item \footnote{162} See S. #700, 96th Cong., 1st Sess., 125 CONG. REC. S3058 (daily ed. Mar. 21, 1979), which extends the investment credit to certain research and experimental expenditures.
  \item \footnote{163} See S. #1435, 96th Cong., 1st Sess., 125 CONG. REC. S8665 (daily ed. June 27, 1979).
  \item \footnote{164} Hughey, supra note 161. See also Schiff, Depreciation: Fast, Faster and Fastest, N.Y. Times, Dec. 9, 1979, § 3, at 16, col. 3.
  \item \footnote{165} The Revenue Act of 1978 eliminated, as to individuals, the alternative capital gains tax under I.R.C. § 1201(b), but increased the deduction for net capital gains (that is, the excess of net long term capital gains over net short term capital losses for the year) from 50% to 60%. Thus, the present maximum tax on net capital gains is 28% (40% x 70% maximum individual rate), whereas a 25% maximum was provided by § 1201(b) before the enactment of the 1969 Tax Reform Act. See also Sloane, Tax Free Capital Gains Proposed, N.Y. Times, Dec. 2, 1978, at 32, col. 1. Some persons feel that the capital gain preference should be totally eliminated. See, e.g., Katsoris, In Defense of Capital Gains, 42 FORDHAM L. REV. 1, 10-13 (1973).}
\end{itemize}}
the relief granted to capital gains by this Act. Such opposition is unfounded. Although the two forms of relief complement each other, they are primarily aimed at different targets. Capital gains relief aids capital formation by inducing savings generally, but is principally directed towards inducing venture or high risk capital, which is essential for the creation of new businesses and the development of new ideas. An investor does not risk capital on an untried venture unless some tax concession is offered. "Without a chance at big winnings, venture capital is a losers' game, as there are inevitably more losses than gains." Eliminating the double taxation of dividends would also encourage savings. More importantly, it would direct the savings of

166. See Buckley & Richert, Return of the Risk-Takers, Venture Capital is Plentiful Once More, Partly Due to Change in Capital-Gains Tax, Wall St. J., June 15, 1979, at 42, col. 1.; Venture Capital Comes Back, NEWSWEEK, June 4, 1979, at 67. But see Capital-Gains Tax Cut to Nowhere, N.Y. Times, Dec. 4, 1979, § A, at 26, col. 1 ("No one knows whether extra capital is flowing into small businesses, but as yet there is no sign that these businesses are expanding plant and equipment." Id.). This comment is surprising in view of the significant increase in venture capital since the enactment of the Revenue Act of 1978. See, e.g., Pappas, Demand for New Stock Issues During '79 Was Greater Than in Previous Six Years, Wall St. J., Jan. 22, 1980, at 37, col. 1. Wallets Open Up For Risky Ventures, U.S. NEWS & WORLD REP., Dec. 24, 1979, at 75.

167. McC Mathias, Jr., To Fuel Investment in Business, N.Y. Times, Mar. 16, 1979, § A, at 31, col. 1. When the 1978 Tax Reform Act lowered the top rate from 49% to 28%, it encouraged the flow of additional savings into prospective high-growth investments. In fact, capital raised by professionally managed venture-capital firms soared to $215 million in 1978 ($165 million of it in the fourth quarter) from $40 million in 1976 and $19 million in 1977. A further increase, to $275 million, is estimated for 1979. As expected, money flowed to high-risk, high growth investments because the lower capital-gains tax rate raised the after-tax rate of return and lowered the risk premium associated with such investment.

Exchange Study, supra note 58, at 18-19.

Large established firms tend to be more conservative than small firms, which are innovative. Wood, Jr., supra note 153. See also Birkelund, Who Would Finance a Xerox Today?, N.Y. Times, July 25, 1976, § 3, at 12, col. 2.


169. In a report of the Securities Industry Association, a survey of 500 top and middle-management executives with security holdings averaging around $100,000 revealed that of five proposals to encourage savings and investments, the elimination of the double taxation of dividends would be most effective. See Forbes, Jr., Will the Politicos Pay Attention?, FORBES, Mar. 3, 1980, at 23. The results of the survey are set forth below.

<table>
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<th>Proposal</th>
<th>Percentage of those who would—</th>
<th>Hypothetical mean investment increase</th>
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<td>Reduce maximum tax on investments</td>
<td>- common stocks</td>
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more cautious investors towards less venturesome equity shares. This investment would insure the maintenance of adequate equity financing ratios, which are required for well balanced financial structures. While both favorable capital gains rates and the elimination of the double taxation of dividends would attract funds to equity shares, thus slightly overlapping, the former more specifically induces funding for high risk situations, while the latter attracts funds to more established dividend paying equities. The two forms of relief should be used in combination, rather than be considered mutually exclusive.

How will we alleviate the effects of tax revenue lost by the enactment of this type of tax relief? Perhaps part of the answer is that the government should eliminate wasteful and unnecessary items from future budgets. Moreover, some lost revenues will return through the expanded capital base and increased business ac-

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<tr>
<td>70% to 50%</td>
<td>55%</td>
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<td>$ 8,100</td>
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<tr>
<td>Defer capital gains tax on reinvested capital</td>
<td>69</td>
<td>42</td>
<td>10,500</td>
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<tr>
<td>Reduce capital gains holding period from 12 months to six</td>
<td>48</td>
<td>39</td>
<td>9,800</td>
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<tr>
<td>Reduce double taxation of dividends</td>
<td>74</td>
<td>67</td>
<td>12,800</td>
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<tr>
<td>Increase dividend exclusion from $100 to $500 for individuals and from $200 to $1,000 for couples</td>
<td>60</td>
<td>54</td>
<td>5,800</td>
</tr>
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Id. (emphasis added).

170. See notes 78-87 supra and accompanying text.
171. Investors seeking capital gains are also often attracted to less venturesome but undervalued stocks, hoping for capital appreciation either through a merger, acquisition, or in the marketplace generally, as the true value of the depressed stock is recognized. This type of investor, however, is usually not a contributor of new capital to mature corporations issuing new shares. If the stock price is truly undervalued, the issuer will rarely float new shares at that low price, because it would tend to further dilute the value of its already outstanding stock.


173. See, e.g., Surrey, supra note 51, which opposes partial integration because of the anticipated revenue loss.

tivity.175 Other revenue raising proposals can counterbalance the effect of the lost revenues;176 one of the present favorites being the imposition of a Value-Added Tax, which may raise billions of dollars annually.177

None of the discussion concerning other current tax proposals is intended to be exhaustive, or necessarily supportive or critical. Instead, it seeks to point out their differing objectives and the ways in which they serve the need of capital formation. Political realities often cause one worthy tax incentive to be traded off against another. Realizing that each of these incentives has its own loyal constituency, the discussion is intended to allay any fears that support for other proposals is in any way inconsistent with advocating relief for corporate dividends. In any event, our capital formation needs can no longer await political compromises. Proposals that exclude up to several hundred dollars of dividend or interest income from taxation will have only a minimal effect on equity funding because even if many investments are attracted, they will undoubtedly be small.178 Moreover, much of the money

177. See Ullman Introduces Value Added Tax Bill That Calls for Sweeping Changes in Code, Wall St. J., Oct. 23, 1979, at 3, col. 2; If the U.S. Ever Switches to VAT—, U.S. News & World Rep., Nov. 5, 1979, at 12. The value-added tax is an “excise tax imposed on the value added at each step of the manufacturing and marketing process. Each firm collects taxes on its sales but deducts those already paid on goods and services it buys.” Id. For a specific example of the operation of the tax, see id. See also Long Seeks to Repeal Social Security Tax and Replace It With a Value-Added Levy, supra note 157, where it is estimated that a 10% value-added tax “would raise $70 billion to $150 billion a year, depending on the extent of exemptions for food, clothing, shelter and other necessities.” Id. Only time will tell whether this suggestion is viable. See generally Pro and Con, Enact a Value-Added Tax?, U.S. News & World Rep., Nov. 12, 1979, at 71; R.I.P. VAT?, Forbes, Dec. 10, 1979, at 13.
178. See Pub. L. No. 96-223 (1980) which amends I.R.C. § 116(a) to increase the dividend/interest exclusion from $100 to $200 ($400 for a joint return). An increased dividend exclusion merely nibbles at partial integration; as such, it will not satisfy corporate equity needs. In addition, doubt has been expressed as to whether such legislation will promote significant amounts of additional savings. See How to Fritter Away $2 Billion, N.Y. Times, Feb. 26, 1980, at 14, col. 1; Forbes, Jr., Incentive For Savings, Forbes, Jan. 21, 1980, at 23. Finally, this approach is not favored because “interest on borrowed capital would still be deductible while dividends on equity capital would not, [thus] so far as the corporation is
attracted by such alternate interest exclusion legislation will be directed towards deposits, which will principally favor the housing industry.\textsuperscript{179}

V. Conclusion

Corporate profits should be taxed the same as other profits—only once. The disparity of treatment that now exists is particularly painful in a period of "bracket creep,"\textsuperscript{180} where inflation involuntarily lifts individuals into higher tax brackets while eroding their purchasing power. Moreover, lest any proposed relief appear to unduly favor the rich, consider that even with integration corporate profits are subject to an individual tax rate of 70\%.\textsuperscript{181}

Ideally, full integration of corporate and individual income taxes would provide the most complete solution. For reasons previously discussed, however, such integration appears impractical.\textsuperscript{182} Instead, some form of partial integration should be instituted. As between the stockholder credit and relief at the corporate level, the stockholder credit is preferable.\textsuperscript{183} Furthermore, although a stock-


\textsuperscript{180} See, e.g., Flint, The biggest tax hike in history, FORBES, Apr. 14, 1980, at 33.

\textsuperscript{181} See notes 119, 131, & 132 supra and accompanying text. Furthermore:

It is shortsighted to dismiss tax policies to stimulate capital formation as breaks for big business. Their main effect is to reduce the capital market wedge, spur capital formation, and increase labor productivity, wages and national income. The combination of inflation and our tax laws has systematically reduced the return to saving and is part of the reason for our lower saving rate than that in many other advanced economies.

\textsuperscript{182} See notes 134-39 supra and accompanying text.

Up to now no country has adopted a system of full tax integration under which a publicly held corporation would be treated essentially as a partnership. Although such a proposal was made in 1966 by Canada's Carter Commission, it was opposed by the Canadian business community and rejected by the Canadian government. Gourevitch, supra note 125, at 110.

\textsuperscript{183} See notes 145-52 supra and accompanying text. See also Evaluation, supra note 50, at 620 ("The shareholder credit method provides greater opportunities for rational and simple treatment of income of United States persons from foreign corporations and income of foreign persons from United States corporations.") McLure, supra note 49, at 581-82.
holder credit for the entire corporate tax allocable to distributions would be more effective and equitable,\textsuperscript{184} political realities point to a partial credit, such as in France and the United Kingdom.

In the final analysis, quite aside from cogent economic arguments for relief, double taxation of corporate profits is patently unfair. It is puzzling why one should have to plead in order to revive an essential source of capital formation—a source whose very malaise stems from the discriminatory treatment by the Internal Revenue Code itself. Instead, the government should justify its singular treatment of corporate profits. Its insatiable need for revenue is not a sufficient reason for the continuation of this policy. The issue is not whether we can afford to sacrifice the bounty of double taxation, but whether, considering the enormous capital needs of the 1980's, can we afford not to.

\textsuperscript{184} But see Gourevitch, supra note 125, at 84. ("It is unclear, however, how much of a revenue loss governments are prepared to tolerate solely on grounds of tax equity.")