UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 68 | Number 4 Article 1

4-1-1990

The Uncertain Case against the Double Taxation of Corporate Income

Jeffrey L. Kwall

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation

Jeffrey L. Kwall, *The Uncertain Case against the Double Taxation of Corporate Income*, 68 N.C. L. Rev. 613 (1990).
Available at: http://scholarship.law.unc.edu/nclr/vol68/iss4/1

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

THE UNCERTAIN CASE AGAINST THE DOUBLE TAXATION OF CORPORATE INCOME

JEFFREY L. KWALL†

Recent commentators have criticized the double taxation of distributed corporate income both as an inequitable tax that imposes greater tax burdens on individual shareholders than other taxpayers and as an inefficient tax that distorts the economic decisions of taxpayers. These scholars have called for "integration," the elimination of a corporate tax on distributed corporate income. Yet, integration certainly would mean loss of tax revenues and would require Congress to maintain tax revenues by alternative methods. In this Article Professor Jeffrey L. Kwall asserts that proponents of integration largely have failed to consider this revenue need constraint. The author questions the prudence of eliminating the double taxation of distributed corporate income because it may jeopardize recent tax reforms aimed at improving the efficiency and equity of our tax system.

I. INTRODUCTION 614
II. DOUBLE TAXATION: PAST, PRESENT, AND FUTURE 618
  A. *Earliest Laws Precluded Double Taxation (1861-1935)* 618
  B. *Creation of Double Taxation Was Inadvertent (1936)* 619
  C. *Structural Buffers Neutralized Double Taxation (1936-1986)* 620
  D. *Double Taxation Emerged (1987-Present)* 623
  E. *Desire to Reduce Double Taxation Must Be Reconciled with Revenue Need* 625
III. CASE AGAINST DOUBLE TAXATION ON EQUITABLE GROUNDS 627
  A. *Undertaxation of Undistributed Income Is Root of Equitable Perspective* 627
  B. *Corporate Tax Is Second-Best Solution to Undertaxation of Undistributed Income* 629

---

† Associate Professor of Law, Loyola University of Chicago School of Law. B.A., Bucknell University; M.B.A., The Wharton School; J.D., University of Pennsylvania Law School. The author wishes to thank Glenn E. Coven, Jr., S. Richard Fine, Alan S. Gratch, and Alvin C. Warren, Jr. for their helpful comments on earlier drafts of this Article. The author expresses gratitude to Dean Nina S. Appel and Loyola University of Chicago School of Law for a research grant that assisted in the preparation of this Article. The author also wishes to thank Paul A. Jorissen, Brigitte M. von Weiss, and Claire P. Murphy, students at Loyola University of Chicago School of Law, for their invaluable assistance.

© Copyright 1989 Jeffrey L. Kwall.

C. *Double Taxation Is Undesirable By-Product of Corporate Tax* 631
IV. CRITIQUE OF EQUITABLE PERSPECTIVE 633
A. *Double Taxation Furthers Progressivity When Tax Rates Are Low* 633
B. *Substituting Higher Tax Rates for Double Taxation Is Likely to Exacerbate Inequities* 638
V. CASE AGAINST DOUBLE TAXATION ON EFFICIENCY GROUNDS 641
A. *Corporate Tax Biases Individuals Against Investing in Corporate Sector* 642
B. *Corporate Tax Biases Corporations Against Utilizing Equity Financing* 643
C. *Corporate Tax Biases Corporations Against Pursuing Profitable Investment Opportunities* 644
VI. CRITIQUE OF EFFICIENCY PERSPECTIVE 645
A. *Fundamental Distortion Associated With Corporate Tax Is Obscured* 645
1. Bias against corporate sector fails to indict corporate tax 646
2. Bias against equity financing fails to indict corporate tax 647
3. Bias against corporate investment is manifestation of taxing income from capital 648
B. *Taxation of Income from Capital Is Root of Distortion Created by Corporate Tax* 649
C. *Efficiency Implications of Alternative Revenue Source Must Be Assessed* 651
D. *Transferring Burdens from Corporate Tax to Individual Income Tax May Be Undesirable* 652
1. Eliminating double taxation sacrifices element that does not distort 652
2. Eliminating element of double taxation that distorts is inconsistent with progressivity 654
3. Multiple broad-based, low rate taxes may further efficiency more than integration 655
VII. CONCLUSION 656

I. INTRODUCTION

Corporate income that is distributed to individual shareholders is taxed twice. Corporate income is subject to the corporate tax when earned.[1] In addi-

1. I.R.C. § 11 (West 1989). *But see id.* § 1363(a) (providing that no corporate tax is imposed

tion, corporate income is subject to the individual income tax when dividends are paid.[2] By contrast, income from all other sources is subject only to the individual income tax.[3] As a result, corporate income distributed as dividends is taxed more heavily than income derived by an individual from any other source.[4]

Commentators frequently criticize the double taxation of corporate income as contrary to the tax policy goals of equity and efficiency.[5] An income tax is equitable when individuals with equal incomes bear equal tax burdens, irrespective of the sources from which their incomes are derived.[6] Critics of double taxation claim that double taxation is inequitable because individuals receiving corporate income bear a heavier tax burden than similarly situated persons deriving their incomes from noncorporate sources.[7] An efficient tax does not change the economic decisions that individuals would make in the absence of the tax.[8] Critics claim that double taxation is inefficient because it causes taxpayers to avoid those alternatives that are subject to double taxation.[9] The implications of double taxation on equity and efficiency have led many to conclude that distributed corporate income should be relieved from the burden of the corporate tax.[10] This form of relief from double taxation is referred to as "integration."[11]

---

on an electing small business corporation; i.e., an "S Corporation"). The primary focus of this Article is on publicly held corporations that do not qualify for S Corporation status.

2. *Id.* § 1. When corporate income is distributed to the corporation's shareholders, it is treated as dividends. *Id.* §§ 301, 316. Dividends are included in the gross income of the recipient. *Id.* § 61(a)(7). If corporate stock is sold before dividends are paid, undistributed corporate income generally will be taxed to the selling shareholder as a gain derived from the sale of stock—assuming that the undistributed income will increase the value, and therefore the price, of the stock. *See id.* §§ 61(a)(3), 1001.

3. *Id.* § 61.

4. Under existing law, the maximum corporate tax rate is 34% and the maximum individual tax rate is 28%. *Id.* §§ 1, 11. *But see id.* §§ 1(g), 11(b)(1) (imposing additional tax on limited range of income). Thus, $1,000,000 of corporate income is subject to a corporate tax of $340,000. If the $660,000 that remains is distributed as dividends, an additional tax of $184,800 is imposed ($660,000 x 28% = $184,800). Thus, total taxes of $524,800 are imposed on $1,000,000 of corporate source income. By contrast, $1,000,000 of income from any other source would be subject only to an individual income tax of $280,000.

5. *See* C. McLure, Must Corporate Income be Taxed Twice? 19-49 (1979); McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532, 534-49 (1975); Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 717, 721-38 (1981).

6. This is the principle of "horizontal equity." R. Musgrave, The Theory of Public Finance 160, 173 (1959).

7. *See* McLure, *supra* note 5, at 535, 537-42; *infra* notes 75-105 and accompanying text.

8. When a tax causes an economic decision to be made differently than it would have been made in the absence of the tax, the taxpayer generally bears a burden in excess of the tax itself. The tax creates an inefficiency because it makes one person worse off without conferring a corresponding benefit on anyone else. *See* R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 291-312 (4th ed. 1984).

9. *See* Warren, *supra* note 5, at 736-38. Specifically, double taxation may bias individuals against investing in the corporate sector, bias corporations against utilizing equity financing, and bias corporations against undertaking profitable investments. *See infra* notes 148-75 and accompanying text.

10. *See, e.g.*, McLure, *supra* note 5, at 558-61, 581-82 (favoring Carter Approach of distribution and allocation); Bravenec, *A Nontraditional Approach to Corporate Integration*, 42 Tax Notes 1381, 1381-82 (1989) (proposing continuation of corporate tax and no corporate deductions for distributions but suggesting that dividend not be included in taxable income of distributee); Steuerle, *A Simplified Integrated Tax*, 44 Tax Notes 335, 335-36 (1989) (proposing no separate tax on distribu-

The case against double taxation as developed in the legal literature is inadequate because it fails to address the requirement that the tax system raise a given amount of revenue.[12] If a need for revenue did not constrain tax reform, efforts to further equity and efficiency logically would lead to the elimination of all taxes. The realistic reform goal, therefore, is to minimize on a system-wide basis the adverse impact on equity and efficiency of a tax system required to generate a given amount of revenue.[13] The need to balance reform against revenue production is particularly pertinent in the current legislative climate.[14]

Relieving corporate income from double taxation would result in a significant loss of revenue.[15] Double taxation, therefore, should be evaluated from a perspective that considers the ramifications of an alternative revenue source. To determine whether integration is desirable, the equity and efficiency gains achieved by eliminating double taxation must be weighed against the equity and efficiency costs incurred by utilizing an alternative revenue source.

Individuals with high incomes most likely will be the primary beneficiaries of integration because these individuals tend to concentrate their wealth in corporate stock and receive a high proportion of the dividend income.[16] To com-

---

tions); Warren, *supra* note 5, at 798-99 (proposing either shareholder credit or dividend deduction for corporation); Warren, *Recent Corporate Restructuring and the Corporate Tax System*, 42 TAX NOTES 715, 719-20 (1989) (proposing shareholder credit).

11. This Article uses the term "integration" to refer to the elimination of the double tax on distributed corporate income in a system in which a discrete corporate tax is applied to undistributed earnings. *See* Warren, *supra* note 5, at 739. Other commentators refer to the foregoing approach as "partial integration" and use the term "integration" to describe a more drastic approach that would eliminate the corporate tax and cause all corporate income, distributed or undistributed, to be taxed immediately to the individual shareholders. *See, e.g.*, McLure, *supra* note 5, at 550-61. This Article uses the term "allocation" to refer to the taxation of all corporate earnings, distributed or undistributed, directly to the individual shareholders in a system that does not utilize a corporate tax. *See* Warren, *supra* note 5, at 739.

Although the double taxation of distributed earnings might be eliminated by removing the burden of either the corporate tax or the individual income tax from such earnings, it generally entails eliminating the corporate tax. *See infra* note 104.

12. Indeed, the legal literature has been critical of justifying double taxation on revenue grounds. *See infra* notes 74 & 212 and accompanying text. By contrast, the economics literature has acknowledged the importance of assessing a reform proposal against a revenue constraint. *See infra* note 213 and accompanying text.

13. *See* Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 98-102 (1976).

14. Congress is facing immense revenue needs under the revised Gramm-Rudman-Hollings legislation. *See* The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, Pub. L. No. 100-119, 101 Stat. 754 (1987). Under the legislation, automatic spending cuts will be triggered unless the budget deficit is reduced to $100 billion in fiscal 1990, $64 billion in fiscal 1991, $28 billion in fiscal 1992, and $0 in fiscal 1993. *See infra* text accompanying notes 70-73.

15. A 1984 Treasury proposal to allow corporations to deduct *half* of the dividends paid to shareholders was estimated by Treasury to lead to a $38 billion revenue loss for fiscal year 1990. 1 TREASURY DEP'T REPORT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 248 (1984); *see also Brady Offers Sermon on Capital Gains Cut and Corporate Integration to the Converted*, 44 TAX NOTES 1311, 1311 (1989) (Treasury official concedes that revenue loss from integration would be about $40 billion).

16. *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 328 (1982) (Integration "would only be accomplished at a substantial cost in . . . progressivity, since a high proportion of dividends flow to high income, wealthy individuals."); JOINT COMM. ON TAXATION, FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 57 (1989) [hereinafter CORPORATE FINANCIAL STRUCTURES] ("high tax rate taxpayers will tend to concentrate their wealth in the form of equity"); *infra* note 107.

pensate for the loss of revenue without dramatically changing the distribution of tax burdens among income classes,[17] the elimination of double taxation would require a tax increase directed at high-income individuals. This tax increase would be likely to take the form of higher tax rates.[18] From an equity standpoint, higher tax rates would exacerbate the differences between individuals who pay tax on all of their income and similarly situated individuals who exploit omissions from the tax base ("preferences") to minimize their tax liabilities. From an efficiency standpoint, higher tax rates would increase the desirability of those economic alternatives that exploit tax preferences and thereby augment the extent to which the tax system distorts economic decisions. Moreover, higher tax rates probably would increase the pressure on Congress to create additional preferences.[19]

Higher individual tax rates and additional preferences would jeopardize the gains in equity and efficiency achieved by recent tax reform efforts. These reform efforts have moved United States law toward a low rate, broad-based income tax.[20] A low rate, broad-based tax system leads to substantial gains in equity and efficiency by reducing the number of preferences that create the potential for different treatment of similarly situated individuals and by moderating the potential benefits associated with those preferences that remain.[21] An increase in individual income taxes would reverse the recent reform trend. Consequently, the extent to which equity and efficiency are compromised by perpetuating double taxation may be a relatively small price to pay to keep the reform effort on its current course.

The purpose of this Article is to demonstrate that double taxation can be reconciled with equity and efficiency when the adverse implications of an alternative revenue source are considered. Part II provides an historical overview of double taxation. Part III states the case against double taxation on equitable grounds. Part IV critiques the equitable perspective on double taxation and demonstrates that substituting higher tax rates for double taxation probably would lead to a more inequitable tax structure. Part V states the case against

---

17. This Article assumes that the existing allocation of tax burdens among income classes reflects the allocation desired by society. *See* McLure, *supra* note 5, at 535 (evaluates double taxation assuming progressivity is desirable social goal). The Tax Reform Act of 1986 was intended to maintain the relative distribution of tax burdens among income classes, which reinforces this view. *See infra* note 51 and accompanying text.

For discussion of the allocation of tax burdens among income classes that should exist as a normative matter, see Bankman & Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CALIF. L. REV. 1905 (1987); Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

18. *See infra* note 129. Economists who have explored the elimination of double taxation in a revenue-neutral manner connect an increase in individual income tax rates to integration. *See, e.g.*, Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. 29, 46-48 (Pt. 2 1978); Fullerton, King, Shoven & Whalley, *Corporate Tax Integration in the United States: A General Equilibrium Approach*, 71 AM. ECON. REV. 677, 683-90 (1981).

19. *See infra* notes 144-47 and accompanying text.

20. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101-44, 100 Stat. 2085, 2096-121; *infra* notes 49-56 and accompanying text.

21. *See infra* text accompanying notes 133-43, 233-40. *See generally* Yorio, *Equity, Efficiency and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395 (1987) (demonstrating gains in equity and efficiency derived from movement toward broad-based, low rate tax system).

double taxation on efficiency grounds. Part VI critiques the efficiency perspective and demonstrates that substituting higher tax rates for double taxation probably would lead to a less efficient tax structure. The Article concludes that equity and efficiency may be better served by refining a low rate, broad-based income tax than by increasing individual taxes to compensate for the revenue loss from integration.

II. DOUBLE TAXATION: PAST, PRESENT, AND FUTURE

Congress has yet to define the relationship between the corporate tax and the individual income tax.[22] Instead, Congress generally has treated the corporate tax and the individual income tax as discrete taxes. As a result, the magnitude of the tax burden on distributed corporate income has evolved largely by chance.

A. Earliest Laws Precluded Double Taxation (1861-1935)

The earliest tax laws treated the corporation as a mere extension of its shareholders. Accordingly, corporate income was taxed only once. From 1861 to 1873, no discrete corporate tax was imposed.[23] Instead, corporate income was included in the tax base of shareholders and subjected immediately to the individual income tax, irrespective of whether dividends were paid.[24]

Although the next round of tax legislation did treat the corporation as a separate entity, these laws continued to ensure that corporate income was not taxed twice. From 1894 to 1895, individuals and corporations paid taxes at a uniform rate of two percent.[25] Dividends, however, were excluded from the individual income tax base.[26] Thus, although corporate income was taxed to the corporation, it was not taxed a second time when dividends were paid.[27]

Beginning in 1913, corporate income was subject to two levels of taxation. For more than two decades, however, a structural limitation on the double taxation of corporate income served as an integral part of the income tax laws. From 1913 to 1935, corporations paid a flat rate tax on their earnings.[28] By

22. J. PECHMAN, FEDERAL TAX POLICY 136 (5th ed. 1987).

23. The first U.S. income tax law was the Act of August 5, 1861, ch. 45, 12 Stat. 292, 309. This Act was superseded by the Act of July 1, 1862, ch. 119, 12 Stat. 432, 473, which, in turn, was superseded by the Act of June 30, 1864, ch. 173, 13 Stat. 223, 281. The 1864 Act, as amended, remained in effect until 1873. *See* Act of 1874, § 3140, 18 Stat. 604. No further tax legislation was enacted until 1894. *See infra* note 25 and accompanying text.

24. Section 117 of the 1864 Act explicitly provided for the inclusion of corporate income in the tax base of the shareholders. Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281-82. Section 117 was upheld in Collector v. Hubbard, 79 U.S. (12 Wall.) 1 (1870).

25. Act of August 27, 1894, ch. 349, §§ 27, 32, 28 Stat. 509, 553, 556.

26. *Id.* § 28, 28 Stat. at 553-54.

27. In 1895, the 1894 Act was declared unconstitutional as a direct tax not properly apportioned among the states. Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 637-38 (1895). No further income taxes were enacted until the sixteenth amendment was ratified. *See* U.S. CONST. amend. XVI (ratified Feb. 25, 1913). Congress did enact an excise tax, however, that applied only to corporations, in the Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112, the constitutionality of which was sustained in Flint v. Stone Tracy Co., 220 U.S. 107, 161 (1910).

28. *See infra* note 32 (Col. 1).

contrast, individuals paid both a flat rate "normal" tax and a progressive rate "additional" tax on their incomes.[29] Dividends, however, were exempt from the individual "normal" tax.[30] Thus, although corporate income was taxed twice, a crude sort of credit was given for the corporate tax when dividends were paid.[31] As a result, corporate income did not bear a significantly greater tax burden than noncorporate income during this period.[32]

B. *Creation of Double Taxation Was Inadvertent (1936)*

Beginning in 1936, dividends were no longer accorded relief from the indi-

---

29. *See infra* note 32 (Cols. 2 & 3).

30. Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167-68; Revenue Act of 1916, ch. 463, § 5(b), 39 Stat. 756, 759-60; Revenue Act of 1918, ch. 18, § 216, 40 Stat. 1057, 1069; Revenue Act of 1921, ch. 136, § 216, 42 Stat. 227, 242-43; Revenue Act of 1924, ch. 234, § 216, 43 Stat. 253, 272; Revenue Act of 1926, ch. 27, § 216(a), 44 Stat. 9, 29; Revenue Act of 1928, ch. 852, § 25(a), 45 Stat. 795, 802-03; Revenue Act of 1932, ch. 209, § 25(a), 47 Stat. 169, 184; Revenue Act of 1934, ch. 277, § 25(a)(1), 48 Stat. 680, 692.

31. The credit was crude for two reasons. First, there was no gross up for the corporate tax paid. *See infra* note 98 (explaining gross up). Second, the corporate tax rate often exceeded the individual normal tax rate. *See infra* note 32 (compare Column 4 to sum of Columns 2 and 3).

32. Maximum corporate tax rates, maximum individual tax rates, and effective tax rates on corporate income distributed as a dividend to an individual in the highest tax bracket during this period were as follows:

Years	(1) Maximum Corporate Tax Rate	(2) Individual Normal Tax Rate	(3) Maximum Individual Additional Tax	(4) Effective Tax Rate on Corporate Income Distributed as a Dividend
1913-15	1.00%	1.00%	6.00%	6.94%
1916	2.00%	2.00%	13.00%	14.74%
1917	6.00%	4.00%	63.00%	65.23%
1918	12.00%	12.00%	65.00%	69.20%
1919-21	10.00%	8.00%	65.00%	68.50%
1922-23	12.50%	8.00%	50.00%	56.25%
1924	12.50%	6.00%	40.00%	47.50%
1925	13.00%	5.00%	20.00%	30.40%
1926-27	13.50%	5.00%	20.00%	30.80%
1928	12.00%	5.00%	20.00%	29.60%
1929	11.00%	4.00%	20.00%	28.80%
1930-31	12.00%	5.00%	20.00%	29.60%
1932-33	13.75%	8.00%	55.00%	61.19%
1934-35	13.75%	4.00%	59.00%	64.64%

Tariff Act of 1913, ch. 16, §§ II(A)1, II(A)2, 38 Stat. 114, 166-67; Revenue Act of 1916, ch. 463, §§ 1, 10, 39 Stat. 756, 756-57, 765-66; Revenue Act of 1917, ch. 63, §§ 1, 2, 4, 40 Stat. 300, 300-301, 302; Revenue Act of 1918, ch. 18, §§ 210, 211, 230, 40 Stat. 1057, 1062-64, 1075-76; Revenue Act of 1921, ch. 136, §§ 210, 211, 230, 42 Stat. 227, 233-37, 252; Revenue Act of 1924, ch. 234, §§ 210, 211, 230, 43 Stat. 253, 264-67, 282; Revenue Act of 1926, ch. 27, §§ 210, 211, 230, 44 Stat. 9, 21-23, 39; Revenue Act of 1928, ch. 852, §§ 11, 12, 13, 45 Stat. 791, 795-97; Joint Resolution Reducing Rates of Income Tax for 1929, ch. 2, 46 Stat. 47 (1929) (reducing rates only for 1929); Revenue Act of 1932, ch. 209, §§ 11-13, 47 Stat. 169, 174-77; Revenue Act of 1934, ch. 277, §§ 11-13, 48 Stat. 680, 684-86. For tax rates for years after 1935, see *infra* note 39.

For a discussion of the formula used to compute the effective tax rate on corporate income distributed as a dividend, see Kwall, *Subchapter G of the Internal Revenue Code: Crusade Without a Cause?*, 5 VA. TAX REV. 223, 229 n.28 (1985).

vidual normal tax.[33] The impetus for the Revenue Act of 1936 was the perceived undertaxation of undistributed corporate income. On March 3, 1936, President Roosevelt suggested that Congress enact a tax on undistributed corporate income to compensate for the omission of undistributed profits from the base of the progressive individual additional tax.[34] The President apparently believed that distributed corporate income could be taxed adequately under the individual income tax. Thus, the President also proposed that the regular corporate tax be repealed and that dividends be included in the individual normal tax base. The effect of the President's proposals with respect to distributed profits, therefore, was to substitute the individual normal tax for the old corporate tax. Quite clearly, the intention was not to augment the burdens on distributed corporate income, since existing law was regarded as taxing dividends too heavily.[35]

The House subsequently passed a tax bill that adopted all of the President's proposals.[36] The Senate, however, passed a bill that entailed a less stringent undistributed profits tax than the House bill. In addition, the Senate bill retained the existing corporate tax, yet failed to exempt dividend income from the individual normal tax.[37] Ultimately, the bill that was enacted included an undistributed profits tax that was closer to the House version. As a concession to the Senate, however, the new law both retained the existing corporate tax and failed to exempt dividend income from the individual normal tax.[38] Thus, for the first time in history, distributed corporate income was subjected not only to the corporate tax and the individual additional tax, but also to the individual normal tax. Although the inclusion of dividend income in the individual normal tax base was but an incidental element of the 1936 Act, it was the seed from which double taxation germinated.

C. *Structural Buffers Neutralized Double Taxation (1936-1986)*

For the next five decades, corporate-source income did not bear a significantly greater burden than other forms of individual income, notwithstanding that dividend income was included in the individual normal tax base. The potential burdens of double taxation were buffered during this period by several structural features: namely, high individual tax rates, lower corporate tax rates, and preferential treatment of capital gains.

The first tax on corporate-source income (the corporate tax) did not cause corporate income to bear a burden significantly greater than this income would have borne had it been subjected only to the individual income tax because individual tax rates were quite high during most of this period. From 1936 to 1980, the maximum individual tax rate ranged from seventy percent to ninety-four

33. Revenue Act of 1936, ch. 690, 49 Stat. 1648.

34. For the text of President Roosevelt's historic address, see 1939-1 C.B. 667.

35. *See* A. BUEHLER, THE UNDISTRIBUTED PROFITS TAX 22 (1937) ("The existing law was regarded as taxing too heavily the dividends going to stockholders who really needed them.").

36. For a detailed discussion of the House bill, see *id.* at 24-28.

37. For a detailed discussion of the Senate bill, see *id.* at 29-30.

38. Revenue Act of 1936, ch. 690, 49 Stat. 1648; *see* A. BUEHLER, *supra* note 35, at 30-31.

percent.[39] By virtue of these high individual tax rates, much of the income absorbed by the corporate tax during this period would have been absorbed by the individual income tax had the corporate tax not been imposed.[40] In 1981, the maximum individual tax rate declined to fifty percent.[41] The corporate tax base, however, was curtailed dramatically at the same time.[42] Consequently, the first-level tax still did not impose a significant burden.

39. Maximum corporate tax rates, maximum individual tax rates, and effective tax rates on corporate income distributed as a dividend to an individual in the highest tax bracket during this period were as follows:

Years	(1) Maximum Corporate Tax Rate	(2) Maximum Individual Tax Rate	(3) Effective Tax Rate on Corporate Income Distributed as a Dividend
1936-1937	15.00%	79.0%	82.15%
1938-1939	19.00%	79.0%	82.46%
1940	22.10%	79.0%	83.64%
1941	31.00%	81.0%	86.89%
1942-1943	40.00%	88.0%	92.90%
1944-1945	40.00%	94.0%	96.40%
1946-1947	38.00%	86.4%	91.57%
1948-1949	38.00%	82.1%	88.90%
1950	42.00%	84.4%	90.95%
1951	50.75%	91.0%	95.57%
1952-1953	52.00%	92.0%	96.16%
1954-1963	52.00%	91.0%	93.76%
1964	50.00%	77.0%	87.50%
1965-1978	48.00%	70.0%	84.40%
1979-1980	46.00%	70.0%	83.80%
1981-1985	46.00%	50.0%	73.00%

Revenue Act of 1934, ch. 277, §§ 11-13, 48 Stat. 680, 684-86; Revenue Act of 1935, ch. 829, §§ 101-02, 49 Stat. 1014, 1014-15; Revenue Act of 1938, ch. 289, §§ 11-13, 52 Stat. 447, 452-55; Second Revenue Act of 1940, ch. 757, § 101(a), 54 Stat. 974 (amending I.R.C. § 13(b) (1939)); Revenue Act of 1941, ch. 412, §§ 101, 103(a), 104(a), 55 Stat. 687, 688-89, 692-93 (amending I.R.C. §§ 12(g), 13(b), 15 (1939)); Revenue Act of 1942, ch. 619, §§ 102, 103, 105(b), 56 Stat. 798, 802-03, 805-06 (amending I.R.C. §§ 11, 12(b), 13(b), 15 (1939)); Individual Income Tax Act of 1944, ch. 210, §§ 3, 4(a), 58 Stat. 231, 231-32 (amending I.R.C. §§ 11, 12(g) (1939)); Revenue Act of 1945, ch. 453, §§ 101(c), 121(a), 59 Stat. 556, 558, 568 (amending I.R.C. §§ 12(g), 15(b) (1939)); Revenue Act of 1948, ch. 168, § 101, 62 Stat. 110, 111 (amending I.R.C. § 12(c) (1939)); Revenue Act of 1950, ch. 994, §§ 101, 121(a), 64 Stat. 906, 910-11, 914-15 (amending I.R.C. §§ 12(c), 13, 15 (1939)); Revenue Act of 1951, ch. 521, §§ 101(b), 121(a), 121(f), 65 Stat. 452, 459-61, 465-66, 468 (amending I.R.C. §§ 12(f), 13, 15 (1939)); Revenue Act of 1964, Pub. L. No. 88-272, §§ 111, 121, 78 Stat. 19, 19-23, 25; Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763, 2820; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-82.

For a discussion of the formulae for computing the effective tax rate on corporate income distributed as a dividend during this period, see Kwall, *supra* note 32, at 240 n.84, 249 n.121.

40. The corporate tax imposed a somewhat greater burden in the case of individual shareholders taxed at lower marginal rates.

41. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-82.

42. The 1981 Act expanded the tax benefits associated with accelerated depreciation and the investment tax credit to the point at which "many firms were expected to be made completely nontaxable." Minarik, *How Tax Reform Came About*, 37 TAX NOTES 1359, 1364 (1987); *see* CONGRESSIONAL BUDGET OFFICE, REVISING THE CORPORATE INCOME TAX 24-25 (1985). These benefits were curtailed to some extent even prior to the 1986 Act. *See id.* at 25-26.

The second tax on corporate income (the individual income tax) often imposed little additional burden on corporate income during the period from 1936 to 1986. Because corporate income is not subject to the individual income tax until dividends are paid, the second tax on corporate income often can be deferred indefinitely.[43] The ability to defer the second tax reduced its cost in present value terms because corporate tax rates during this period were lower than individual tax rates.[44] The ability to defer the second tax also facilitated the conversion of potential dividend income to capital gains when shareholders sold their stock before dividends were paid.[45] Because capital gains were taxed at lower rates than dividend income,[46] the individual tax imposed on corporate-source income often was less than the individual tax imposed on income from other sources. In sum, high individual tax rates, lower corporate rates, and preferential treatment of capital gains generally precluded corporate income from bearing a burden greater than that imposed on noncorporate income.[47]

---

43. The corporate level penalty taxes, which apply primarily to closely held corporations, limit the ability to defer the second tax on corporate income. *See* Kwall, *supra* note 32, at 223-58. Many closely held corporations can avoid double taxation entirely by electing S Corporation status. *See* I.R.C. §§ 1361-1378 (West 1989). This Article focuses primarily on publicly held corporations that generally are outside of the scope of the penalty tax provisions. *But see id.* § 532(c) (imposing accumulated earnings tax on corporations formed for the purpose of avoiding income tax with respect to shareholders).

44. The maximum corporate tax rate always was less than the maximum individual tax rate during this period. *See supra* note 39, Cols. 1 & 2).

A benefit is derived from deferral only if the returns on the deferred income are taxed at a lesser rate than the rate of tax that would be imposed on the deferred income if deferral were not possible. Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499, 501 (1986). For example, assume that a corporation has $1,000 of earnings after paying the corporate tax, the corporate tax rate is 30%, the individual tax rate is 50%, and both the corporation and its shareholders can earn a pretax return of 10% from investments. If the corporation invests the $1,000, it would earn $100 on which it would pay a tax of $30. If the corporation then paid a dividend of the $1,070 that remained, the individual shareholder would pay a tax of $535 on the dividend. Thus, the shareholder would net $535 after all taxes were paid. By contrast, if the corporation paid a dividend of the $1,000 rather than investing it, the shareholder would pay a tax of $500 and have $500 to invest. When the shareholder invests the $500, the shareholder would earn $50 on which the shareholder would pay a tax of $25. Thus, the shareholder would net $525 after all taxes were paid. Because the individual tax rate exceeds the corporate tax rate in this example, total tax liabilities are reduced where the earnings are accumulated in the corporation and the returns are taxed at the lower corporate tax rate. *See generally* Canellos & Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983) (illustrating the implications of the time value of money).

45. *Compare* I.R.C. § 61(a)(7) (West 1989) (dividends) *with id.* § 61(a)(3) (gains derived from dealings in property). The amount of income derived from a sale of stock is quantified by offsetting the consideration received by the taxpayer's adjusted basis in the stock. *Id.* § 1001. The gain on a sale of stock generally includes undistributed corporate earnings because those earnings add to the value of corporate stock. *See* C. MCLURE, *supra* note 5, at 20 n.3. *But see* Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1, 3 (1981) (claiming that each dollar of retained earnings increases the value of equity by one dollar minus the individual tax rate).

Under certain circumstances, conversion facilitates a reduction in income by virtue of the opportunity to offset potential income by basis. The most obvious instance is when stock is held until death at which time the decedent's successor takes a fair-market-value basis in the decedent's stock. I.R.C. § 1014 (West 1989).

46. JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 178 (1987) [hereinafter GENERAL EXPLANATION OF THE 1986 ACT]. Although the same rates applied to both capital gains and other income, only 40%-50% of long-term capital gain were included in taxable income by virtue of a capital gain deduction allowed to individuals. *Id.*

47. Indeed, corporate-source income often was burdened less heavily than other sources of income during this period, causing some to view the double taxation of corporate income as a shelter

D. Double Taxation Emerged (1987-Present)

The structural attributes that minimized the potential burdens of double taxation for half a century were modified dramatically by the Tax Reform Act of 1986 ("1986 Act").[48] The 1986 Act significantly increased the burdens imposed by each of the two taxes that apply to corporate-source income. As a result, double taxation currently causes corporate income to bear a much greater tax burden than income from other sources.

The 1986 Act was the product of a melding of two very different interest groups. One group was sympathetic to the arguments of liberal reformers that a tax code ridden with loopholes was inequitable and inefficient.[49] The other group was sympathetic to the conservative advocates of supply side economics who argued that economic growth would be served by dramatically reducing tax rates. The two groups came together to produce legislation that was intended to raise the same amount of revenue as prior law.[50] In addition, although an objective of the new legislation was to redistribute tax burdens among individuals within each income class in a more fair manner, it was not intended to change the relative distribution of the total tax burden among income classes.[51]

As a general matter, the rate-reduction and base-broadening strategy of the 1986 Act furthered equity and efficiency.[52] The 1986 Act eliminated a myriad of individual tax preferences that had crept into the law[53] and reduced the maximum individual tax rate to a seventy-year low of twenty-eight percent.[54] In

---

rather than a burden. *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION ON TAXATION AND NEW YORK STATE BAR ASSOCIATION TAX SECTION, CORPORATE TAX REFORM: A REPORT ON THE INVITATIONAL CONFERENCE ON SUBCHAPTER C 135 (1988) [hereinafter ABA & NYSBA].

48. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 601-47, 701, 100 Stat. 2085, 2249-94, 2320.

49. *See* J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH xv (1987).

50. In other words, the new law was intended to be "revenue neutral." J. BIRNBAUM & A. MURRAY, *supra* note 49, at 59; THE PRESIDENT'S TAX PROPOSALS FOR FAIRNESS, GROWTH, AND SIMPLICITY 8 (1985) [hereinafter TREASURY II].

51. *See* J. BIRNBAUM & A. MURRAY, *supra* note 49, at 289 ("[The 1986 Act] made no fundamental changes in the distribution of the tax burden among income groups."); TREASURY II, *supra* note 50, at 8 ("The President's proposals would result in roughly the same percentage of total revenues contributed by each income class as under current law—except for the poor who would pay a much smaller percentage."). The 1986 Act, however, did shift $120 billion of the tax burden from individuals to corporations. J. BIRNBAUM & A. MURRAY, *supra* note 49, at 288.

52. *See generally* J. BIRNBAUM & A. MURRAY, *supra* note 49, at 288-89 ("In the long run, few experts doubted that lower tax rates would improve the efficiency of the economy and boost the chances for economic growth. . . . Reform narrowed the enormous inequities that permeated the existing system. . . . It did make it more likely that individuals and corporations with similar incomes would pay similar taxes."); Yorio, *supra* note 21, at 438-40 (delineating gains in equity and efficiency).

53. From 1974 to 1986, tax preferences increased from 50% of total tax revenues to more than 100% of total tax revenues. Leonard, *Perspectives on the Tax Legislature Process*, 38 TAX NOTES 969, 971 (1988). The 1986 Act reduced the level of tax preferences in 1988 by $193 billion. *Tax Reform Act Reduced Tax Expenditures by $193 Billion, Say Treasury Analysts*, 43 TAX NOTES 169 (1989); *see* Yorio, *supra* note 21, at 430-32 (delineating deductions, credits, and exclusions that were curtailed by the 1986 Act).

54. *See* I.R.C. § 1 (West 1989). Although not expressly stated in the statute, a marginal tax rate of 33% applies to individual income ranging from approximately $70,000 to $200,000 in the case of married individuals filing a joint return. *See id.* § 1(g). The purpose of this provision is to phase out the benefits derived from the 15% rate that applies approximately to the first $30,000 of income and the exemptions allowed for individuals and their dependents. Its effect is to increase the

addition, the corporate tax base was expanded dramatically[55] and the corporate tax rate was reduced to thirty-four percent (six percentage points higher than the maximum individual rate).[56] Although the legislative history to the 1986 Act reveals some concern about setting a corporate rate below the individual tax rate,[57] little, if any, attention was directed at the implications of the converse, a corporate rate higher than the individual rate.

By continuing to view the corporate tax and the individual income tax as discrete taxes, Congress inadvertently increased the relative tax burden on corporate-source income to almost twice the burden imposed on other income.[58] The first tax on corporate-source income no longer can be dismissed as insignificant by virtue of the expanded corporate tax base and the revised rate structure.[59] Indeed, now that the maximum corporate rate exceeds the maximum individual rate, the first tax alone on corporate income often will be greater than the single tax imposed on income from other sources.

The burden imposed by the second tax on corporate income also increased dramatically as a result of the rate structure that emerged from the 1986 Act. Although the second tax on corporate income still is deferred until corporate earnings are distributed,[60] the ability to utilize the deferral feature to reduce the magnitude of the second tax has been curtailed substantially. Deferral of the second tax no longer confers an economic benefit in present value terms because the corporate tax rate now generally exceeds the individual tax rate.[61] In addi-

---

average tax rate to 28% with respect to those individuals with incomes above approximately $200,000.

55. *See* Yorio, *supra* note 21, at 434-35 (explaining that exclusions, credits, and deductions were curtailed, while alternative minimum tax was expanded). The base broadening resulted in a corporate tax increase of roughly $120 billion, the largest corporate tax increase in history. H.R. CONF. REP. NO. 99-841, 99th Cong., 2d Sess. 884 (1986). In effect, however, these changes simply restored the corporate tax to its pre-1981 level. *See* Leonard, *A Pragmatic View of Corporate Integration*, 35 TAX NOTES 889, 893 (1987).

56. The first $50,000 of corporate income is taxed at 15% and the next $25,000 is taxed at 25%. Corporate income ranging from $100,000 to $335,000 is taxed at a marginal rate of 39% to eliminate the benefit derived from the lower rates on the first $75,000. I.R.C. § 11(b)(1) (West 1989). The 39% corporate rate is analogous to the 33% marginal rate that applies to a limited range of individual income. *See supra* note 54.

57. *See* J. BIRNBAUM & A. MURRAY, *supra* note 49, at 59; Minarik, *supra* note 42, at 1367-68 ("[Treasury] lowered the corporate rate to two percentage points below the top individual rate, but hesitated to go further because of a possible inducement to incorporate hitherto unincorporated businesses to cut taxes with the lower corporate rate.").

58. *See supra* note 4; *see also* Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C.L. REV. 839, 875 (1988) ("Clearly, Congress did not grasp the potential consequences of the 1986 and 1987 Acts on the taxation of corporations and their shareholders, nor did it intend these results."). Although the original proposals from which the 1986 Act emerged provided limited relief from double taxation for dividend income, the prospect of such relief was dismissed early in the legislative process largely because of the revenue loss that would have resulted from such relief. *See* J. BIRNBAUM & A. MURRAY, *supra* note 49, at 87; Minarik, *supra* note 42, at 1365.

59. *See supra* text accompanying notes 39-42.

60. *See supra* text accompanying note 43.

61. When corporate income is taxed at a rate in excess of the individual tax rate, it becomes more costly to defer the second tax than to incur the second tax immediately. For example, assume that the corporate tax rate and the individual tax rate in the example set forth, *supra* note 44, are reversed; in other words, that the corporate tax rate is 50% and that the individual tax rate is 30%. If the corporation invests the $1,000, it would earn $100 on which it would pay a tax of $50. If the

tion, the 1986 Act repealed the individual capital gains deduction as part of its base-broadening strategy.[62] Consequently, the second tax on corporate income generally will not be reduced by converting potential dividend income to capital gains.[63] For the first time in history, therefore, the double taxation of corporate income often causes such income to bear a tax burden substantially greater than the single tax imposed on income from other sources.[64]

E. Desire to Reduce Double Taxation Must Be Reconciled With Revenue Need

The overtaxation of distributed corporate income is likely to command attention in the near future. For instance, the 1986 Act explicitly instructed the Treasury to prepare a study of the corporate tax provisions.[65] That study is likely to address the magnitude of double taxation after tax reform. In addition, congressional hearings conducted in 1989 considered integration as a possible

---

corporation then paid a dividend of the $1,050 that remained, the individual shareholder would pay a tax of $315 on the dividend. Thus, the shareholder would net $735 after all taxes were paid. By contrast, if the corporation paid a dividend of the $1,000 rather than investing it, the shareholder would pay a tax of $300 and have $700 to invest. When the shareholder invests the $700, the shareholder would earn $70 on which the shareholder would pay a tax of $21. Thus, the shareholder would net $749 after all taxes were paid. Because the corporate tax rate exceeds the individual tax rate, total tax liabilities are reduced when the earnings are distributed and the subsequent returns are taxed at the lower individual tax rate.

62. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2216.

63. Capital gain treatment still will be desired by those taxpayers with capital losses. *See* I.R.C. § 1211(b) (West 1989). Moreover, converting potential dividend income to gain from the sale of property will be beneficial to those taxpayers whose stock basis includes part of the earnings attributable to such stock. *See, e.g., id.* § 1014.

Congress considered restoring preferential treatment to capital gain income in 1989. *See* Revenue Reconciliation Bill of 1989, H.R. 3299, §§ 11951-11953 (passed by House of Representatives Oct. 5, 1989) (providing for reduction in capital gains tax for noncorporate taxpayers); *Taxwriters Moving Slowly But Surely on Capital Gains*, 44 TAX NOTES 623, 623 (1989). The legislation that ultimately was enacted did not address capital gains. Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, — Stat. —.

64. An alternative view is that corporate income still is not overtaxed relative to other sources of income. *See* Leduc & Gordon, *Two Visions of Subchapter C: Understanding the 1986 Reform Act and the 1987 Revenue Act and Predicting the Near Future*, 46 N.Y.U. TAX INST. 37-1 (1988). From this perspective, the corporate tax is minimized by virtue of the ability of corporate taxpayers to gravitate to the noncorporate sector and to eradicate the corporate tax base through excessive debt financing. *Id.* at 37-9 to 37-12. For a discussion of the extent to which these factors indict double taxation, see *infra* text accompanying notes 177-89. This alternative view also highlights that the shareholder level tax is reduced in certain cases. *See* I.R.C. § 1014 (West 1989) (step up in basis of appreciated corporate stock at death of shareholder occurs without imposition of any tax on gain attributable to undistributed corporate income); CORPORATE FINANCIAL STRUCTURES, *supra* note 16, at 14 (32.2% of corporate equity owned by private pension funds, state and local government retirement plans, charitable organizations, foundations, and private trusts not subject to shareholder level tax); Leduc & Gordon, *supra*, at 37-14 to 37-16 (corporations increasingly have avoided or limited second-level taxes on individuals by substituting stock redemption plans for ordinary dividend distributions).

65. Tax Reform Act of 1986, Pub. L. No. 99-514, § 634, 100 Stat. 2282. It is anticipated that the Treasury study will focus on debt/equity issues and choice of entity issues, both of which are believed to indict double taxation. Matthews & Moriarty, *Subchapter C Study on Hold Until Treasury Tax Vacancy Filled*, 42 TAX NOTES 1426, 1426 (1989); *see infra* text accompanying notes 157-69. The House Subcommittee on Select Revenue Measures also is studying whether modifications should be made to the corporate tax provisions. *Rostenkowski Announces Select Revenue Measures Subcommittee Agenda*, 42 TAX NOTES 1014, 1014 (1989).

response to the problems posed by the excessive utilization of debt financing.[66] Most recently, Treasury officials have been arguing in favor of integration.[67] Before interest in relieving the overtaxation of corporate income gathers momentum,[68] it is critical to consider the revenue implications of eliminating double taxation.

It is widely accepted that the elimination of double taxation would entail a significant loss of revenue.[69] The revenue implications of tax reform have taken on increased significance in recent years. Prior to the current decade, taxing and spending decisions were not formally connected to one another. Since 1980, however, a reconciliation process has been implemented which mandates that tax legislation accommodate the priorities of the budget.[70] The enactment of the revised Gramm-Rudman-Hollings statute in 1987 strengthened the reconciliation process by mandating automatic spending cuts unless the budget deficit falls below predetermined levels.[71] Congress now faces immense pressure to raise revenue in light of the budget goals established by the revised Gramm-Rudman-Hollings statute.[72] As a result, a proposal involving a significant loss of revenue, such as integration, can be expected to be accompanied by a tax increase to compensate for the revenue loss.[73]

---

66. CORPORATE FINANCIAL STRUCTURES, *supra* note 16, at 82-103.

67. *See Brady Offers Sermon on Capital Gains Cut and Corporate Integration to the Converted*, *supra* note 15, at 1311 (reporting that Treasury Secretary endorsed working toward the goal of tax integration in Sept. 12, 1989 speech to American Business Conference); *Still Out of the Loop: Treasury Miffed Over Bentsen's Fait Accompli*, 45 TAX NOTES 139, 140 (1989) (reporting Assistant Treasury Secretary Gideon's statements that double taxation places United States business at a competitive disadvantage and that Treasury is beginning a study on integration).

68. Popular support for integration may remain limited. The public generally favors the corporate tax because of the perception that it only burdens big business. *See* Leonard, *supra* note 55, at 895; Sheppard, *Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 646 (1985). Corporate management historically has been opposed to any relief mechanism that might create additional pressures to pay dividends rather than to utilize accumulations in the business. Leonard, *supra* note 55, at 895; Minarik, *supra* note 42, at 1367; Sheppard, *supra*, at 645. The limited number of legislative efforts in recent years to minimize the burden of double taxation have been dismal failures. *See* Leonard, *supra* note 55, at 894.

69. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 399; Leonard, *supra* note 55, at 894-95; *supra* note 15.

70. A 1980 budget resolution instructed the tax writing committees to increase revenues by $4.2 billion in fiscal 1981. H.R. CONF. REP. No. 1051, 96th Cong., 2d Sess. 3 (1980). For a discussion of history of the reconciliation process, see Leonard, *supra* note 53, at 973.

71. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, Pub. L. No. 100-119, 101 Stat. 754 (1987); *see* Leonard, *supra* note 53, at 974.

72. *See Administration Continues Retreat from 'No-New-Taxes' Pledge*, 43 TAX NOTES 1063 (1989); Minarik, *supra* note 42, at 1372; *Tax Writers Moving Slowly But Surely on Capital Gains*, *supra* note 63, at 624-25 (quoting following language of letter to colleagues from nine members of Ways and Means Committee: "Our continuing massive budget deficit will require us to raise substantial revenues, probably as soon as next year.").

73. *See, e.g.*, Steuerle, *Fair Budget Policy, Bad Tax Policy*, 44 TAX NOTES 455, 455 (1989) (stating that since 1986 Act, "Congress has operated under a set of rules that typically require increased revenue to accompany expenditure increases"); *Bentsen to Treasury: Take a (Useful) Stand on Section 89*, 43 TAX NOTES 779, 779 (1989) (reporting that Senate Finance Committee Chairman castigated Treasury for failing to recommend ways of offsetting revenue loss from changes Treasury supports to I.R.C. § 89); *Rostenkowski Sets Ground Rules for Members' Amendments to Tax Bill*, 44 TAX NOTES 1063, 1063 (1989) (paraphrasing House Ways and Means Committee Chairman's statement to committee members that no amendments to 1989 Tax Bill "will be entertained that lose revenue and are not accompanied by an offsetting revenue-raising proposal").

The legal literature generally has not accorded significant attention to the revenue implications of double taxation. Indeed, critics of double taxation argue that revenue need can justify any method of taxation regardless of how odious its effect might be.[74] The real question, however, is whether the effect of double taxation is objectionable relative to the effect of an alternative method of raising revenue.

To evaluate the case against double taxation, the remainder of this Article will articulate and critique the two perspectives from which double taxation historically has been condemned. The tendency to appraise the impact of double taxation solely upon the goals of equity and efficiency, without consideration of a revenue constraint, has distracted attention from the possibility that double taxation may extract revenue in a more desirable manner than an alternative revenue source.

III. Case Against Double Taxation on Equitable Grounds

The equitable principle that individuals with equal incomes should bear equal tax burdens appears inconsistent with any corporate tax, let alone double taxation of corporate income. It is only because the individual income tax fails to reach *undistributed* corporate income that the corporate tax is accepted as a second-best approach to achieving equity. The double taxation of *distributed* corporate income is regarded as an undesirable by-product of this second-best approach. Those who accept the corporate tax as a mechanism for correcting the undertaxation of undistributed corporate income favor integration as a means for eliminating the overtaxation of distributed corporate income.

A. Undertaxation of Undistributed Income Is Root of Equitable Perspective

The income tax laws of the United States reflect the philosophy that government expenditures are to be financed based on the ability of the individual members of society to pay.[75] Income is the index on which ability to pay is gauged in the United States.[76] The fairness criterion that emerges from a system in which income measures ability to pay is that all individuals with equal in-

74. *See, e.g.*, Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, 1965 WIS. L. REV. 576, 578-79 ("Similarly disturbing is the opinion offered by some experts . . . that the corporate tax can be defended on the ground that it is a good source of revenue—a view that . . . apparently is based upon some well concealed antidemocratic value judgments.").

75. Two primary philosophies exist as to how societal wants and needs should be matched with tax revenues. Under a "benefits approach," taxation is related to the benefits received from public expenditures. Under an "ability-to-pay approach," contributions for public expenditures are based on an individual's resources rather than benefits derived. The United States has adopted an ability-to-pay approach. *See* R. MUSGRAVE, *supra* note 6, at 61-115.

76. Income and consumption are both valid indices of equality. *See id.* at 161-64. Much disagreement exists about which index is preferable to utilize for taxing purposes. *See* Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

comes should be taxed alike, irrespective of the sources from which their incomes are derived.[77] The manner in which income is defined is of critical importance in assessing the equitable implications of an income tax.

Although income often is conceptualized in terms of payments received, the concept of income on which United States tax law is based looks to actual and potential purchasing power.[78] The Haig-Simons economic definition of income[79] is the ideal to which the income tax base is compared. According to the Haig-Simons definition, income is the sum of consumption and the increase in net wealth between two points in time.[80]

The Haig-Simons income definition is somewhat broader than the definition utilized by the United States tax law. Most significantly, existing law departs from the Haig-Simons principle that asset appreciation is income when it occurs.[81] Instead, the tax law generally requires a sale or other disposition ("realization") before asset appreciation is included in the individual income tax base.[82] Thus, under United States law, an individual does not pay tax on asset appreciation until the individual sells the appreciated property.

The realization requirement operates to insulate owners of corporate stock from more than conventional asset appreciation. Because the tax law treats corporations as entities separate from their owners,[83] accumulated operating in-

77. The principle of horizontal equity, that taxpayers in similar positions should be treated equally, is "perhaps the most widely accepted principle of equity in taxation." R. MUSGRAVE, *supra* note 6, at 160.

78. *See* D. BRADFORD, UNTANGLING THE INCOME TAX 15 (1986) (contrasting "factor payment" view that income is what is received with "uses" view that income is to be measured by the sum of consumption and additions to wealth, the latter view being generally accepted as the basis for taxation in the United States).

79. R. HAIG, THE FEDERAL INCOME TAX 7 (1921); H. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

80. A more complete definition is as follows:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain *to* someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

H. SIMONS, *supra* note 79, at 50.

Economists question the value of the Haig-Simons tax base in comparing tax burdens of different individuals due to differences in tastes and abilities among individuals. *See* Atkinson & Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55, 70-73 (1976); Feldstein, *supra* note 13, at 82-83, 87-89.

81. *See* H. SIMONS, *supra* note 79, at 99-100 ("Strictly speaking, the calculation of income demands complete reevaluation of all assets and obligations at the end of every period.").

82. A "realization event"—a sale or other disposition—must occur before asset appreciation is reflected in income. I.R.C. §§ 61(a)(3), 1001 (West 1989). For an exception to this rule in the case of certain options and futures contracts, see *id.* § 1256. For a recent proposal to curtail substantially the realization requirement, see Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986). For more specific proposals to curtail realization with respect to publicly traded corporate stock, see ABA & NYSBA, *supra* note 47, at 73; Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Thuronyi, *The Taxation of Corporate Income—Proposal for Reform*, 2 AM. J. TAX POL'Y 109 (1983).

83. I.R.C. § 11 (West 1989). *But see id.* §§ 1361-1378 (an S Corporation is treated in many

come simply adds to the value of each shareholder's stock.[84] Accumulated corporate income is not included in the individual tax base until the individual shareholders either receive dividends[85] or sell their stock.[86] Thus, in addition to conventional asset appreciation, operating income generated by a corporation will be shielded from the individual income tax by the realization requirement.

The omission of corporate operating income from the individual income tax is a source of inequity even in a tax system that imposes a realization requirement. Short of eliminating the realization requirement,[87] the most direct way of remedying this inequity would be to allocate undistributed corporate income proportionately among the individual shareholders, with each shareholder including a portion of such income on his individual tax return.[88] Needless to say, if an allocation approach were adopted, the equitable ideal that all individuals with equal incomes bear equal tax burdens would not be furthered by imposing a separate tax on corporations.[89] Because of its burdensome nature, however, the allocation approach is not considered to be a viable option.[90] Thus, unless a tax that simulates the burdens of the individual income tax is imposed on undistributed corporate income, the equitable goal of causing all individuals with equal incomes to bear equivalent tax burdens will be violated.

B. Corporate Tax Is Second-Best Solution to Undertaxation of Undistributed Income

In the absence of a corporate tax, the ability to defer the taxation of undistributed corporate income until dividends are paid would cause undistributed corporate income to bear a lesser burden than other forms of income.[91] Conse-

---

respects as a conduit). For an insightful commentary on the arbitrary manner in which the entity/conduit distinction is made under United States tax law, see Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13 (1972).

84. *See supra* note 45.

85. I.R.C. § 61(a)(7) (West 1989).

86. *Id.* §§ 61(a)(3), 1001.

87. Taxing undistributed corporate income to shareholders is less extreme than eliminating the realization requirement in its entirety. *See* J. BALLENTINE, EQUITY, EFFICIENCY AND THE U.S. CORPORATION INCOME TAX 7 (1980) ("While there are good reasons for taxing capital gains only when they have been realized . . . these reasons do not apply to [corporate] retentions."); Warren, *supra* note 5, at 741 n.65 ("[T]he abandonment of the realization criterion . . . would go a step beyond allocation, which retains the realization concept in taxing shareholders only on income realized by the corporation.").

88. The Treasury Department published a model for allocating undistributed corporate income to shareholders and utilizing the corporate tax as no more than a withholding device. U.S. TREASURY DEP'T, BLUEPRINTS FOR BASIC TAX REFORM 68-75 (1977); *see supra* note 11 (distinguishing allocation from integration).

89. The earliest tax laws of the United States caused corporate income to be allocated to shareholders and imposed no discrete corporate tax. *See supra* text accompanying notes 23-24.

90. *See, e.g.*, ABA & NYSBA, *supra* note 47, at 132-33; C. MCLURE, *supra* note 5, at 35-36. Some analysts do favor allocation. *See, e.g.*, Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 153-61 (1977) (advocating allocation of undistributed earnings to shareholders); McLure, *supra* note 5, at 581; *see also* Warren, *supra* note 5, at 740 (implying that allocation might be desirable at some future time).

91. Even if the individual income tax is imposed in the future at the same rate that would apply to a current dividend, the shareholders will derive an economic benefit from being able to invest the deferred income without incurring a tax on the returns generated by such income. Consequently, it is not the deferral of the individual income tax that would lead to undertaxation, but rather, that the

quently, a corporate tax on undistributed corporate income can be justified from an equitable perspective to the extent that it simulates the individual income tax that would be imposed if dividends were paid immediately.[92] Thus, a corporate tax intended to remedy the undertaxation of undistributed corporate income should mirror the individual income tax. Specifically, the corporate tax would be imposed on a broad base and at the individual income tax rate that would apply if dividends were paid immediately.

The tax structure that emerged from the 1986 Act can be reconciled with the goal of designing a corporate tax to resemble the individual income tax. The 1986 Act dramatically broadened the corporate tax base.[93] Furthermore, it reduced the number of marginal individual tax rates from fourteen to two,[94] thereby eliminating much of the variability that previously existed with respect to the individual tax rate that would apply if corporate income were distributed as dividends. Moreover, the individual rate structure is designed in a manner that causes all but the lowest income individuals to be taxed at a rate of twenty-eight percent.[95] Rather than setting the corporate tax rate at twenty-eight per-

---

returns generated by the deferred tax are not subjected to tax during the deferral period. *See supra* notes 44 & 61.

92. *See* R. MUSGRAVE, *supra* note 6, at 173-75. The extent to which a corporate tax imposed on undistributed corporate income furthers equity is questionable. A corporate tax imposed on undistributed corporate income may cause such *income* to bear the same burden as other forms of income. The equitable ideal, however, focuses on the burdens borne by *people*, not the burdens borne by income. Thus, the belief that a corporate tax potentially can serve as a substitute for subjecting undistributed corporate income to the individual income tax implicitly assumes that the burdens of the corporate tax fall on the shareholders. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 386-87. *Compare* Warren, *supra* note 5, at 731 n.37 (develops case for integration assuming profit-maximizing behavior) *with* J. BALLENTINE, *supra* note 87, at 16 (assumption of maximization of profits is inconsistent with shifting).

The extent to which the burdens imposed by the corporate tax are borne by shareholders is unclear. *See* J. PECHMAN, *supra* note 22, at 141-46; Goode, *Who Bears the Corporation Income Tax?*, 32 U. CHI. L. REV. 410, 410 (1965). It is possible that part or all of the corporate tax is borne by all owners of capital by virtue of equilibrating forces in the economy. *See* Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962). For an analysis of the efficiency implications of this phenomenon, see *infra* notes 193-96 and accompanying text. Part or all of the corporate tax may be shifted to labor through reduced wages, *see* J. PECHMAN, *supra* note 22, at 144, or to consumers through increased prices, *see* M. KRZYZANIANK & R. MUSGRAVE, THE SHIFTING OF THE CORPORATION INCOME TAX 2 (1963). For a critical analysis of the view that the corporate tax can be shifted away from the owners of capital, see Goode, *supra*, at 410. The incidence of the corporate tax is unknown and many believe that the answer never will be found. *See* Klein, *supra* note 74, at 601 ("[I]t is reasonably clear that for the present and the foreseeable future the question of who pays the corporation income tax remains wholly unanswerable, and that this rules out diffident assertions of probabilities as much as it does bold assertions of certainties."); *see also* C. SHOUP, PUBLIC FINANCE 11-19 (1969) (arguing that incidence is invalid concept since effect of tax cannot be isolated where one does not know what distributional consequences would be in absence of tax); Bittker, *Effective Tax Rates: Fact or Fancy?*, 122 U. PA. L. REV. 780, 798 (1974) (querying why the incidence of individual income tax is assumed in light of great uncertainty about incidence of corporate tax).

93. *See supra* note 55.

94. Although the rate tables reveal marginal individual rates of 15% and 28%, a limited range of individual income does bear a marginal rate of 33% by virtue of the phaseout of the 15% rate and the personal exemptions. I.R.C. § 1(g) (West 1989); *see supra* note 54.

95. Married individuals filing a joint return with income in excess of $29,750 (as adjusted for inflation) pay tax at a marginal rate of 28%. I.R.C. § 1(a) (West 1989). The limited range of individual income that is taxed at a marginal rate of 33% is intended to eliminate the benefit of the 15% rate and personal exemptions thereby causing such individuals with income in that range to approach an average tax rate of 28%. *See supra* note 54.

cent, however, the 1986 Act established an even higher corporate tax rate of thirty-four percent.[96] The prevailing view, therefore, is that undistributed corporate income no longer is undertaxed.[97]

A corporate tax that simulates the individual income tax is believed to further the equitable ideal with respect to undistributed corporate income. The imposition of a corporate tax on distributed corporate income, however, causes such income to bear a burden greater than the burden imposed on income from other sources.

C. *Double Taxation Is Undesirable By-Product of Corporate Tax*

One might expect that distributed corporate income would bear twice the tax burden of other forms of income if it were subjected to a corporate tax that resembles the individual income tax as well the individual income tax itself. Corporate income used to pay the corporate tax, however, is not subject to the individual income tax.[98] Consequently, literal "double" taxation will not occur when distributed corporate income is subjected to two similar taxes.

Because the individual income tax is not imposed on corporate income absorbed by the corporate tax, the overtaxation of distributed corporate income *relative* to other income rises as a uniform corporate and individual tax rate falls. For example, if both the corporate tax rate and the individual tax rate were fifty percent, distributed corporate income would bear one hundred fifty percent of the burden of other forms of income. If, however, the tax rate were ten percent, distributed corporate income would bear one hundred ninety percent of the bur-

---

96. I.R.C. § 11(b) (West 1989). Although lower marginal rates continue to apply to threshold amounts of corporate income, the scope of the lower marginal rates has been dramatically reduced in recent years. *See id.* § 11(b). A limited range of corporate income is taxed at a marginal rate of 39% to eliminate the benefit of the lower marginal rates. *Id.* § 11(b)(1); *see supra* note 56.

97. The view that undistributed corporate income is no longer undertaxed emerges from the analysis that the current rate structure no longer provides an incentive to accumulate corporate earnings to defer the individual income tax and, in fact, that the higher corporate rate may create a disincentive to accumulate. *See* Warren, *supra* note 5, at 724 (finds small incentive to accumulate even when rates equalized because he assumes distributed earnings will be reinvested in the corporation); Zolt, *supra* note 58, at 866-68 (assumes distributed earnings will not be reinvested in corporation); *supra* note 61.

98. Distributed corporate income would bear twice the burden of other sources of income only if the corporate tax paid with respect to dividends were added to the base on which the individual income tax was imposed. For example, if both the corporate tax rate and the individual tax rate were 20%, a $20 corporate tax would be imposed on $100 of corporate income but only a $16 individual income tax would be imposed when the earnings net of the corporate tax were distributed as a dividend ($80 x 20% = $16). If, however, the shareholder were required to include in gross income the $20 corporate tax paid with respect to the earnings that generated the dividend as well as the $80 dividend, a $20 individual income tax would be imposed. *See, e.g.*, I.R.C. § 78 (West 1989) (domestic corporation must include in gross income amount equal to deemed paid foreign taxes to claim a credit against United States tax liability for those foreign taxes). It would not be sensible to cause shareholders to include the corporate tax in gross income where no credit against individual tax liability is allowed for the corporate tax.

den of other income.[99] This analysis suggests that efforts to expand the individual and corporate tax bases and to reduce tax rates as low as possible inevitably will worsen the overtaxation of distributed corporate income. This relative rate perspective makes the overtaxation of distributed corporate income appear to be a more pressing problem in the face of the policy goals expressed by the recent tax reform effort.[100]

The relationship between tax rates and the overtaxation of distributed corporate income differs dramatically, however, when one analyzes the burdens in absolute terms. Whereas the *relative* overtaxation of distributed corporate income increases as the tax rate falls, *absolute* overtaxation decreases as the tax rate falls below fifty percent. For example, if both the corporate tax rate and the individual tax rate were fifty percent, the difference between the tax burden on distributed corporate income and the burden on other income would be twenty-five percent. By contrast, if the tax rate were ten percent, the difference in tax burdens would be only nine percent.[101] When one focuses on the overtaxation of distributed income in absolute terms, it becomes possible to reconcile the goal of minimizing the overtaxation of distributed corporate income with goals of base broadening and rate reduction manifested by the recent tax reform effort. Specifically, as tax rates are reduced, the overtaxation of distributed corporate income also will be curtailed in absolute terms.

Regardless of how low tax rates are set, however, distributed corporate income that is subject to both the corporate tax and the individual income tax will

99.

(1) Uniform Tax Rate t	(2) Burden on Dividends t+t(1−t)	(3) Relative Burden (2)/(1)	(4) Absolute Burden (2)−(1)
90%	99%	110%	9%
80%	96%	120%	16%
70%	91%	130%	21%
60%	84%	140%	24%
50%	75%	150%	25%
40%	64%	160%	24%
30%	51%	170%	21%
20%	36%	180%	16%
10%	19%	190%	9%

100. Under existing law, distributed corporate income may bear as much as 187% of the burden of other forms of income. *See supra* note 4 (524,800 / 280,000 = 1.874). The burden on corporate-source income is much greater than might be expected because the maximum corporate tax rate exceeds the maximum individual tax rate. *See* I.R.C. §§ 1, 11(b)(1) (West 1989).

Relative overtaxation is higher in the case of those individuals who pay tax at a marginal rate of less than the maximum marginal rate. *See* McLure, *supra* note 5, at 535-36. Because the 1986 Act dramatically reduced the number of marginal tax rates and the range between the highest and lowest rates, this observation is of less significance now than under prior law. *See infra* text accompanying notes 120-27.

101. *See supra* note 99 (Col. 4). Under existing law the difference between the tax burden on distributed corporate income and the tax burden on other forms of income is approximately 24.5% (52.48%−28%=24.5%). *See supra* note 4.

bear a burden in excess of the tax burden imposed on other sources of income.[102] This additional burden appears inconsistent with the equitable ideal that all individuals with equal incomes should bear equivalent tax burdens.[103] Consequently, many commentators argue that the remedy for double taxation from an equitable perspective is to eliminate the corporate tax on distributed corporate income by adopting integration.[104]

The equitable perspective on double taxation, therefore, focuses on the overtaxation that results from applying the corporate tax, in addition to the individual income tax, to distributed corporate income. Integration is regarded as desirable from an equitable perspective because it would eliminate the relative overtaxation of distributed corporate income by eliminating the burden of the corporate tax on distributed corporate income.[105]

IV. CRITIQUE OF EQUITABLE PERSPECTIVE

The equitable argument against double taxation of corporate income is problematic because it fails to acknowledge adequately the interest of society in causing affluent individuals to bear relatively greater tax burdens than less affluent individuals. More of the burdens resulting from the double taxation of corporate income appear to be borne by the rich than the poor. Attempting to maintain this allocation of tax burdens by substituting higher individual tax rates for double taxation may cause the tax system to move further from the goal of causing all similarly situated individuals to bear equivalent tax burdens.

A. Double Taxation Furthers Progressivity When Tax Rates Are Low

Double taxation appears inconsistent with horizontal equity, the principle that all similarly situated individuals should bear the same tax burden irrespective of the sources of their incomes.[106] Although ownership of corporate stock

102. *See supra* note 99.

103. *See supra* note 77 and accompanying text.

104. *See supra* note 11 (defining integration). Various methods of integration have been proposed. One approach is to allow the corporation a deduction for dividends paid. *See* ABA & NYSBA, *supra* note 47, at 134; CONGRESSIONAL BUDGET OFFICE, *supra* note 42, at 151-52; McLure, *supra* note 5, at 554-55; Warren, *supra* note 5, at 774. A similar approach is to utilize a "split-rate" whereby the corporation would be taxed at a higher rate on undistributed earnings than on distributed earnings. *See* ABA & NYSBA, *supra* note 47, at 134; Warren, *supra* note 5, at 775. Alternatively, shareholders might be required to include both dividends and the corporate tax paid with respect to the dividends in income and be allowed a credit for the corporate tax against their individual tax liabilities. *See* ABA & NYSBA, *supra* note 47, at 133-34; CONGRESSIONAL BUDGET OFFICE, *supra* note 42, at 153; McLure, *supra* note 5, at 553-54; Warren, *supra* note 5, at 773-74. Proposals also have been made to eliminate the individual income tax on distributed corporate income by excluding dividends from the individual tax base. *See* Bravenec, *supra* note 10, at 1381; McLure, *supra* note 5, at 552-53; Peel, *A Proposal for Eliminating the Double Taxation of Corporate Dividends*, 39 TAX LAW 1 (1985); Steuerle, *supra* note 10, at 335; Jacobs, *The Disincorporation of America: A Prospective Historical Perspective* (unpublished paper presented to New York City Tax Club Apr. 15, 1987) (on file with the *North Carolina Law Review*).

105. This Article focuses on the cost of integration in terms of forgone revenue and does not address the many technical problems associated with integration. *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 42, at 154-60; Warren, *supra* note 5, at 772-94.

106. *See supra* note 77 and accompanying text.

is concentrated in the hands of high-income individuals,[107] all high-income individuals do not derive the same percentage of their incomes from dividends. Similarly, although individuals with lower incomes derive some dividend income,[108] it is unlikely that all individuals at any given income level derive the same percentage of their incomes from dividends. Consequently, the double taxation of corporate income probably does cause similarly situated individuals to bear somewhat different tax burdens.[109]

In spite of its impact on horizontal equity, double taxation does further a second dimension of equity: namely, vertical equity. Vertical equity is the principle that an individual's tax burden should increase as that individual's ability to pay increases.[110] Where ability to pay is measured by income, vertical equity can be furthered simply by causing an individual's tax burden to increase at a steady rate as income increases. For example, a tax system in which individuals with ten dollars of income pay one dollar of tax and individuals with one hundred dollars of income pay ten dollars of tax would be consistent with vertical equity, notwithstanding that both groups of individuals pay taxes equal to ten percent of their incomes. By contrast, a tax system in which an individual's tax burden rises at an increasing rate as income increases also is consistent with vertical equity. For example, a tax system in which individuals with ten dollars of income pay one dollar of tax and individuals with one hundred dollars of income pay twenty dollars of tax also would be consistent with vertical equity.

A tax system in which an individual's tax burden increases at an increasing rate as income rises is progressive.[111] The United States generally has regarded progressivity as desirable.[112] Empirical studies demonstrate that the double taxation of corporate income adds to the progressivity of the United States tax system.[113] The progressive nature of double taxation is attributable to the fact that

---

107. *See* CORPORATE FINANCIAL STRUCTURES, *supra* note 16, at 57 ("high tax rate taxpayers will tend to concentrate their wealth in the form of equity"). An indication of the extent to which equity ownership is concentrated among high-income shareholders can be determined from the distribution of dividend income among income classes. In 1984, 73.8% of total dividend income reported by all individuals was reported by taxpayers with adjusted gross incomes in excess of $30,000. STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERVICE, INDIVIDUAL INCOME TAX RETURNS 1984: RETURNS FILED, SOURCES OF INCOME, EXEMPTIONS, ITEMIZED DEDUCTIONS, AND TAX COMPUTATIONS 18 (1986) [hereinafter STATISTICS OF INCOME] (percentage derived from data in Table 1.4).

108. *See* STATISTICS OF INCOME, *supra* note 107, at 18.

109. It may be that part or all of the burden of the corporate tax is shifted away from shareholders to other individuals. *See supra* note 92. The shifting process may eliminate much of the horizontal inequity associated with the corporate tax. *See* Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979).

110. R. MUSGRAVE, *supra* note 6, at 160.

111. *See* D. BRADFORD, *supra* note 78, at 152. Care should be taken not to associate progressivity only with higher marginal tax rates. For example, the 1986 Act reduced differences in marginal tax rates dramatically but at the same time sustained the relative tax burdens borne by each income class other than the lowest. *See supra* note 51 and accompanying text.

112. The question of how progressive the income tax should be is beyond the scope of this Article. The Article assumes simply that the degree of progressivity achieved by the existing tax laws reflects the desires of society. *See supra* note 17.

113. *See, e.g.*, J. PECHMAN, WHO PAID THE TAXES, 1966-85, 80 (1985). Dr. Pechman's study establishes the following with respect to the effective rate of corporate tax (corporate tax as a per-

stock ownership tends to be concentrated among high-income individuals.[114] Consequently, if the corporate tax operates as an indirect tax on shareholders,[115] it can be defended on equitable grounds as having a progressive effect.[116]

Opponents of double taxation have attempted to undermine its contribution to progressivity by focusing on the impact of double taxation on dividend recipients who do not pay tax at the maximum individual rate.[117] When lower income individuals pay tax at a lower rate than higher income individuals, double taxation has a regressive effect: it causes low-income dividend recipients to bear

---

centage of individual income) borne by individuals at each level of the income scale for the year 1985:

Population decile	Effective rate of corporate tax
First	.5%
Second	.5%
Third	.6%
Fourth	.6%
Fifth	.7%
Sixth	.8%
Seventh	.8%
Eighth	.9%
Ninth	1.2%
Tenth	3.6%
Top 5%	4.5%
Top 1%	5.7%

Id. at 35 (derived from Table 3-1). Pechman derived these results by allocating 50% of the corporate tax to dividend recipients and 50% to capital income in general. *Id.* Progressivity is likely to be even greater if the entire corporate tax were allocated to dividend recipients. *See also* Feldstein, *Imputing Corporate Tax Liabilities to Individual Taxpayers*, 41 NAT'L TAX J. 37, 37-38, 49-51 (1988) (demonstrating progressivity of corporate tax when 100% of corporate tax is allocated to capital income in general).

Correspondingly, integration is likely to reduce progressivity. *See* AMERICAN LAW INSTITUTE, *supra* note 16, at 328 (Integration "would only be accomplished at a substantial cost in . . . progressivity, since a high proportion of dividends flow to high income wealthy individuals."); C. MCLURE, *supra* note 5, at 29-30 (discusses study indicating that integration would reduce tax burdens at bottom of the income scale by less than 1% and at top of income scale by 3% to 5%); Manvel, *Is A Dividend Tax Credit "Progressive"?*, 6 TAX NOTES 391, 391-93 (1978) (demonstrating that the late Senator Ullman's March 1978 proposal to allow a partial credit against the individual tax for dividends received may have had a regressive effect).

114. *See supra* note 16 and accompanying text.

115. The equity critique follows the incidence assumption generally made by those arguing for integration on equitable grounds; namely, that the corporate tax is borne by shareholders. *See supra* note 92. The possibility that the corporate tax is borne by individuals other than corporate shareholders undermines the logic by which those advocating integration can reconcile a corporate tax on undistributed corporate income with horizontal equity. To the extent that the burden of the corporate tax is not borne by shareholders, the corporate tax fails to eliminate the inequity that results from the omission of undistributed corporate income from the individual tax base. *See supra* text accompanying notes 75-92.

116. *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 42, at 56 ("If one assumes that the corporate tax is paid by stockholders, . . . then the tax appears highly progressive given the concentration of share ownership in the higher income classes."); R. GOODE, THE CORPORATION INCOME TAX 40 (1951) ("Stock ownership and dividends are an important source of inequality of income and wealth. A corporation income tax is one means of reducing such inequalities.").

117. *See* J. PECHMAN, *supra* note 22, at 179-81; McLure, *supra* note 5, at 535-36, 539.

a relatively greater tax burden than high-income dividend recipients.[118] For example, when individual tax rates ranged from fourteen percent to seventy percent, the additional burden that double taxation imposed on individuals subject to the lowest individual marginal rate was almost three times the additional burden that double taxation imposed on high-income shareholders.[119]

Efforts to undermine the progressivity of double taxation by citing its impact on individual shareholders taxed at less than the maximum marginal rate have been weakened considerably by the individual rate reductions accomplished by tax reform.[120] As the 1986 Act demonstrates, a substantial reduction in the highest individual tax rate allows for a significantly lower income threshold above which the maximum rate applies. Under existing law, the twenty-eight percent maximum individual rate applies to the taxable income of a married couple in excess of approximately $30,000.[121] By contrast, under prior law the fifty percent maximum individual rate did not apply until a married couple reported taxable income in excess of $160,000![122] As a result of the 1986 Act, therefore, far more individual income will be subjected to the maximum margi-

118. McLure, *supra* note 5, at 539.

119. Break & Pechman, *Relationship Between the Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 341, 342 (1975) (assuming that all corporate profits are paid out as dividends, the additional burden on a 14%-tax-bracket shareholder was 187% greater than the burden on a 70%-tax-bracket shareholder). The following table (modified from the table in J. PECHMAN, *supra* note 22, at 180) illustrates the regressive impact of a corporate tax imposed at a flat rate of 48% (the rate in effect when Break and Pechman conducted their study) and borne entirely by shareholders (when all earnings are paid out as dividends):

Marginal individual income tax rate (1)	Corporate income before tax (2)	Corporation tax at 48% (3)	Dividends received by stockholders (4)	Stockholder individual income tax (5)	Total tax burden (6)	Additional burden of corporate tax (7)
14%	$100	$48	$52	$ 7.28	$55.28	$41.28
20%	100	48	52	10.40	58.40	38.40
30%	100	48	52	15.60	63.60	33.60
50%	100	48	52	26.00	74.00	24.00
70%	100	48	52	36.40	84.40	14.40

Col. 3 = .48 × Col. 2
Col. 4 = Col. 2 − Col. 3
Col. 5 = Col. 4 × Col. 1
Col. 6 = Col. 3 + Col. 5
Col. 7 = Col. 6 − (Col. 1 × Col. 2)

The additional burden of $41.28 on the 14%-tax-bracket shareholder is 187% greater than the additional burden of $14.40 borne by the 70%-tax-bracket shareholder. The relative difference between additional burdens would be even greater if those shareholders subject to the individual income tax at a marginal rate of 0% were considered.

120. *See supra* text accompanying notes 54 & 56.

121. I.R.C. § 1(a) (West 1989). The 28% rate applies to an even lower threshold of income for individual taxpayers who do not file joint returns. *Id.* § 1(b)-(d). As previously indicated, a limited range of income for certain taxpayers with income above the threshold to which the 28% rate applies will be subjected to an additional tax of 5% to eliminate the benefit of the lower marginal rate and exemptions. *Id.* § 1(g); *see supra* note 54.

122. I.R.C. § 1(a)(3) (West 1985) (current version at I.R.C. § 1(a) (West 1989)). The threshold was somewhat lower for taxpayers not filing joint returns but not less than $80,000. *Id.* § 1 (d)(3) (West 1985) (current version at I.R.C. § 1(d) (West 1989)).

nal rate.[123]

A low maximum marginal rate also tends to reduce the differential between the marginal rates faced by all taxpayers. Under prior law, the difference between the maximum individual rate of fifty percent and the minimum rate of fourteen percent was thirty-six percent.[124] By contrast, under current law, the difference between the maximum rate of twenty-eight percent and the minimum rate of fifteen percent is thirteen percent.[125] This limited range of rates significantly reduces the regressive effect of double taxation. Specifically, the additional burden that double taxation imposes on individual shareholders subject to the current minimum tax rate is less than twenty percent greater than the additional burden that double taxation imposes on shareholders subject to the current maximum rate.[126] Thus, both the frequency with which double taxation has a regressive impact and the magnitude of that impact decline considerably

---

123. A rough estimate of the percentage of dividend income received by individuals that is subjected to the 28% individual tax rate can be made from government statistics. *See* STATISTICS OF INCOME, *supra* note 107, at 18 (illustrating that 73.8% of all dividends reported by individual taxpayers in 1984 were received by taxpayers with adjusted gross incomes in excess of $30,000). If the distribution of dividends by income class is the same today, the foregoing statistic both understates and overstates the percentage of dividend income subjected to the 28% rate. It understates that percentage because 38.3% of dividends were reported by individuals not filing joint returns who are subjected to the 28% tax rate at a lower taxable income threshold than $30,000. *See* I.R.C. § 1(b)-(d) (West 1989). It overstates the percentage of dividend income subjected to the 28% rate because certain taxpayers with adjusted gross incomes in excess of $30,000 are likely to have taxable incomes below $30,000, the threshold at which the 28% marginal rate applies to taxpayers filing joint returns. *Id.* § 1(a). One should not overestimate this latter effect, however, since 65.3% of all dividends were reported by taxpayers with adjusted gross incomes above $40,000. STATISTICS OF INCOME, *supra* note 107, at 18.

The above analysis does not treat individuals subject to the 5% additional tax imposed on a limited range of income differently from individuals subject to the 28% marginal rate. I.R.C. § 1(g) (West 1989). Even if the 5% additional tax were regarded as a 33% marginal rate, however, its impact on progressivity is not very different from the 28% rate. *See infra* note 126.

124. I.R.C. § 1 (West 1985) (current version at I.R.C. § 1 (West 1989)).

125. I.R.C. § 1 (West 1989).

126. The following table (modified from the table in J. PECHMAN, *supra* note 22, at 180) illustrates the regressive impact of a corporate tax imposed at a flat rate of 34% that is borne entirely by shareholders when all earnings are paid out as dividends:

Marginal individual income tax rate (1)	Corporate income before tax (2)	Corporation tax at 34% (3)	Dividends received by stockholders (4)	Stockholder individual income tax (5)	Total tax burden (6)	Additional burden of corporate tax (7)
15%	$100	$34	$66	$ 9.90	$43.90	$28.90
28%	100	34	66	18.48	52.48	24.48
33%	100	34	66	21.78	55.78	22.78
50%	100	34	66	33.00	67.00	17.00

Col. 3 = .34 × Col. 2
Col. 4 = Col. 2 − Col. 3
Col. 5 = Col. 4 × Col. 1
Col. 6 = Col. 3 + Col. 5
Col. 7 = Col. 6 − (Col. 1 × Col. 2)

The $28.90 additional burden imposed on 15% shareholders (Col. 7) is only 18% greater than the $24.48 additional burden imposed on 28% shareholders (24.48 x 118% = 28.90). *Cf. supra* note 119 (illustrating that additional burden imposed on low rate shareholders under prior law's wider

when individual tax rates are low.[127]

B. *Substituting Higher Tax Rates for Double Taxation Is Likely to Exacerbate Inequities*

A more fundamental objection to the progressivity achieved by double taxation is the view that it would be preferable to impose progressivity explicitly by utilizing higher marginal individual tax rates.[128] If integration were implemented, it is quite likely that Congress would compensate for the resulting revenue loss by raising individual tax rates.[129] Whether higher individual rates would be a good substitute for double taxation, therefore, is of more than theoretical significance.

The corporate tax is a hidden tax.[130] The surreptitious manner in which the corporate tax adds to the burdens on individuals has engendered much criti-

---

range of individual tax rates was approximately 187% greater than additional burden imposed on high rate shareholders).

Even if the additional 5% tax that applies to a narrow range of income of shareholders generally subject to the 28% rate is treated as a separate 33% marginal rate, the $28.90 additional burden imposed on shareholders subject the 28% rate is only 27% greater than the $22.78 additional burden that results from a 33% marginal rate. If the maximum individual marginal rate were restored to 50%, however, the $28.90 additional burden on 15% shareholders would be 70% greater than the $17.00 additional burden on 50% shareholders. Those dividend recipients subject to a 0% marginal rate are ignored because fewer than 7% of all dividends reported by individuals were received by individuals with adjusted gross incomes of less than $10,000. STATISTICS OF INCOME, *supra* note 107, at 18. The $34.00 additional burden (equivalent to corporate tax) imposed on 0% shareholders is approximately 39% greater than the $24.48 additional burden imposed on 28% shareholders.

127. Critics of double taxation also have argued that the variable impact of the corporate tax is exacerbated by the ability to defer the individual income tax by accumulating income in the corporation rather than paying dividends. *See* McLure, *supra* note 5, at 539-40. When the corporate rate approximates the individual tax rate, however, these differences are minimized. *See supra* notes 44 & 61.

128. *See* C. MCLURE, *supra* note 5, at 40 ("In theory, almost any degree of progressivity can be achieved by changing marginal rates. Thus integration . . . should be appraised primarily for [its effect] on horizontal equity . . . .").

129. An alternative source of revenue will be needed if integration is implemented. *See supra* text accompanying notes 69-73. Enactment of a new tax, such as a value-added tax or a business transfer tax, seems highly unlikely at the present time. *See* Leonard, *supra* note 53, at 977. Moreover, little room remains to increase revenue by base broadening. *See* Minarik, *supra* note 42, at 1372. The most likely source of revenue, therefore, is an increase in individual tax rates.

Threats of increasing individual tax rates have been voiced in Congress. *See Capital Gains Battle Royale Shaping Up for House Floor*, 44 TAX NOTES 1447, 1447 (1989) (reporting proposal by House Democrats to increase maximum individual tax rate to 33% in response to proposal by Republicans to reduce capital gains tax rate); *Taxwriters Moving Slowly But Surely on Capital Gains*, *supra* note 63, at 623 (citing Representative Rostenkowski's earlier threats to increase the maximum individual tax rate if capital gain rates were lowered); *see also* CONGRESSIONAL BUDGET OFFICE, REDUCING THE BUDGET DEFICIT: SPENDING AND REVENUE OPTIONS (1988) (exploring possibility of increase in top tax rate to 30% or 33%). Integration is likely to be perceived as benefiting the wealthy because corporate stock ownership is concentrated among high-income individuals. *See supra* note 16. Consequently, it is likely that the quid pro quo for integration would be higher tax rates for high-income taxpayers.

Even if integration does not lead directly to an increase in individual tax rates, it is likely to influence this result indirectly because any source of revenue that is used to compensate for the elimination of double taxation would not be available to satisfy future revenue needs resulting from Gramm-Rudman-Hollings targets. *See supra* text accompanying notes 71-72.

130. *See* J. BALLENTINE, *supra* note 87, at 7 ("Most taxpayers never know, even approximately, how much their disposable income is reduced by taxes on corporate profits.").

cism.[131] It certainly would seem more fair to raise the needed revenue now generated by the corporate tax directly by imposing higher individual tax rates, rather than covertly by imposing the corporate tax.[132] Substituting higher individual tax rates for double taxation probably would eliminate the horizontal inequities that result from the fact that individuals at any given income level do not derive the same percentage of their incomes from dividends.[133] Although the elimination of these inequities appears desirable at first, closer analysis reveals that higher individual tax rates are likely to substitute system-wide horizontal inequities. Higher individual tax rates would impede the ability of the marketplace to moderate the inequities that result from tax preferences and probably would reverse the recent trend of reducing the number of preferences that exist.

When certain investments are taxed more favorably than other investments, the marketplace generally will operate to equalize the rate of return on a tax-favored investment with the after-tax rate of return on a comparable fully taxable alternative.[134] An example of a tax-favored investment under existing law is a municipal bond on which the interest income paid is exempt from the individual income tax.[135] A municipal bond may yield an eight percent return in a marketplace in which a comparable taxable bond yields ten percent. Under these circumstances, the marketplace imposes an "implicit tax" on the tax-favored investment that has the effect of lowering its yield by two percent.[136] If all individuals were taxed at a rate of twenty percent, the implicit tax on the municipal bond would eliminate the horizontal inequity otherwise created by the tax-free alternative.[137] In this situation, the return derived by purchasers of municipal bonds would be equivalent to the after-tax income of similarly situated individuals who derived their incomes from other sources.[138]

The ability of the marketplace to moderate inequities resulting from preferences is limited, however, when individuals are subject to different rates of

131. *See* Klein, *supra* note 74, at 578-79 ("Similarly disturbing is the opinion offered by some experts . . . that the corporate tax can be defended on the ground that it is a good source of revenue—a view that . . . apparently is based upon some well concealed antidemocratic value judgments.").

132. Query, however, whether an incidence question remains even when the individual income tax is utilized. *See* Bittker, *supra* note 92, at 798.

133. *See supra* notes 75-86 and accompanying text.

134. *See* Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 698-701 (1985).

135. *See* I.R.C. § 103 (West 1989).

136. The implicit tax benefits the issuer of the bond by enabling it to pay a lower rate of interest. By contrast, the government collects the explicit tax on the taxable bond.

137. *See* Cooper, *supra* note 134, at 700-01.

138. The comparison is as follows:

	Municipal Bond	Taxable Alternative
Amount Invested	$1,000	$1,000
Pretax Return	80	100
Less: Tax	0	20
After Tax Return	80	80

tax.[139] When individuals are taxed at different rates, the magnitude of the benefit derived from the tax-free alternative varies from individual to individual. As a result, the implicit tax imposed by the marketplace on the tax-free alternative represents a compromise between the range of potential benefits offered by the tax-favored investment. For example, if individual tax rates ranged from zero to forty percent and the average rate was twenty percent, the marketplace in which a taxable bond yields ten percent still might cause the nontaxable bond to yield eight percent. Under these circumstances, however, an individual subject to a forty percent marginal rate who derives income from tax-free bonds will bear a lesser burden than an individual subject to the same marginal rate who derives her income from other sources.[140] These differences become more pronounced as the spread between marginal tax rates increases.[141] Higher individual marginal tax rates are likely to cause the range of rates to expand.[142] The horizontal inequities resulting from higher marginal rates are even more pronounced with respect to those preferences not subject to the imposition of an implicit tax by the marketplace.[143]

In addition to limiting the equilibrating force of the marketplace with respect to existing preferences, substituting higher marginal rates for double taxation is likely to lead to the creation of additional preferences that would reverse the gains in horizontal equity achieved by the recent reform effort. Based on the manner in which the compromise that led to the 1986 Act was reached,[144] it is likely that additional tax preferences would be created if tax rates were increased. As discussed in Part II, liberal interests that desired the elimination of the myriad of loopholes in the Code achieved their desired end only because they could appease more conservative interests that found lower marginal tax rates

139. *See* Yorio, *supra* note 21, at 406-08.

140. The comparison is as follows:

	Municipal Bond	Taxable Alternative
Amount Invested	$1,000	$1,000
Pretax Return	80	100
Less: Tax	0	40
After Tax Return	80	60

Horizontal inequities may not result if the comparison is confined to those who derive income from capital since utilization of a tax exempt alternative is within their discretion. *See* Bittker, *supra* note 109, at 742-44. Individuals who derive their incomes from labor, however, do not have a tax exempt alternative. *See* Yorio, *supra* note 21, at 401.

141. *See* Browning, *Elasticities, Tax Rates and Tax Revenue*, 42 NAT'L TAX J. 45, 52-53 (1989) (develops quantitative analysis of how higher marginal rates encourage taxpayers to convert resources into nontaxable forms); Yorio, *supra* note 21, at 407-08.

142. *See supra* text accompanying notes 124-26. Higher individual tax rates also may increase tax evasion. *See* Crane & Nourzad, *Inflation and Tax Evasion: An Empirical Analysis*, 68 REV. ECON. STATISTICS 217, 221 (1986). Ambiguity exists in this relationship because of certain offsetting effects. Allingham & Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 330 (1972) (increase in tax rates makes it more profitable to evade taxes on the margin but also makes taxpayer less wealthy and, therefore, more averse to high-risk alternatives).

143. *See* Yorio, *supra* note 21, at 398-99. For example, the virtually limitless supply of an artificial entity, such as a trust, prevents demand for these entities from affecting their price via an implicit tax.

144. *See supra* text accompanying notes 49-51.

appealing.[145] The equitable gains resulting from base broadening would not have been achieved had the quid pro quo of dramatically lower rates not been offered.[146] If tax rates were increased, it is likely that pressures would intensify to restore old preferences and to create new ones.[147]

In sum, on equitable grounds, double taxation can be defended because it adds to the progressivity of the individual income tax and criticized because it results in horizontal inequities. Instinct might suggest that by substituting higher individual tax rates for double taxation progressivity could be achieved in a more desirable fashion because the horizontal inequities associated with double taxation would be eliminated. Substituting higher individual tax rates for double taxation, however, is likely to limit the equilibrating forces of the marketplace and upset the political bargain that paved the way for the elimination of many tax preferences, thereby causing horizontal inequities potentially more profound than those caused by double taxation.

V. Case Against Double Taxation on Efficiency Grounds

Taxation generally is regarded as inconsistent with economic efficiency to the extent that it distorts economic decisions.[148] To minimize the distortions resulting from taxation, it is desirable to strive for neutrality. Neutrality refers to a tax system that does not change behavior in the marketplace.[149] To the extent that double taxation distorts economic decisions, it represents a departure from neutrality.

The legal literature has identified and analyzed several distortions that it attributes to double taxation.[150] This literature recognizes that these distortions are caused to some extent by differences between corporate and individual tax rates rather than by the double taxation of distributed corporate income.[151] As a result of the 1986 Act, the maximum corporate tax rate, maximum individual

---

145. *See supra* note 49 and accompanying text.

146. *See* J. Birnbaum & A. Murray, *supra* note 49, at 4 (stating that 1986 Act wiped out multitude of special interest tax breaks in return for sharp cuts in tax rates).

147. *See* Minarik, *supra* note 42, at 1373 ("a reaction among liberals to raise statutory rates . . . would draw more lobbyists from the woodwork; the unraveling process would proceed").

148. The assumption underlying this view, that the economy operates most efficiently when government intervention is minimized, suggests that any tax-induced change in behavior is bad. *See, e.g.*, S. Rep. No. 313, 99th Cong., 2d Sess. 7-8 (1986).

149. A tax system that causes decisions to be made differently from how decisions would be made on purely economic grounds departs from neutrality. *See* D. Bradford, *supra* note 78, at 178-79. When this departure occurs, the taxpayer bears a burden in excess of the tax itself. Because this burden is not offset by a corresponding benefit to the government, the tax creates an inefficiency (that is, the "excess burden" makes one taxpayer worse off without conferring a corresponding benefit on anyone else). See R. Musgrave & P. Musgrave, *supra* note 8, at 291-300. Neutrality is an ideal that cannot be achieved on a system-wide basis because distortions are inevitable. The realistic goal is to minimize, rather than eliminate, the aggregate excess burdens of a tax system. *See id.* at 311 (acknowledging that some excess burden is inevitable).

150. *See* Warren, *supra* note 5, at 721-38; Zolt, *supra* note 58, at 841-44, 858-68.

151. The magnitude of the distortions created by the biases discussed in this Part differs depending upon the relationship between the rate at which corporate income, dividends, and capital gains are taxed. *See* Warren, *supra* note 5, at 723-24, 731-33. When these rates are not identical, double taxation also may bias the desire of shareholders to have corporations retain or distribute their earnings. *See* Zolt, *supra* note 58, at 843-44, 866-68.

tax rate, and the capital gains rate are closer together than at any time in recent history.[152] In addition, the number of individual marginal rates and the range of individual and corporate rates have been decreased dramatically.[153] Thus, it is no longer unrealistic to envision a system in which all rates are the same.[154]

Even if all rates were the same, however, the legal literature claims that double taxation biases individuals against investing in the corporate sector, biases corporations against utilizing equity financing, and biases corporations against making economically profitable investments.[155] Integration is regarded as a mechanism that would further neutrality by eliminating the distortions attributed to double taxation.[156]

A. Corporate Tax Biases Individuals Against Investing in Corporate Sector

If equivalent pretax returns can be earned regardless of where an individual invests capital,[157] returns to capital invested in the corporate sector, which are taxed twice, obviously bear a heavier burden than returns to capital invested in an unincorporated enterprise, which are taxed only once.[158] For example, if all capital generates a ten percent pretax return and all income is taxed at a rate of thirty percent, the tax burdens would be as follows:

	Corporate Investment	Noncorporate Investment
Amount Invested	$1,000	$1,000
Pretax Return (10%)	$100	$100
Corporate Tax (30%)	$30	0
Return Net of Corp. Tax	$70	$100
Individual Tax (30%)	$21	$30
Return Net of Individual Tax	$49	$70

If shareholders bear the corporate tax,[159] it would be logical for individuals

152. *See supra* notes 32 & 39.

153. *See supra* text accompanying notes 120-27.

154. The restoration of preferential treatment of capital gains, *see supra* note 63, would mark a reversal of the trend toward equalizing all rates. A tax system that equalizes corporate, individual, and capital gains rates still can be viewed as a viable ideal against which to compare the gains derived from eliminating double taxation. Moreover, the distortions directly attributable to double taxation can be isolated only if one assumes equivalent tax rates.

A more meaningful rate comparison might be made by comparing effective tax rates rather than statutory tax rates but this is uncertain in light of the many shortcomings of effective rate analysis. *See generally* Bittker, *supra* note 92, at 780 (highlighting the inadequacies of effective rate analyses).

155. *See* Warren, *supra* note 5, at 724, 732-33.

156. *See id.* at 744-53.

157. This assumption is commonly made. *See* Warren, *supra* note 5, at 725; Zolt, *supra* note 58, at 860.

158. I.R.C. § 61(a)(2) (West 1989) (proprietorship); *id.* § 701 (partnership); *id.* § 1361 (S Corporations). Income generated by individual investment in nonbusiness activities also is subject only to the individual income tax. *See id.* § 61(a)(4) (interest); *id.* § 61(a)(5) (rents); *id.* § 61(a)(6) (royalties).

159. This assumption generally is made in the legal literature. *See* Warren, *supra* note 5, at 725; Zolt, *supra* note 58, at 860.

to favor noncorporate investment over corporate investment.[160] By eliminating the burden of the corporate tax on distributed corporate income, integration would equalize the burdens on corporate income and noncorporate income and thereby eliminate the bias against investing capital in the corporate sector.[161] Thus, those who favor the elimination of double taxation regard the manner in which the corporate tax biases individuals against investing in the corporate sector as justification for integration.

B. Corporate Tax Biases Corporations Against Utilizing Equity Financing

If equivalent pretax returns can be earned regardless of how a corporation finances its investments,[162] investments financed with equity will bear a heavier tax burden than investments financed with debt. Debt-financed investments bear a lesser tax burden because interest paid for the use of debt capital is deductible from the corporate tax base,[163] whereas dividends paid for the use of equity capital are not deductible. For example, if all investments generate a ten percent pre-tax return, the cost of both debt capital and equity capital is five percent,[164] and all income is taxed at a rate of thirty percent, the tax burdens would be as follows:

	Equity Finance	Debt Finance
Amount Invested	$1,000	$1,000
Pretax Gross Return (10%)	$100	$100
Cost of Capital (5%)	$50	$50
Return Net of Cost of Capital	$50	$50
Corporate Tax (30%)	$30[165]	$15
Return Net of Tax	$20	$35

If corporate management endeavors to maximize the amount available for distribution to shareholders,[166] it would be logical for the different tax treatment to cause corporations to favor debt over equity financing.[167] Because integration

160. The economics literature indicates that the disparity in after-tax returns will not be perpetuated because the burden of the corporate tax eventually will be spread among all income from capital. *See infra* text accompanying notes 193-96.

161. *See* Warren, *supra* note 5, at 744-47.

162. This assumption is commonly made. *See* Warren, *supra* note 5, at 725; Zolt, *supra* note 58, at 860.

163. I.R.C. § 163 (West 1989).

164. Treating the cost of debt and equity capital as identical is consistent with the legal literature, which does not take into account different degrees of risk. *See* Warren, *supra* note 5, at 724.

165. Because dividends are not deductible, the 30% corporate tax is imposed on the corporation's pretax gross return of $100.

166. This assumption is made in the legal literature. *See, e.g.*, Warren, *supra* note 5, at 730-31. Note that the tax savings at the corporate level from debt financing will be offset to some extent by an increased shareholder-level tax when dividends are paid.

167. When all tax rates are equivalent, retained earnings financing is economically equivalent to debt financing because retained earnings can be invested without imposition of the deferred shareholder tax. *See* Warren, *supra* note 5, at 731-32 (illustrating equivalence of retained earnings and debt financing when all tax rates are equal).

would allow corporations to deduct dividends,[168] integration would equalize the tax burdens on debt and equity capital and thereby eliminate the bias against equity financing.[169] Thus, those who favor the elimination of double taxation regard the manner in which the corporate tax biases corporations against utilizing equity financing as justification for integration.

C. *Corporate Tax Biases Corporations Against Pursuing Profitable Investment Opportunities*

The beliefs that the corporate tax biases individuals against investing in the corporate sector and that the corporate tax biases corporations against using equity are well publicized and commonly cited as bolstering the case for integration.[170] A more subtle bias created by the corporate tax and one that has received far less attention is the bias against the acceptance by corporations of investment opportunities that would generate an economic profit in the absence of taxes.[171] Although this anti-investment bias has a lower profile than the other biases, it is the only bias identified by the legal literature that necessarily indicts the double taxation of corporate income.[172]

The bias that the corporate tax creates against corporate investment extends from the analysis of the bias against equity financing. If one assumes that corporations have a limited ability to utilize debt financing,[173] the nondeductibility of the cost of equity capital probably causes corporations to forego investment opportunities that would generate an economic profit in the absence of taxes. In the preceding example, a corporation compelled to use equity financing would not undertake an investment when the cost of equity capital was more than seven percent even though such an investment would generate an economic profit in the absence of taxes. The corporation is likely to refrain from undertaking that investment because its inability to deduct the cost of equity capital would cause the corporation to suffer an after-tax loss from the investment, notwithstanding the pretax profit. For example, if the cost of equity capital had been eight percent, the following chart demonstrates that a corporation com-

168. *See supra* note 104. Although not all integration methods would allow for a deduction of dividends, the most common methods have the same substantive effect. *See* Warren, *supra* note 5, at 775-77.

169. *See* Warren, *supra* note 5, at 747-49.

170. *See generally* Graetz, *Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions*, 42 TAX NOTES 721 (1989) (suggesting that corporate tax will influence leveraging decisions unless corporate earnings on both debt and equity are subjected to identical tax treatment); Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 VA. TAX REV. 57 (1988) (analyzing conceptual shortcomings of manner in which existing tax system distinguishes enterprises subject to corporate tax from those exempt from corporate tax); Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1989-90) (arguing that refined corporate tax would not distort individual investment decisions if only publicly traded enterprises were subjected to corporate tax); Warren, *supra* note 10, at 715 (advocating integration as solution to bias against equity financing).

171. *See* Warren, *supra* note 5, at 733-35.

172. *See infra* text accompanying notes 193-205.

173. This assumption is made in the legal literature. *See, e.g.*, Warren, *supra* note 5, at 734-35.

pelled to use equity capital is unlikely to undertake an investment offering a $20 pretax profit because it results in a $10 after-tax loss:

	Equity Finance	Debt Finance
Amount Invested	$1,000	$1,000
Pretax Gross Return (10%)	$100	$100
Cost of Capital (8%)	$80	$80
Return Net of Cost of Capital	$20	$20
Corporate Tax (30%)	$30[174]	$6
Return Net of Tax	($10)	$14

Because integration would equalize the tax burden on debt and equity capital by reducing the burden on equity capital, the bias against undertaking economically profitable investments would no longer exist if integration were adopted.[175] Thus, those who favor the elimination of double taxation regard the manner in which the corporate tax biases corporations against pursuing profitable investment opportunities as justification for integration.

In sum, the efficiency perspective on double taxation developed in the legal literature focuses on the biases against individual investment in the corporate sector, corporate equity financing and corporate investment opportunities. Those who favor the elimination of double taxation regard integration as desirable because it would eliminate these biases.

VI. Critique of Efficiency Perspective

The case against double taxation on economic efficiency grounds as developed in the legal literature is problematic in two respects. First, the legal literature obscures the fundamental distortion to which the corporate tax contributes. Second, and more significant, the efficiency perspective developed in the legal literature focuses on achieving neutrality between corporate income and other forms of income without regard to the efficiency implications of an alternative revenue source.

A. Fundamental Distortion Associated With Corporate Tax Is Obscured

The legal literature claims that double taxation biases individuals against investing in the corporate sector and biases corporations against both utilizing equity financing and undertaking investments that would generate an economic profit in the absence of taxes.[176] The first two biases indict the different treatment of similar economic alternatives, not double taxation. The third bias is but a manifestation of the distortion that results when income from capital is taxed.

174. Because dividends are not deductible, the 30% corporate tax is imposed on the corporation's pretax gross return of $100.

175. *See* Warren, *supra* note 5, at 747-49.

176. *See supra* text accompanying notes 157-75.

1. Bias against corporate sector fails to indict corporate tax

Because corporate income is taxed twice and noncorporate investment income is taxed only once, individuals are likely to be biased toward investing capital outside of the corporate sector.[177] Commentators attribute the distortion to the overtaxation of corporate income; therefore, they advocate integration.[178] The distortion, however, could be attributed just as readily to the undertaxation of returns to capital invested outside of the corporate sector. Thus, expanding the burdens of the corporate tax to noncorporate investment income appears as desirable as adopting integration.

The burdens imposed by the corporate tax might be extended by converting the corporate tax to a doing-business tax imposed on all business enterprises irrespective of legal form[179] or augmenting the individual income tax imposed on income from capital other than dividends.[180] Any approach that results in identical treatment for income from all forms of capital investment would elimi-

177. *But see* Ebrill & Hartman, *The Corporate Income Tax, Entrepreneurship, and the Noncorporate Sector*, 11 PUB. FIN. Q. 419 (1983) (advancing theory that corporate tax is a tax on size); Rudnick, *supra* note 170, at — (arguing that refined corporate tax would not distort investment decisions if only publicly traded enterprises were subjected to corporate tax because investors would seek liquidity irrespective of presence of such a tax).

178. *See supra* text accompanying notes 157-61.

179. If a doing-business tax were imposed on returns to capital invested in an incorporated business or an unincorporated business, all capital generated a 10% pretax return, and all income were taxed at a rate of 30%, the tax burdens on income from capital would be identical regardless of where the capital was invested:

	Corporate Investment	Noncorporate Investment
Amount Invested	$1,000	$1,000
Pre-Tax Return (10%)	$100	$100
Doing Business Tax (30%)	$30	$30
Return Net of Corp. Tax	$70	$70
Individual Tax (30%)	$21	$21
Return Net of Indiv. Tax	$49	$49

Although the concept of a doing-business tax is not novel, it generally has been suggested as a substitute for, rather than as a supplement to, the individual income tax imposed on business income of unincorporated enterprises. *See* Caplin, *Income Tax Pressures on the Form of Business Organization: Is It Time for a "Doing Business" Tax?*, 47 VA. L. REV. 249, 260-63 (1961); Jacobs, *supra* note 104, at 1. *But see* ABA & NYSBA, *supra* note 47, at 260 ("You could have an unincorporated business tax, if you think something ought to be subject to two taxes and it's not in corporate form."). Although it is difficult to imagine how a two-tiered regime would operate with respect to capital invested in a proprietorship or a passive investment (such as a bank deposit), the feasibility of such an approach has yet to be analyzed. *See infra* note 183.

180. If all income is taxed at the same rate, the burden of double taxation could be simulated by imposing the individual tax on income from capital other than dividends at a rate equal to 1-[(1-rate) x (1-rate)]. For example, if all capital generates a 10% pretax return, all income (other than nondividend capital income) is taxed at a rate of 30%, and nondividend capital income is taxed at a rate of 51% [1 - (.7 x .7)], the tax burdens on income from capital would be identical regardless of where the capital was invested:

nate the distortion.[181] It is only because taxing income from capital creates other distortions[182] that curtailing the scope of the corporate tax might be preferable to expanding its scope.[183] Thus, the bias against individual investment in the corporate sector does not indict double taxation per se, but rather indicts the different tax treatment of investment in the corporate sector and investment in the noncorporate sector.

2. Bias against equity financing fails to indict corporate tax

Interest is deductible from the base on which the corporate tax is imposed, but dividends are not deductible from that base; therefore, corporations may be biased toward financing investments with debt rather than equity capital.[184] Although the legal literature attributes this distortion to the overtaxation of corporate income disbursed as dividends,[185] the distortion could be attributed just as readily to the undertaxation of corporate income disbursed as interest.

Expanding the corporate tax base by not allowing corporations to deduct interest payments would neutralize the bias against equity financing as effectively as curtailing the corporate tax base by allowing a deduction for dividends.[186] Indeed, any approach that results in identical tax treatment of the cost of all forms of capital would neutralize the distortion. For example, a deduction might be allowed for a fixed, identical percentage of both interest and

	Corporate Investment	Noncorporate Investment
Amount Invested	$1,000	$1,000
Pretax Return (10%)	$100	$100
Corporate Tax (30%)	$30	0
Return Net of Corp. Tax	$70	$100
Individual Tax	(30%) $21	(51%) $51
Return Net of Indiv. Tax	$49	$49

The possibility of subjecting income from unincorporated enterprises to a higher individual income tax than dividend income has been acknowledged. *See* Brooks, *A Proposal to Avert the Revenue Loss from "Disincorporation,"* 36 TAX NOTES 425, 425 (1987) (proposing to impose surtax on the income of pass-through entities).

181. *See* McLure, *supra* note 5, at 545 ("[I]t might be suggested that if capital is to be taxed more heavily than labor, the capital tax should be levied at the same rate on all capital, regardless of its use."). The criticisms McLure lodges toward this suggestion focus on a rate differential rather than the corporate tax itself. *See id.* at 545-46.

182. *See infra* text accompanying notes 197-203.

183. Whether curtailing the corporate tax is indeed desirable depends on how the efficiency implications of double taxation compare to those of an alternative revenue source. *See infra* text accompanying notes 207-14.

Aside from the overtaxation of income from capital, curtailing the scope of the corporate tax also may be favored because of the belief that it would not be possible to develop a system that would cause capital income from all sources to bear equal tax burdens. *See supra* notes 179-80 and accompanying text. This conclusion is premature, however, because little attention has been devoted to the possibility of developing such a system.

184. For a list of factors that may limit the extent to which debt financing will be favored over equity financing, see Zolt, *supra* note 58, at 843.

185. *See supra* text accompanying notes 162-69.

186. For example, if all investments generate a 10% pretax return, the cost of both debt capital and equity capital is 5%, all income is taxed at a rate of 30%, and neither interest nor dividends are deductible, then the following equivalent tax burdens would result from either method of finance:

dividend payments.[187] It is only because taxing income from capital creates its own distortions[188] that curtailing the corporate tax base might be preferable to expanding that base.[189] Thus, the bias against equity financing does not indict double taxation, but instead indicts the different tax treatment of interest and dividends.

3. Bias against corporate investment is manifestation of taxing income from capital

Corporations are likely to forego investment opportunities that would generate an economic profit in the absence of taxes because the cost of equity capital is not deductible.[190] In contrast to the biases against individual investment in

	Equity Finance	Debt Finance
Amount Invested	$1,000	$1,000
Pretax Gross Return (10%)	$100	$100
Cost of Capital (5%)	$50	$50
Return Net of Cost of Capital	$50	$50
Corporate Tax (30%)	$30	$30
Return Net of Tax	$20	$20

For a proposal to eliminate the deduction for interest on corporate debt, see Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585 (1974). *See also* J. PECHMAN, *supra* note 22, at 183 (acknowledging disallowance of interest deduction as neutralizing mechanism); *House Taxwriters End LBO Hearings; Prospects of Bill This Year Unclear*, 43 TAX NOTES 930, 930 (1989) (reporting proposal by Columbia law professor Louis Lowenstein not to permit deductions for dividends or interest payments). Professor Warren subsequently rejected his proposal because it would add to the manner in which the corporate tax biases corporations against making economically profitable investments. Warren, *supra* note 5, at 734 & n.43.

To achieve complete neutrality, it also would be necessary to increase the tax burden on retained earnings. *See* Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 WAYNE L. REV. 1057, 1071 (1984) ("[M]aybe interest deductions should be disallowed. But one important disadvantage of that course is that it would introduce a substantial discrepancy in cost of capital, favoring accumulated equity over debt."); *supra* note 167.

187. *See* Graetz, *supra* note 170, at 724 (advocating shareholder tax credit for some portion or all of the corporate tax paid on earnings distributed as interest or dividends in lieu of corporate interest deduction); *The Outlook: Corporate Debt Rises Despite Worries*, Wall St. J., June 26, 1989, at A1, col. 5 (referencing Joint Committee on Taxation option that would allow companies to deduct only 60% of their interest payments but allow a new deduction for 60% of dividends).

188. *See infra* text accompanying notes 197-203.

189. Whether curtailing the corporate tax is indeed desirable depends on how the efficiency implications of double taxation compare to those of an alternative revenue source. *See infra* text accompanying notes 207-14.

190. It is unclear, however, that allowing a deduction for the cost of equity capital would necessarily increase investment. If all firms demanded additional investment, the increase in demand for investment could drive up the price of financing to the point where the increased pretax cost of capital would offset part or all of the tax savings derived from deductibility. *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 42, at 63-64. For example, a corporation utilizing equity capital to finance an investment generating a pretax return of 10%, when the cost of capital was 8% and all taxes were imposed at a rate of 30%, would not undertake the investment if the cost of equity capital were not deductible. *See supra* text accompanying notes 173-75. If the cost of equity capital were deductible and the additional demand for investment increased the cost of capital to 11%, the corporation still would not undertake the investment:

the corporate sector and corporate equity financing,[191] the bias against corporate investment opportunities can be neutralized only by curtailing the corporate tax. The bias against corporate investment opportunities is the only bias identified by the legal literature that necessarily indicts the double taxation of corporate income.[192]

Framing the case against double taxation on efficiency grounds in terms of the impact of the corporate tax on corporate investment opportunities still obscures the fundamental distortion to which double taxation contributes. This fundamental distortion inevitably results from a system that taxes income from capital.

B. Taxation of Income from Capital is Root of Distortion Created by Corporate Tax

The prevailing view among economists is that the burden of the corporate tax is shared by all owners of capital.[193] Imposing the corporate tax only on capital invested in the corporate sector attracts capital to noncorporate investments because those investments initially offer a higher after-tax rate of return. As a result of the influx of additional capital into the noncorporate sector, the pretax rate of return offered by that sector eventually falls to the point at which both the corporate sector and the noncorporate sector offer investors equivalent after-tax rates of return. The process by which returns to capital are equalized distorts the allocation of capital between the corporate sector and the noncorporate sector.[194] As explained above, this "intersectoral" distortion need not be attributed to double taxation.[195] Rather, this distortion is attributable to taxing capital invested in the corporate sector differently from capital invested outside of the corporate sector.[196]

	Equity Finance
Amount Invested	$1,000
Pretax Gross Return (10%)	$100
Cost of Capital (11%)	$110
Return Net of Cost of Capital	($10)
Corporate Tax (30%)	-
Return Net of Tax	($10)

191. *See supra* text accompanying notes 177-89.

192. It may not be necessary to eliminate the corporate tax to neutralize even this bias because that part of the corporate tax base that represents a "pure" profit can be taxed without distorting economic decisions. *See infra* text accompanying notes 215-21.

193. *See* Feldstein, *supra* note 13, at 38 ("The assumption that 100% of the corporate tax increase is borne by capital and that all capital bears that tax increase equally . . . [probably] has become the conventional wisdom among most public finance specialists.").

194. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 283-85. This view is known as the "Harberger view." *See supra* note 92. The desire to invest capital in the corporate sector will not always be deterred by the imposition of additional burdens on that capital—for instance, in certain cases the demand for corporateness may be inelastic. *See* Ebrill & Hartman, *supra* note 177, at 419; Rudnick, *supra* note 170, at —.

195. The distortion created by the process of equalizing returns to capital in both the corporate sector and the noncorporate sector is referred to in the economics literature as an "intersectoral" distortion. *See* J. BALLENTINE, *supra* note 87, at 73-82.

196. *See supra* text accompanying notes 177-83.

Even if the corporate tax were designed to fall evenly on all income from capital,[197] however, the economics literature recognizes that such a tax would be distorting simply because it taxes income from capital.[198] A tax on income from capital affects the decisions individuals make about the timing of their consumption.[199] Because a tax on income from capital lowers the after-tax rate of return on an investment, it operates to encourage individuals to consume currently rather than to save for future consumption.[200] The corporate tax is but a contributing factor to this "intertemporal" distortion.[201] Even in the absence of the corporate tax, the individual income tax imposed on income from capital (interest, dividends, rents) would affect consumption and savings decisions.[202] The corporate tax therefore imposes an additional burden on income from capital.[203]

Existing legal literature fails to recognize explicitly that to the extent the corporate tax operates as a tax on all income from capital, the corporate tax distorts consumption and savings decisions.[204] This "intertemporal" distortion alone might appear to justify integration on efficiency grounds. Integration probably would reduce the extent to which the existing tax structure modifies consumption and savings decisions—if it were not necessary to compensate for the revenue loss from integration.[205]

---

197. *See supra* notes 179-81 and accompanying text.

198. *See generally* Feldstein, *supra* note 18, at 29 (elaborating on distortions created by any tax on income from capital).

199. *See* J. BALLENTINE, *supra* note 87, at 82-84; Feldstein, *supra* note 18, at 34-37. The distortions created by a tax on income from capital have led some to conclude that a tax on expenditures would be preferable to a tax on income. *See supra* note 76.

200. For example, if the rate of interest is 10% and no tax is imposed, one might be indifferent between consuming $100 of a particular good currently or $110 of a similar good next year. If a tax of 20% on income from capital is imposed, the good that can be consumed for $100 this year becomes more attractive than the good that can be consumed for $110 next year because one would need to save more than $100 ($101.85) to afford the $110 good next year. As a result, one would expect current consumption to increase and savings to decline. At the same time, however, a tax on income from capital makes future consumption more expensive. Thus, individuals will need to save more to satisfy future consumption plans. *See* J. BALLENTINE, *supra* note 87, at 84. It is uncertain, therefore, whether a tax on income from capital increases or reduces aggregate savings. *Compare* Boskin, *Taxation, Saving, and the Rate of Interest*, 86 J. POL. ECON. 3, 3 (1978) (finding direct relationship between savings and the interest rate) *with* Weber, *Interest Rates, Inflation and Consumer Expenditure*, 65 AM. ECON. REV. 843, 843 (1975) (finding inverse relationship between savings and the interest rate). Regardless of the impact of a tax on income from capital on the level of savings, such a tax is distorting simply because it changes the time at which individuals consume. *See* Feldstein, *supra* note 18, at 34-37.

201. The distortion created by the corporate tax by virtue of being a tax on income from capital that distorts consumption and savings decisions is referred to in the economics literature as an "intertemporal" distortion. *See* J. BALLENTINE, *supra* note 87, at 82-88.

202. The individual income tax applies to income from capital and to income from labor. I.R.C. § 61(a) (West 1989). That part of the individual income tax that applies to income from labor also is distortionary. *See infra* text accompanying note 225.

203. *See* Feldstein, *supra* note 18, at 46-47. For a technical discussion touching upon the relationship between the corporate-level investment bias focused on in the legal literature and the more general individual-level consumption/savings distortion focused on in the economics literature, see J. BALLENTINE, *supra* note 87, at 82-84.

204. *See supra* text accompanying notes 171-72.

205. Integration may not necessarily be beneficial since double taxation is one of many distortions imposed by the tax system and the impact of one distortion in the presence of many others may be significantly different from the impact of one distortion where no other distortions exist. *See* J. BALLENTINE, *supra* note 87, at 79-80; Atkinson & Stiglitz, *supra* note 80, at 74.

Because an alternative revenue source would have to finance the revenue loss from integration,[206] integration will further neutrality on a system-wide basis only if the alternative revenue source creates distortions less severe than those existing under double taxation. The legal literature generally has not considered the efficiency implications of an alternative revenue source. Therefore, the case against double taxation developed in that literature is incomplete.

C. *Efficiency Implications of Alternative Revenue Source Must Be Assessed*

Neutrality becomes a relative goal once it is acknowledged that a given amount of revenue must be raised through taxes.[207] If taxes are inevitable, some distortions must be tolerated.[208] The tax reform goal must be to minimize on a system-wide basis the adverse impact on efficiency of a tax system required to raise a given amount of revenue.[209] In other words, the gains in efficiency derived from eliminating a source of revenue must be weighed against the losses in efficiency incurred by a compensatory change to determine whether reform is desirable.[210] It is likely that the revenue loss from integration would be financed through higher individual taxes.[211] Legal literature for the most part ignores the impact of this or any other alternative revenue source on efficiency.[212] In contrast, economics literature that examines the efficiency implications of integration does consider the efficiency costs of substituting higher individual taxes for double taxation.[213] Although economic studies performed prior to the 1986 Act suggest that some efficiency gain might be derived from substituting higher

---

206. *See supra* text accompanying notes 69-73.

207. If revenue need did not constrain tax reform, neutrality could be achieved simply by eliminating all taxes. *See supra* note 149.

208. Tax revenues might be generated in a manner that is not distorting by imposing an equivalent dollar amount of tax on every living individual, but such a tax would be unacceptable from an equity standpoint. R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 291; *see* Atkinson & Stiglitz, *supra* note 80, at 63. For a discussion of the possibility that some part of the corporate tax may not be distorting, see *infra* text accompanying notes 215-21.

209. *See generally* Feldstein, *supra* note 13, at 90 ("[A] comprehensive income tax is itself a distortionary tax and therefore an inefficient tax. The problem is to select the set of tax rates . . . on different sources of income that minimizes inefficiency or maximizes welfare."). Equity considerations also limit the ability to maximize efficiency. *See supra* note 208.

210. The economics literature consistently has recognized the need to balance the gains in efficiency from a revenue losing proposal against the efficiency costs associated with an alternative revenue source. *See* Atkinson & Stiglitz, *supra* note 80, at 60; Feldstein, *supra* note 13, at 79-80; Sandmo, *Optimal Taxation*, 6 J. PUB. ECON. 37, 40 (1976).

211. *See supra* note 129. If the revenue loss from integration were financed by a new tax, such as a value-added tax, rather than an increase in individual income taxes, the inefficiencies associated with the new tax would have to be considered. It is possible that a new tax, simply because of its newness, would result in more significant distortions than a more traditional revenue source.

212. *See* Warren, *supra* note 5, at 725, 770 (comparing individual investment distortions created by double taxation to the result that would prevail *in the absence of taxation* and suggesting that if the revenue cost of integration is objectionable, it might be reduced by partially integrating taxes). Indeed, the legal literature has been critical of justifying double taxation on revenue grounds. *See supra* note 74 and accompanying text.

213. *See* Chang, *Optimal Taxation of Business and Individual Incomes*, 35 J. PUB. ECON. 251, 252 (1988); Feldstein, *supra* note 18, at 46-48; Fullerton, King, Shoven & Whalley, *supra* note 18, at 677. *See generally* J. BALLENTINE, *supra* note 87, at 82 n.16 ("Since virtually any tax causes some inefficiency, the inefficiency caused by whatever tax might be used in place of the corporation income tax must be taken into account in a final evaluation of the corporate tax with respect to efficiency.").

individual taxes and integration for double taxation,[214] fundamental reasons exist for believing that it may not be desirable to transfer existing burdens from the corporate tax to the individual income tax.

D. Transferring Burdens from Corporate Tax to Individual Income Tax May Be Undesirable

From an efficiency standpoint, it may be undesirable to adopt integration at the cost of higher individual income taxes for several reasons. First, double taxation may entail an element that does not distort economic decisions. By contrast, the individual income tax does not share this element. Second, substituting higher individual income taxes for double taxation will yield efficiency gains only if existing tax burdens are shifted from capital to labor, a measure that would be inconsistent with maintaining progressivity. Finally, at this point in time, an income tax system that utilizes multiple, low rate, broad-based taxes is a realistic goal. It may be more productive from an efficiency standpoint to refine that system than to jeopardize the gains derived from such a system by increasing individual income taxes to pay for integration.

1. Eliminating double taxation sacrifices element that does not distort

When a tax is imposed on a quality that is desired irrespective of the tax, the tax will not distort economic decisions.[215] Certain income derived from capital should be desired by owners of capital regardless of whether that income is taxed. Specifically, any return that exceeds the minimum return that an investor would accept for the use of that investor's capital should be desired regardless of how heavily that excess return might be taxed. In this regard, the minimum return ("normal" profit) acceptable to an investor must be differentiated from any additional return ("pure" profit) generated by an investment.[216] The pure profit is a bonus that can be taxed away without encouraging the individual investor to spend rather than to save.[217]

Quite clearly, the existing corporate tax base represents more than a pure

214. *See* Feldstein, *supra* note 18, at 46-48; Fullerton, King, Shoven & Whalley, *supra* note 18, at 77. These commentators do acknowledge that gains in efficiency will be substantially reduced where revenue neutrality is achieved by increasing individual tax rates. *See* Feldstein, *supra* note 18, at 41 (stating that gains in efficiency from eliminating tax on capital income are reduced and may be negative if revenue must be recovered by a higher rate of tax on capital income); Fullerton, King, Shoven & Whalley, *supra* note 18, at 690 (stating that potential gains under integration from removal of intertemporal distortions would be reduced significantly if marginal income tax rates are increased); *infra* notes 227-31 and accompanying text. The efficiency gain emerging from the Feldstein study also would be reduced if a tax on capital income caused an increase in savings. *See* J. BALLENTINE, *supra* note 87, at 84-85; *supra* note 200.

215. The demand for a quality that remains desirable regardless of the extent to which it is taxed is said to be "inelastic." A commodity for which demand is inelastic, "is an ideal object of taxation from an efficiency point of view." Sandmo, *supra* note 210, at 45; *see* R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 295 ("Excess burden is absent wherever surplus can be isolated out as a base of taxation.").

216. *See* J. BALLENTINE, *supra* note 87, at 20.

217. *See supra* text accompanying notes 197-203 (generally tax on income from capital encourages taxpayers to consume currently rather than save).

profit.[218] No deduction is allowed to a corporation for any payments made with respect to an equity investor's capital; therefore, at least a part of the base on which the corporate tax is imposed represents a normal profit.[219] Imposition of the corporate tax on the normal profit on equity capital distorts consumption and savings decisions.[220] By eliminating the double taxation of corporate income in its entirety, however, integration would do more than eliminate the inefficiencies created by subjecting this normal profit to double taxation. It also would eliminate the part of the corporate tax that applies to the pure profit, which is not distortionary.[221]

Unlike the corporate tax, which represents a tax on capital,[222] the individual income tax taxes both capital and labor.[223] In other words, the individual income tax taxes not only income from capital but also income derived by individual wage earners. If integration were financed through higher individual taxes, a tax imposed on income from both capital and labor would be substituted for the corporate tax that falls only on capital.[224] That part of the individual income tax that applies to labor, however, does not share the neutral element of

---

218. The pure profit has been illustrated by assuming that corporations can finance all investment with debt. The "normal" profit attributable to debt financing would be represented by the interest rate that the corporation must pay on the borrowed funds. Any taxable income that remains after the payment of interest represents a "pure" profit because interest is deductible from the corporate tax base. *See* I.R.C. § 163 (West 1989); King, *Taxation, Corporate Financial Policy, and the Cost of Capital—A Comment*, 4 J. PUB. ECON. 271 (1975); Stiglitz, *The Corporation Tax*, 5 J. PUB. ECON. 303 (1976); Stiglitz, *Taxation, Corporate Financial Policy and the Cost of Capital*, 2 J. PUB. ECON. 1 (1973).

219. The cost of equity financing tends to be associated with dividends. Dividends are not deductible. Equity investors also are compensated by the appreciation in stock that results from retained earnings. Part or all of this appreciation also may represent a cost of equity capital. It is difficult, therefore, to quantify the normal profit associated with equity capital.

220. The entire corporate tax may operate to raise revenue in a fashion that does not distort after the risk of uncertainty is taken into account. By taxing income from capital, the government absorbs a part of the expected return from capital. It also absorbs a part of the uncertainty in that return. The fact that the investor bears less risk may compensate for the lower expected return caused by the tax. *See* Gordon, *Taxation of Corporate Capital Income: Tax Revenues Versus Tax Distortions*, 100 Q.J. ECON. 1 (No. 1, 1985).

221. Professor Andrews, as Reporter for the American Law Institute, has long advocated refining the corporate tax base to allow a deduction for the cost of new equity capital. *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY DRAFT 88-97 (1989); AMERICAN LAW INSTITUTE, *supra* note 16, at 356-401. Although this ALI proposal does not embrace the pure-profits view of the corporate tax specifically, it is consistent with that view. *See* Warren, *supra* note 5, at 760. Professor Andrews believes that the ALI proposal would entail a lesser revenue cost and a smaller redistributional impact than integration. *See* AMERICAN LAW INSTITUTE, *supra* note 16, at 331. The actual revenue cost of the proposal has not been quantified. *See id.* at 398-99. It would be productive to quantify the revenue effect of all of the proposals in the ALI Subchapter C Study to determine whether those proposals together would lose revenue. If the ALI proposals would lose revenue, any gains in equity and efficiency resulting from those proposals would be offset by the costs in equity and efficiency of a compensatory revenue source.

222. *See supra* note 193 and accompanying text.

223. *See* I.R.C. § 61 (West 1989).

224. The efficiency critique follows the incidence assumption made in the economics literature (that the corporate tax is borne by all owners of capital) because the heart of the case against double taxation on efficiency grounds is developed in the economics literature. *See supra* notes 197-203 and accompanying text. *But see supra* note 115 (equity critique follows incidence assumption generally made by those arguing for integration on equitable grounds; namely, that shareholders bear the corporate tax). It is possible that part or all of the burden of the corporate tax may be shifted to labor through wage reductions and by price increases of consumer goods. *See supra* note 92.

a tax on capital. Rather, taxing labor income distorts the decisions individuals make between work and leisure because the benefits derived from leisure are outside the scope of the individual income tax base.[225] Consequently, to substitute higher individual taxes for double taxation would be to replace, in part, a distorting tax on labor income for the present tax on capital income (a part of which is not distorting). System-wide efficiency currently may be furthered by double taxation, therefore, notwithstanding the disproportionate burden double taxation imposes on capital income.[226]

2. Eliminating element of double taxation that distorts is inconsistent with progressivity

The corporate tax distorts savings and consumption decisions because it represents a tax on capital income.[227] Because a part of the individual income tax is imposed on income from capital, gains in efficiency will not be achieved if the burden imposed by the corporate tax is transferred to that part of the individual income tax that applies to capital. Substituting higher individual tax rates for double taxation might simply convert a hidden burden on income from capital to an overt burden on that income, because much of the income derived by high-income individuals is from capital rather than labor.[228] Consequently, if integration is to be financed with higher individual income taxes, efficiency considerations dictate that the increase in individual income taxes be designed to transfer to labor the burden that the corporate tax currently imposes on capital.[229] At least one group of commentators has acknowledged that the greatest gains in efficiency would be achieved if integration were compensated for "by taxing the poor who do not save" because taxing the poor would not distort the decisions individuals make between consumption and savings.[230] Even if such a shift in tax burdens were desirable from an efficiency standpoint, it might be objectionable on equitable grounds because it represents a significant departure

---

225. *See* J. BALLENTINE, *supra* note 87, at 79; R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 294; Feldstein, *supra* note 18, at 31-32.

226. *See* Chang, *supra* note 213, at 262-63. Chang concludes that even when a business income tax does not allow dividends to be deducted from taxable income, efficiency requires both a business income tax and a personal income tax. *Id.* at 262. He acknowledges that reducing the burden on distributed corporate income deserves further investigation but demonstrates that it is not a foregone conclusion that efficiency gains would be derived by shifting this burden to the individual income tax. *See id.* at 263. Chang's study implies that earlier economic studies that derived a welfare gain by shifting the burden of the corporate tax to the individual income tax did not focus adequately on the pure profit element of the corporate tax. *See supra* note 214 and accompanying text.

227. *See supra* text accompanying notes 197-203.

228. *See* Fullerton, King, Thomas & Whalley, *supra* note 18, at 690 ("the potential gains under integration from removal of intertemporal distortions would be significantly reduced if marginal income tax rates are raised").

229. *See* Feldstein, *supra* note 18, at 48 ("This [study] reinforces the traditional case for eliminating the corporate income tax *if that can be done in a way that removes the excess taxation of capital income.*" (emphasis added)).

230. Fullerton, King, Shoven & Whalley, *supra* note 18, at 690 ("[T]he dynamic results . . . suggest significant potential gains from corporate tax integration, provided replacement taxes do not excessively interfere with intertemporal consumption choice. . . . [T]he largest intertemporal gain could be secured by taxing the poor who do not save.").

from the progressivity of the tax system that presently exists.[231]

3. Multiple broad-based, low rate taxes may further efficiency more than integration

The 1986 Act suggests that a tax system that entails a broad-based individual income tax and a broad-based corporate tax, both of which are imposed at the same low rate, is an obtainable goal. Quite clearly, however, that ideal has not yet been achieved; the highest corporate rate exceeds the highest individual rate by six percent and neither the corporate tax nor the individual tax is imposed at a flat rate.[232] Nevertheless, the existing tax system approaches that broad-based, low rate ideal to a greater extent than many ever thought possible.

A tax system that entails broad-based individual and corporate taxes imposed at identical low rates is desirable from an efficiency standpoint. To the extent that the two taxes operate independently, the breadth of each tax base and the single low rate minimize the potential for each tax to distort economic decisions.[233] To the extent that the two taxes operate in the alternative—when the choice is between undistributed corporate income and some other form of income—even the integrationists acknowledge that equivalent rates will minimize differences that otherwise would be distorting.[234] Distributed corporate income will continue to bear a heavier burden than other forms of income under this system. Yet, broad-based taxes imposed at identical low rates also have a prophylactic effect on the overtaxation of distributed corporate income because this system of taxation reduces the difference, in absolute terms, between the tax burden on distributed corporate income and the burden on other forms of income.[235]

If the overtaxation of distributed corporate income is eliminated by increasing individual tax rates, the gains in efficiency derived from the broad-based, low rate ideal will be jeopardized. History as well as reason suggest that higher marginal rates are likely to augment the difference between the highest and lowest individual tax rates.[236] As the range of rates expands, the distortions created by existing preferences will be accentuated.[237] Moreover, higher rates are likely to

---

231. *See supra* note 17; *supra* notes 106-47 and accompanying text.

232. I.R.C. §§ 1, 11 (West 1989); *see supra* text accompanying notes 54-56. Some additional base broadening also might be desirable.

233. *See* R. MUSGRAVE, *supra* note 6, at 173 (stating that a tax on business income designed to treat different firms equally is desirable from neutrality standpoint); Fullerton & Mackie, *Economic Efficiency in Recent Tax Reform History: Policy Reversals or Consistent Improvements?*, 42 NAT'L TAX J. 1 (1989) (noting several measures of economic efficiency that are enhanced by lower marginal tax rates); Minarik, *supra* note 42, at 1373 (acknowledging that low rates spread the burden of government thinly); Yorio, *supra* note 21, at 440 ("The reduction in marginal tax rates may make taxpayers less inclined to substitute leisure for work. In making investment decisions, taxpayers will be less likely to pursue tax objectives both because of lower marginal rates and because of the elimination (or restriction) of various tax preferences.").

234. *See supra* notes 91-97 and accompanying text.

235. *See supra* notes 100-01 and accompanying text.

236. *See supra* text accompanying notes 124-26.

237. *See supra* text accompanying notes 134-43.

intensify pressures to restore old preferences and create new ones.[238] In addition, the ability to generate additional revenues from higher rates may be limited.[239] Therefore, it may be more productive from an efficiency standpoint to endeavor to refine the reform theme of multiple low rate, broad-based taxes than to jeopardize the gains in efficiency resulting from reform by adopting integration and increasing individual taxes.[240]

VII. CONCLUSION

The view that the double taxation of corporate income is undesirable is well established. It is difficult to quarrel with that view because double taxation entails a departure from the ideals of horizontal equity and efficiency. These departures, however, are prescriptive of the elimination of double taxation only if revenue needs and progressivity are ignored.

No realistic tax ever will achieve perfect horizontal equity or efficiency. Rather, a given amount of revenue must be raised in a manner that furthers equity and efficiency while maintaining the distribution of tax burdens among income classes that society desires. Before double taxation can be judged as good or bad, one must weigh the gains from the elimination of double taxation against the losses that would result from whatever mechanism is utilized to ensure revenue neutrality.

The Tax Reform Act of 1986 demonstrates that a tax system utilizing multiple, flat rate, broad-based taxes is a feasible goal. Such a tax system not only minimizes inequities on a system-wide basis, it also minimizes the magnitude of the extra burden imposed by the double taxation of corporate income. Eliminating double taxation in the face of a revenue constraint likely would lead to an individual income tax increase that would undermine the gains in equity and efficiency derived from the 1986 Act. Moreover, to further efficiency, such a tax increase must be designed to shift tax burdens from capital to labor. It is not apparent that such a shift is desirable from a social policy standpoint.

The case against double taxation, therefore, is not as clear as instinct and existing legal literature suggest. At the present time, moving further toward a tax system that imposes multiple, flat rate taxes appears to be more productive than jeopardizing progress toward that goal by compensating for integration. The ability of double taxation to help finance a multiple, flat rate tax system,

238. *See supra* text accompanying notes 144-47.

239. When tax rates rise above some undetermined level, productive activity may decline to the point at which less tax revenue will be generated than would be the case if lower rates were utilized. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 8, at 304-07; Fullerton, *On the Possibility of an Inverse Relationship Between Tax Rates and Government Revenues*, 19 J. PUB. ECON. 3, 3-22 (1982). For an argument that current rates may be closer to the revenue maximizing level than previously believed, see Browning, *supra* note 141, at 56.

240. *See* Chang, *supra* note 213, at 262-63 (finding that efficiency requires both corporate tax and individual income tax, that individual tax rates should be markedly reduced, and that integration should be considered, but is not preordained); *see also* Surrey, *Reflections on "Integration" of Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 335, 340 (1975) ("[W]hile the economists may plant their integration flag on allocation of resources, the Congress should not follow in their path.... The uncertainties surrounding the effects on allocation of resources are hardly the base to support a major change in the United States tax system ....").

along with the progressivity derived from double taxation, very well may outweigh the costs double taxation imposes on horizontal equity and efficiency.