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Taxing as Ordinary Income the Appreciation of Publicly Held Stock

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This nation is committed to the individual income tax as its principal source of revenue. Since 1958, the federal government has collected more money from the individual income tax than from all other taxes combined,¹ and the proportion is rising. Congress enacted legislation in 1965 that will more than double the per capita burden of the Social Security system²—another form of individual income tax—and repealed or reduced several important taxes not based on income.³ Thirty-seven states levy a tax on individual incomes,⁴ along with many municipalities,⁵ including New York.⁶ All proposals for increased public spending in the cities⁷ rely heavily upon an individual income tax.⁸

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1. U.S. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1957, Ser. 259-77 [hereinafter cited as HISTORICAL STATISTICS]. See also a companion volume to the above publication, CONTINUATION TO 1962 AND REVISIONS [hereinafter cited as CONTINUATION AND REVISIONS].

2. Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286.

3. Excise Tax Reduction Act of 1965, Pub. L. No. 89-44, 79 Stat. 136.

4. U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, TAX OVERLAPPING IN THE UNITED STATES 25, 141 (1964).

5. *Id.* at 140-42 (29 cities with population of 50,000 or more had an individual income tax as of January 1, 1964).

6. Laws of the City of New York, 1966, chs. 773, 774 (July 1, 1966).

7. See Heller, *Deductions and Credits for State Income Taxes*, 51 KY. L.J. 260, 264-67 (1962); R. MARTIN, *THE CITIES AND THE FEDERAL SYSTEM* 13-19 (1965); J. Alsop, *The Washington Post*, March 30, 1966, at A-25, cols. 1-3.

8. See, e.g., Heller, *supra* note 7 *passim* (proposal to permit a portion of state or local income taxes to be credited against the federal income tax); Alsop, *supra* note 7 (proposal to refund part of federal income tax collected in a metropolitan area to the core city).

This method of taxation has become so important that any fault in the individual income tax is now, *ipso facto*, a fault in the American tax system as a whole.

Yet income tax laws barely touch what has become one of the most important and highly concentrated kinds of individual income: the annual increment in value of publicly traded corporate stock. Such holdings now constitute about a fourth of the nation's wealth; more than 70 per cent of it is held by or for the wealthiest one per cent of the population. The corporations that issued it typically have thousands of shareholders, few of whom exercise significant control over corporate operations. These companies obtain most of their funds for reinvestment from their earnings and almost all the rest from borrowing, and once established, they seldom issue more stock. Their self-sustained growth proceeds rapidly, at a faster pace than the rest of the economy. Their stock prices grow apace.

Shareholders with other sufficient sources of income can allow this stock appreciation to continue indefinitely; if they should need to sell, their assets are as liquid as a bank deposit. Their relationship to the process that produces their wealth is as passive as that of a depositor to his bank. But unlike depositors, shareholders enjoy substantial tax immunities. They realize only a small part of their profits as taxable dividends. Most corporate profits are reinvested in the company and reflected as appreciation in the value of its stock. Under present law less than a sixth of such appreciation is ever reported, and then usually not until years after it has accrued. Even then it is taxed at only a fraction of the rate applicable to other income. The consequent loss of revenue is immense, amounting to thirty to fifty per cent of total federal individual income tax receipts. An equally important result is that income tax liability does not even roughly correspond to ability to pay, because corporate stock is so intensely concentrated among the wealthy.

It is the thesis of this article that publicly held corporations, having grown independent of their scattered shareholders and the equity capital market, no longer require the tax incentives which encourage investment in their outstanding stock. These tax privileges, by unnecessarily favoring wealthy investors and passive accumulation, unjustly burden the talented and the energetic as well as the poor. If appreciation of publicly-traded stock were taxed annually as ordinary income, whether or not the stock was sold, the tax system would become genuinely progressive without impairing industry's accumulation of capital.

A conceptual difficulty with this proposal is its frank treatment of

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what has not been sold—what is “unrealized”—as “income.” To date, such treatment has been used only as a marginal device to prevent tax avoidance by premature gifts of about-to-be realized assets, transfer of high-income property to private trusts, failure to call callable obligations, and the like.⁹ It does not yet occupy a prominent place in income tax law¹⁰ or, especially, in the layman’s financial thinking. The typical homeowner, for example, does not consider an upward fluctuation in the value of his house as income. But even conventional thinking treats unrealized appreciation as income in some situations. For example, a depositor probably considers the rising value of his savings account as income whether or not the account is withdrawn. The Internal Revenue Service certainly takes that view.¹¹

Liquidity and measurability characterize the kind of appreciation that can also be regarded as “income.” Liquidity is here used in its broadest sense, taking into account any reasonable obstacle to converting property to cash—factual, legal or subjective. When all the barriers to conversion are low, the increased value of appreciated property is indistinguishable from cash in its effect on the owner’s ability to pay, and ability to pay is the touchstone of liability for an income tax.

Measurability is necessary simply because if appreciation is taxed before property is sold, there must be some convenient measure of its amount other than the price realized on an actual sale. Measurability thus operates as a practical limit on how close the individual income tax can approach its own ideal of matching tax liability to ability to pay.

A few illustrations may clarify the use of the terms. Unimproved real estate held as an investment and located in or near a populated

9. See, e.g., Treas. Reg. § 1.451-2 (1957) (constructive receipt of income); Rev. Rul. 66-44 and Rev. Rul. 66-45, 1966 INT. REV. BULL. no. 9 (interest accrued in respect to bank savings certificates, even though not payable until certificate for both principal and interest is surrendered, is “income” even to a cash basis taxpayer); *Corliss v. Bowers*, 281 U.S. 376, 378 (1930) (“The income that is subject to a man’s unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.”—income of a revocable trust); *Hedrick v. Commissioner*, 154 F.2d 90 (2d Cir. 1946), cert. denied, 329 U.S. 719 (1946) (uncashed check); *Thomas Watson*, 12 P-H TAX CT. REP. & MEM. DEC. 1411 (1943) (interest accrued to account); *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945) (right to proceeds from law suit which seemed certain to be won but on which judgment had not yet been entered). See also 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.39, at 129-30 (“A taxpayer may not turn his back upon income and postpone the year of its recognition for tax purposes by choosing not to actually receive income which is available to him. [Such income] . . . is taxable when the amount is ascertained and available to the taxpayer without restriction or is subject to his control.”).

10. Cf. BROWNLEE & ALLEN, ECONOMICS OF PUBLIC FINANCE 242-47 (2d ed. 1954); SIMON, PERSONAL INCOME TAXATION 50-51 (1938).

11. *Thomas Watson*, 12 P-H TAX CT. REP. & MEM. DEC. 1141 (1943).

area is usually highly liquid, because buyers are not hard to find and because a sale of the property, by hypothesis, will deprive the seller of nothing except its investment value. But since every parcel of real estate is to an extent different from every other, smoothly functioning markets or "exchanges" in which they can be bought and sold at predictable prices do not exist. On the other hand, real estate which the owner occupies as a residence or operates for a profit, for example, a farm or a restaurant, is normally neither readily measurable in value nor readily liquidable, because a sale would materially inconvenience the seller.

But publicly traded stocks amply meet both the test of liquidity and of measurability. They can be sold quickly, easily and at a known price. For reasons that will be shown, their sale has no detrimental effect on the corporation or the economy and imposes no extraordinary hardship on the selling shareholder. Appreciation of publicly held stock therefore must be regarded as income if the income tax is to remain true to its own basic rationale, ability to pay, within the limits of measurability. How such stock could be fitted into the scheme of the individual income tax, and why that is both possible and desirable, remain to be discussed.

I. The Present System of Taxing, and Not Taxing, Capital Appreciation

Capital appreciation generally receives three tax privileges that in the case of corporate stock render its appreciation nearly taxfree. First, it is taxed only when property is sold or exchanged,¹² thus allowing the owner who retains his property to continue earning a return on the money he would otherwise have had to pay in taxes. For example, a thousand dollars of stock appreciating ten per cent per year would be worth \$47,500 in fifty years if the shareholder had to reduce each year's appreciation by one-fourth in order to pay the maximum income tax applicable to such gains. The same amount of stock appreciating at the same rate for the same period without offset for an annual tax is worth \$135,500. The advantage of not having to pay an annual tax is thus equal to \$88,000—almost two-thirds the entire appreciation. Holding periods of this magnitude are not unusual for corporate stock. About 85 per cent of it is apparently not sold or otherwise exchanged in a taxable transaction from one generation to the next.¹³

12. INT. REV. CODE of 1954, §§ 1001, 1002 [hereinafter cited as IRC].

13. See text accompanying note 16 *infra*.

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The second privilege eliminates all taxes on appreciation if the owner of property dies while holding it. His heir, if he sells the property, is taxed only on appreciation subsequent to his benefactor's death.¹⁴ Finally, when (if ever) appreciation is taxed, it is at a singularly low rate: either at half what would have been paid had the same amount been earned as wages or other ordinary income, or at a rate of 25 per cent, whichever is less.¹⁵

The result is to reduce the effective tax rate on corporate stock appreciation to less than 4 per cent. The first two privileges permit individuals holding appreciated securities to reap the benefits of better than 85 per cent of their appreciation without ever reporting it,¹⁶ and on the fraction reported the third privilege insures that the tax liability is never more than 25 per cent.¹⁷ The average effective rate on ordinary income, most of which, unlike stock appreciation, is received by individuals in the lower income brackets, is about 12 per cent.¹⁸

14. IRC § 1014.

15. IRC §§ 1201(b), 1202.

16. In 1961 the net capital gain less loss from sales of capital assets reported as adjusted gross income was \$6.0 billion. U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1961, INDIVIDUAL INCOME TAX 7, Table H. In 1960, the closest year for which data is available, the comparable figure on taxable estate and fiduciary income tax returns was \$1.0 billion. U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1960, FIDUCIARY AND ESTATE TAX RETURNS 3, Table A, 25, Table 8. About 60 per cent of the income reported by fiduciaries on taxable returns was rendered non-taxable by the "distribution to beneficiaries deduction," so to avoid duplication the \$1.0 billion should be reduced to \$0.4 billion. *Id.* at 10-12, Table 2. Only half of capital gains reported on individual returns are includable in adjusted gross income (IRC § 1202) so the total is \$6.0 times 2 plus \$0.4, or \$12.4 billion. About half or less of this derives from sales of corporate stock. U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS 10, Table 2 [hereinafter cited as STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS] (including a portion of the item "share of gain or loss from partnerships or fiduciaries"). So the stock-derived capital gains reported was probably about \$6.2 billion. Stocks in the hands of individuals and nonprofit institutions in 1961 appreciated about \$100 billion. See SEC Release No. 2042 (April 7, 1965). But because 1961 was an atypically high year, the average yearly appreciation from 1950 to 1964 will be used instead. It was \$42.5 billion. (The value of such stock at the end of 1960 was \$379.3 billion. *Id.* The average yearly appreciation was 11.2 per cent. Standard and Poor's Index, cited in U.S. BUREAU OF THE CENSUS, 1965 STATISTICAL ABSTRACT OF THE UNITED STATES 473, Table 647 [hereinafter cited as STATISTICAL ABSTRACT]). Non-profit institutions hold about 5 per cent as many stocks as do individuals. NEW YORK STOCK EXCHANGE FACT BOOK 1965 [hereinafter cited as NYSE FACT BOOK 1965], \$42.5 billion less 5 per cent is about \$40 billion. The fraction reported in 1961 was therefore about 15.5 per cent, that is, \$6.2 billion out of \$40 billion. This method of computation yields approximately the same result no matter what year is chosen.

See M. Bailey, Capital Gains and Income Taxation, 1963, pp. 8-11 (unpublished, available at the Brookings Institution, Washington, D.C.). Bailey concluded that from 1926 to 1961 the ratio of reported capital gains on corporate stock to capital gains actually accruing was about 10 per cent. His method is essentially the same as mine, but much more statistically precise.

17. IRC §§ 1201(b), 1202.

18. Total adjusted gross income from all sources in 1962 was \$348.7 billion. U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1962, INDIVIDUAL INCOME TAX RETURNS 33 & Table 1 [hereinafter cited as 1962 INDIVIDUAL INCOME TAX RETURNS]. \$5.8 billion of that was from sales of capital assets. *Id.* at 38 & Table 4. Total tax liability was \$44.9 billion. *Id.* at 33 & Table 1. The \$5.8 billion of sales of capital assets

The concern of this article, however, is only with the appreciation of the stock of large corporations with widely held stock—so-called “public corporations.” To determine the revenue loss represented by the failure to tax this appreciation as ordinary income, we shall first estimate the average annual amount of such appreciation; second, estimate the distribution of the appreciating stock among taxpayers in various ordinary-income rate brackets; third, calculate the tax which that amount of annual appreciation would pay if it were realized as ordinary income; and fourth, subtract the amount of tax that it is already paying.

Annual Appreciation

The value of all individually held corporate stocks at the close of 1964 was slightly less than \$600 billion.¹⁹ They account for about a third of all individually owned wealth²⁰ and about half of the capital gains reported on individual and fiduciary income tax returns.²¹ The value of the stock of public corporations alone at the close of 1964 was about \$478 billion.²² From 1950 through 1964 prices of publicly held stocks rose an average of 11 per cent per year, compounded.²³

could not have accounted for more than \$2.9 billion of the tax. IRC §§ 1201(b), 1202. The effective rate on ordinary income is thus at least \$44.9 billion less \$2.9 billion divided by \$348.7 billion less \$5.8 billion, or 12 per cent.

19. SEC Release No. 2042 (April 7, 1965), Table 2 (total of corporate stocks plus 81 per cent of investment company shares). Investment company portfolios contain about 81 per cent common stocks. A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. 119, 129 (1962). About 5 per cent has been subtracted for securities held by nonprofit institutions. See NYSE FACT BOOK 1965 at 25.

20. First National City Bank of New York, Monthly Economic Letter, July 1964, at 78.

21. STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS 10 & Table 2 (including an indeterminate portion of the item, “share of gain or loss from partnerships and fiduciaries”).

22. (i) At the end of 1964 individuals held about \$400.2 billion of the common stocks of American companies listed in the New York Stock Exchange. NYSE FACT BOOK 1965, at 25, 36 (including holdings of common trust funds and investment companies).

(ii) Institutions other than common trust funds and investment companies held about 13.9 per cent of the stocks listed on the NYSE. *Id.* The stocks listed on the NYSE as of 1962 constitute about 92.5 per cent (in value) of all listed stocks. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. 95, 88th Cong., 1st Sess., pt. 1, at 27 (1963) [hereinafter cited as SPECIAL STUDY]. Assuming that the same per cent of all listed stocks are held by individuals as are those listed on the NYSE, this gives another \$33 billion of listed stocks not on the NYSE that are held by individuals.

(iii) The value of over-the-counter stocks is something “less than one-third” of those listed. SPECIAL STUDY pt. I, at 14. We will use the figure 25 per cent to be conservative. About 41 per cent of such stocks represent companies with assets of at least \$3 million and with 500 or more shareholders. *Id.* at 27. We will assume that such companies, at least, are “public.” See text accompanying note 120. Again assuming that the per cent held by institutions on the NYSE holds approximately true throughout, we have (\$400.2 plus \$33) times 25 per cent times 41 per cent or about \$45 billion of unlisted public-corporation stocks held by individuals. The grand total is then \$478 billion.

23. During that period the average value of an NYSE-listed common stock increased 379.2 per cent. See STATISTICAL ABSTRACT 473 & Table 647 (stock prices, 1950 to 1964); STANDARD AND POOR'S CORPORATION, TRADE AND SECURITIES, STATISTICS: CURRENT STATISTICS COMBINED WITH BASIC STATISTICS 69 (January 1966) (stock prices, 1965). On a compounded-

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However, during that period stocks underwent a revaluation, being valued substantially higher relative to earnings and book value at the end of the period than at its beginning, so 11 per cent represents somewhat too high a figure for predicting future growth. From 1950 through 1964 (data for 1965 is not yet available) the average book value per share of publicly traded stocks increased about 6½ per cent per year.²⁴ That rate, on the other hand, probably represents too low a figure for predicting future growth. The argument over the intentional use of federal deficits to promote full employment and rapid growth was not resolved in the affirmative until about 1964. The amount of stimulus which the economy can safely tolerate is still under dispute, but the principle of federal fiscal intervention now seems too solidly established ever to permit a recurrence of the long periods of recession and sluggish advance that characterized the fifties and early sixties. So it can reasonably be predicted that the long range rate of growth of publicly traded stocks will be better than 6½ per cent, less than 11 per cent, and probably closer to the lower figure. Applying these long range averages to 1965 stock values yields an amount of public stock appreciation for that year of from \$31 billion to \$53 billion.²⁵

Distribution Among Taxpayers

Five years ago, Robert J. Lampman, working under the sponsorship of the National Bureau of Economic Research, published his study of

annually basis, that equals 11 per cent per year. Stocks listed on the New York Stock Exchange account for about 80 per cent of all publicly traded stocks. See note 22 *supra*. However, the other 35 per cent probably appreciated more rapidly than those listed on the New York Stock Exchange and so using the 11 per cent figure is conservative.

Values for all stocks are not available back to 1950, so a more recent period must be used for comparing the rates of growth. From 1960 to 1964 the Standard and Poor's "Standard 500" Index increased from 55.85 to 81.37, or about 46 per cent. STATISTICAL ABSTRACT 473 & Table 647. That index covers about 85 per cent in value of all stocks listed on the New York Stock Exchange, so it is fully representative of them. Letter to author from Research Department, Standard and Poor's Corporation, July 23, 1965. During the same four-year period individually held common and preferred stocks, listed and unlisted, appreciated about 58 per cent. SEC Release No. 2042, Tables 1, 2 (April 7, 1965). Thus, since the total of all stocks appreciated more than those listed on the New York Stock Exchange, those not listed on the Exchange must have appreciated much more than those that were.

24. STANDARD AND POOR'S CORPORATION, TRADE AND SECURITIES, STATISTICS, CURRENT STATISTICS 31 (August 1966) (industrials). Data for industrials had to be used because the more comprehensive "Standard 500" data is available only through 1962. But the rates of growth shown by the two sets of data are almost identical, so the use of industrials introduces no significant error. Compare STANDARD AND POOR'S CORPORATION, TRADE AND SECURITIES, STATISTICS, 1964 SECURITY PRICE INDEX RECORD 124 ("Standard 500" book values through 1962).

25. Eleven per cent of \$478 billion is \$52.58 billion, and 6½ per cent of \$478 billion is \$31.07 billion. The actual appreciation of public stocks during 1965 was about \$40 billion. STANDARD AND POOR'S CORPORATION, TRADE AND SECURITIES, STATISTICS, CURRENT STATISTICS 31 (August 1966).

the distribution of national wealth as revealed in estate-tax data from 1928 to 1953.²⁶ He concluded that 82 per cent of the individually owned corporate stock was held by or for the richest one per cent of the families in the population, and counting only adults, by or for the richest 1.6 per cent,²⁷ and that this distribution had held steady over a twenty-five year period.²⁸

Professors Butters, Thompson and Bollinger of the Harvard School of Business Administration in a 1952 survey using a confidential interview technique, found a concentration that in some ways was even more striking:²⁹ 65 to 70 per cent of all individually owned marketable³⁰ stock was held by "spending units" with a net worth of more than \$250,000.³¹ The authors concluded that at the time of their survey, only a "small fraction of one per cent" of the population had this net worth.³² They concluded further that 35 per cent of such stock was held by spending units with income in excess of \$50,000 (then about one tenth of one per cent of the population) and 75 per cent by spending units with incomes over \$10,000 (then about 3 per cent of the population).³³ And in their opinion this data substantially understated the true concentration.³⁴

There is good evidence that a larger proportion of all corporate stocks are held by institutions such as charitable foundations and pension trusts today than in the early 1950's.³⁵ But there is no evidence that the proportion that still remains in the hands of individuals is any less concentrated in the hands of the wealthiest. Certainly, in the light of Lampman's conclusion that the concentration did not change materially from 1922 to 1953³⁶—a period spanning a series of major economic disruptions and the imposition of very high corporate and individual income taxes—it is reasonable to conclude, in the absence

26. R. LAMPMAN, *THE SHARE OF TOP WEALTH-HOLDERS IN NATIONAL WEALTH, 1922-56* (1962).

27. *Id.* at 191, 195.

28. *Id.* at 208.

29. BUTTERS, THOMPSON & BOLLINGER, *EFFECTS OF TAXATION, INVESTMENTS BY INDIVIDUALS* (1953).

30. That is, stock that can be purchased by the public. *Id.* at 373.

31. *Id.* at 396, 399.

32. *Id.* at 399.

33. *Id.* at 440.

34. *Id.* at 393-96.

35. See NYSE FACT BOOK 1965 25. The portion of NYSE-listed stocks held by institutions has grown from 12.7 per cent in 1949 to 20.4 per cent in 1964. If investment companies are eliminated from the category of institutions, on the grounds that they are purely holding companies for their own shareholders, the respective portions are 8.7 per cent and 14.4 per cent. The percentage of stocks held by institutions fell slightly in 1965, however. *Wall Street Journal*, Feb. 3, 1966, at 13, col. 2.

36. LAMPMAN, *supra* note 26, at 209; BUTTERS, THOMPSON & BOLLINGER, *supra* note 29, at 397 ("no great change" apparent during three-year course of their study).

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of any evidence to the contrary, that the distribution remains approximately the same.

The comprehensive statistical analysis of individual income tax returns published by the Internal Revenue Service for the year 1962³⁷ discloses that tax returns reporting adjusted gross income of \$20,000 or more comprise 1.7 per cent of the total.³⁸ Since Lampman found that the 1.6 per cent of the adult population holding 82 per cent of the stock was also the wealthiest 1.6 per cent in other respects³⁹ and since personal wealth is by far the most important source of income of individuals in the highest brackets,⁴⁰ it is a fair approximation to conclude that this 1.6 per cent coincides with the 1.7 per cent of the tax-paying public reporting \$20,000 or more income.⁴¹ The accuracy of the approximation is further confirmed by the Butters, Thomson and Bollinger data,⁴² and a study made in 1959 by the Internal Revenue Service.⁴³ An estimate of how the 82 per cent of the stock is distributed among the income levels above \$20,000 can be obtained from the same Internal Revenue Service study, which also shows the distribution among various income levels of the amount of capital gains reported.⁴⁴

Estimate of the Tax Loss

On these assumptions the \$31 to \$53 billion of public stock appreciation⁴⁵ would have incurred a tax liability between \$16 and \$27 billion

37. 1962 INDIVIDUAL INCOME TAX RETURNS was the most recent available data when this article was written.

38. *Id.*, pt. I at 38, Table 4.

39. LAMPMAN, *supra* note 26, at 191, 195.

40. 1962 INDIVIDUAL INCOME TAX RETURNS pt. I, at 38-40, Table 4.

41. In any event the accuracy of the approximation is not critical. If it is assumed even that the 82 per cent of the stock held by or for the richest 1.6 per cent of the adult population is spread out among the 11 per cent of individuals reporting the highest incomes (those reporting incomes of \$10,000 or more), the estimated revenue loss from the failure to report appreciation of public stock as ordinary income amounts to only about a fifth less than if the approximation stated in the text is used.

42. BUTTERS, THOMPSON & BOLLINGER, *supra* note 29, at 393-97. Their data shows a very high concentration of corporate stock among those with the highest incomes—though because their computations were carried out in “spending units” rather than individuals and because they admitted that their results substantially understated the true concentration, their data cannot be used directly for our purposes.

43. See STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS 33, Table 3. This study showed a strikingly high concentration of reported capital gains from sales of corporate stock by members of the highest income brackets.

44. *Id.* at 36, Table 3, col. 10. No breakdown for capital gains from corporate stock alone for adjusted gross income levels of \$20,000 and above is available, but the distribution of all capital gains probably does not differ materially from the distribution of such gains from corporate stock alone in the highest brackets. The distribution of the two quantities can be compared in STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS 11, Table 3. The distributions are seen to be very similar in the brackets above \$50,000, but corporate-stock capital gain is much less common than other kinds below the \$50,000 bracket.

45. See text accompanying note 25 *supra*.

if it had been taxed as ordinary income at the 1965 rates applicable to married couples filing joint returns. The rate tables applicable to married couples filing joint returns are the lowest of the several provided by the Internal Revenue Code.⁴⁶ Since this same appreciation in fact incurred a tax liability of only about \$1 billion,⁴⁷ the revenue loss was approximately \$15 to \$26 billion. In 1965 the total revenue from the entire individual income tax was about \$48.8 billion.⁴⁸

The estimated revenue loss thus obtained is almost certainly too low. Approximations were intentionally conservative.⁴⁹ But even a

46. See IRC, § 1.

47. The total reported adjusted gross income derived from sales of capital assets was \$5.8 billion. 1962 INDIVIDUAL INCOME TAX RETURNS 36, Table 3. Less than half of that derived from corporate stock. See note 21 *supra*. Only about 80% of that half derived from publicly traded corporate stock. See text accompanying notes 19-23, *supra*. So only \$2.3 billion of reported adjusted gross income derived from sales of publicly traded stock. That means that \$4.6 billion of appreciation of such stock was reported, because only half of that which is reported is includible in adjusted gross income. IRC § 1202. The maximum tax rate on that reported is 25 per cent. IRC § 1201(b), § 1202. Twenty-five per cent of \$4.6 billion is \$1.15 billion.

48. THE BUDGET OF THE UNITED STATES GOVERNMENT FOR THE FISCAL YEAR ENDING JUNE 30, 1967, at 55.

49. The "exclusion plus deduction" effect of charitable gifts of appreciated property was ignored. Such gifts not only fail to count as a realization for tax purposes of accrued appreciation, but are deductible to the full extent of their appreciated value against other income. *Elsie Sorelle*, 22 T.C. 459 (1954); Rev. Rul. 55-531, 1955-2 CUM. BULL. 520 (gift of appreciated property is not income to the donor); IRC § 170, Treas. Reg. § 1.170-1(c) (1965) (amount of deduction for gift of property to charity is market value of property at time of gift). The estimate took account of the exclusion of accrued appreciation on such gifts but not its deductibility. Certain underlying assumptions in the computation also tended to understate the amount of revenue loss. First, it was assumed that the corporate-stock appreciation received by taxpayers in different tax brackets is proportionate to the value of the stock they hold. In fact, wealthier people are probably motivated to purchase stocks that have high potential for growth but relatively low dividends in order to escape the high ordinary-income tax rates that apply to dividends. Individuals in the higher tax brackets therefore benefit from proportionately more appreciation than the value of their stock holdings indicates.

Second, the distribution of the 82 per cent of the stock held by those with adjusted gross incomes of \$20,000 or more ("the wealthiest 1.6 per cent") was assumed to be proportionate to the amount of capital gains from sales of corporate stock reported on individual income tax returns. Yet most capital appreciation from corporate stock—more than four-fifths of it (see text accompanying note 16 *supra*)—goes unreported. The principal reason must be that stock is either not sold at all or sold only after its tax basis was raised by the death of the person holding the shares. The very rich must account for much more than their proportionate share of such unreported appreciation because only they can commonly afford to live on dividends or other income alone and to pass on their stock to their descendants instead of selling it. The 1959 study on capital gains, STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS, contains an item supporting this conclusion. The average price at which a share of stock was sold by the wealthiest category that reported capital gains income (those with adjusted gross income of \$1 million or more) was almost five times the price at which it was purchased, or the value at which it was inherited, whichever initial value applied. STATISTICS OF INCOME, 1959, SALES OF CAPITAL ASSETS 11, Table 3. For those with incomes of about \$10,000, on the other hand, the average share of stock had appreciated only by 1/3 its initial value before it was sold. *Id.* Stock that had appreciated by a factor of five is likely to have been held much longer than stock that appreciated only by a factor of 1/3. It seems clear that families in which stock is characteristically held for much longer periods without being sold are also families in which stock is much more likely to have been held until the owner dies.

The necessity of resorting so frequently to conservative approximations and assumptions

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revenue loss of from \$15 to \$26 billion is serious enough. Since the loss occurs almost entirely in the highest brackets, it also contributes a severe regressive factor that eliminates most progression at all levels and introduces a sharp regression above \$25,000. Counting as income the average annual stock appreciation since 1950, the effective tax rate in 1962 was 8 per cent on incomes over \$1,000,000; 12½ per cent on incomes between \$100,000 and \$1,000,000; and 15½ per cent on incomes between \$20,000 and \$25,000.⁵⁰ These calculations take into account only the effect of failing to tax public stock appreciation. An even more strongly regressive pattern would reveal itself if other factors were taken into account, for example, depletion allowances.

If the available data permitted an accurate separation of investors from earned-income recipients at the same income level, it would undoubtedly show the wealthy corporate investors virtually riding free when compared to other taxpayers. The regression above \$25,000 is apparent even from data that fails to differentiate the incomes of large investors from those of doctors, engineers, executives and others whose earnings over \$25,000 are subject to the full progressive rates. Al-

points up the difficulty of making reliable estimates of the distribution of capital appreciation when the only accessible data are income-tax data. The fact is, wealth in the United States is immensely more concentrated than income. Some indication of how much more is that in 1959 the four one-hundredths of one per cent of the tax returns reporting the highest incomes accounted for 1.6 per cent of the total income, U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1959, INDIVIDUAL INCOME TAX RETURNS 24, Table 1 [hereinafter cited as 1959 INDIVIDUAL INCOME TAX RETURNS] whereas the same small fraction reporting the most capital gains from sales of corporate stock accounted for over 50 per cent of the total of such gains.

50. Individuals held directly or through investment companies and common trust funds about \$478 billion of public-corporation stocks at the end of 1964. See note 22 *supra*. The average rate of appreciation of such stocks from 1950 to that time was 11.2 per cent. Authorities cited note 24 *supra*. Their appreciation during 1962 can therefore be taken as about \$39 billion. At least 82 per cent of such appreciation was probably accounted for by stocks held by individuals reporting adjusted gross incomes of \$20,000 or more. See text accompanying notes 37-44 *supra*. Eighty-two per cent of \$39 billion is \$32 billion. No more than 20 per cent of the \$32 billion was reported. See text accompanying note 16 *supra*. Only half of that which is reported is includible in adjusted gross income. IRC § 1202. So the adjusted gross incomes of those with adjusted gross incomes of \$20,000 or more fail to show about \$28.8 billion (90 per cent of \$32 billion) of appreciation on public-corporation stocks held by the individuals reporting such incomes. The percentages in the text are obtained by assuming that the \$28.8 billion is distributed among the brackets above \$20,000 in proportion to the amount of net gain less net loss from sales of capital assets reported by each such bracket as shown in 1962 INDIVIDUAL INCOME TAX RETURNS 36, Table 3, and that the actual tax paid by each bracket and the adjusted gross income reported by each bracket are as shown in *id.* at 33-34, Table 1. The rate for the \$5000-\$6000 bracket is taken directly from *id.* at 33-34, Table 1, without regard for the negligible amount of unreported public-corporation stock appreciation accruing to that bracket.

Since the foregoing computation used *averages* of public-stock appreciation taken from a 14-year period and since the *relative* amounts of gains and losses from sales of capital assets and of adjusted gross income among different brackets do vary widely from year to year, the results of the computation are not dependent upon the use of the year 1962. They would have been approximately the same no matter what year was used.

though the tax liability on \$22,500 of ordinary income in 1962 was 39 per cent for a separate return and 28 per cent for a joint return, the average rate actually paid on this income was 15 per cent. The gap in tax receipts is largely accounted for by the favored treatment of investment income which begins to become a prominent income source in this bracket. The effective tax rate for higher income levels is even smaller.⁵¹ The fact that the investor is fully taxed on his dividends changes the picture very little. From 1960 to 1964, New York Stock Exchange common stocks appreciated more than \$140 billion⁵² while paying dividends of only \$47 billion,⁵³ and the wealthy investor with his "growth stocks" probably obtains an even higher appreciation-to-dividends ratio than the average.

Both the loss of revenue and the injustice to earned-income recipients will probably grow worse, because the relative importance of stock appreciation to other forms of income is increasing. The wealth represented by publicly held stocks has grown about a third more than the economy as a whole since 1950. From 1950 to 1964 the total book value of common stocks listed on the New York Stock Exchange increased about 168 per cent.⁵⁴ The sample is representative: New York Stock Exchange stocks account for about 70 per cent of the value of all marketable stocks in the country, both listed and over-the-counter,⁵⁵ and their rate of growth is probably slightly *less* than that of the other 30 per cent.⁵⁶ Over the same fourteen years the gross national product increased only 119 per cent.⁵⁷ And since the wealth represented by gross

51. 1962 INDIVIDUAL INCOME TAX RETURNS 188.

52. The figure is obtained by multiplying the average value of such stocks during 1960, *see* NYSE FACT BOOK 1965, by the Standard and Poor's price-index change from 1960 to 1964, *see* STATISTICAL ABSTRACT 473, Table 647. The figure is conservative because it ignores the appreciation attributable to shares that obtained listing privileges after 1960 whereas it includes their dividends.

53. NYSE FACT BOOK 1965, at 47.

54. Average book value increased 144 per cent. *See* note 24 *supra*. The approximate growth of total book value is derived by assuming that it bore the same relation to growth of average book value as the growth of total market value bore to the growth of average market value. The ratio of the latter two growth rates for 1950 to 1964 was 1.17. *Compare* the growth of average market prices, Standard and Poor's Stock Price Index, summarized, STATISTICAL ABSTRACT 473, Table 647, *with* the growth in total market price of all NYSE-listed stocks, NYSE FACT BOOK 1965, at 36. One and seventeen-hundredths times the growth of average book value, which was 144 per cent, is 168 per cent.

55. The stocks listed on the NYSE constitute about 92.5 per cent (in value) of all listed stocks. SPECIAL STUDY pt. I, at 27. Over-the-counter stocks equal something "less than one-third" of listed stocks. *Id.*, pt. I, at 14.

56. From 1960 to 1964 all corporate stocks held by individuals and nonprofit institutions appreciated at the rate of 12.08 per cent per year. SEC Release No. 2042 (April 7, 1965). During the same period the Standard and Poor's representative index of stocks listed on the NYSE rose at the average rate of 9.9 per cent per year. STATISTICAL ABSTRACT 473, Table 647.

57. STATISTICAL ABSTRACT 324, Table 444.

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national product includes the wealth represented by publicly held stock, it can be estimated that the wealth represented by such stock has grown about twice as much as other forms of individual and institutional wealth since 1950.⁵⁸ The value of New York Stock Exchange stocks is substantially higher relative to the gross national product and the national income now than at any other time in our history, including the peak of the stock market boom in 1929.⁵⁹

Those who write the federal tax laws have shown little enthusiasm for closing the gap between the shareholders' burden and the wage and salary-earners'. President Kennedy's 1963 Special Message to Congress on Tax Reduction and Reform proposed that the tax rates applicable to capital gain be reduced even further but also that capital assets be valued as of the date of the owner's death and appreciation up to that time be deemed "realized" and taxed.⁶⁰ The proposal would have substantially increased the revenue from capital gains tax on corporate stock,⁶¹ but it never came close to enactment. The only significant new tax-connected proposal that has become law in recent years, the Medicare⁶²-Old Age and Survivor's Insurance⁶³ package, will be financed in part by an increase in the Social Security tax and in part by funds from the general revenues. The increase in the Social Security tax will be sharply regressive, burdening all earned income from \$0 up to \$6600, taxing no income at all in excess of that amount, and applying only to wages and salaries. Not only will all profits of capital appreciation escape the tax, but so will the dividends, interest, and rents that are derived from investments.⁶⁴ A tax better fashioned to aggravate existing inequities is hard to imagine.⁶⁵

58. The figures on gross national product and national income do not include a category for stock appreciation, so the comparison suggested in the text can only be rough. *Id.*

59. At the end of 1964, the value of stocks listed in the NYSE stood at \$622.6, \$509.8 (STATISTICAL ABSTRACT 324, Table 444) and \$474.3 billion (NYSE FACT BOOK 1965, at 36) respectively, compared to \$104.4, \$87.8 (STATISTICAL ABSTRACT 324, Table 444) and \$64.7 billion (NYSE FACT BOOK 1965, at 36) in 1929. The total value of all stocks, listed or not listed, is now more than \$600 billion (see note 19 *supra*).

60. PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES, JOHN F. KENNEDY 1963, *Special Message to Congress on Tax Reduction and Reform, Jan. 24, 1963*, at 73, 89-90.

61. See text accompanying notes 16 and 45-48 *supra*.

62. Health Insurance for the Aged Act, 42 U.S.C. § 1395 (1964).

63. Social Security Amendments of 1965, 79 Stat. 286.

64. 42 U.S.C. §§ 411(2)-11(3) (1964).

65. Its founders did not intend the Social Security tax to be as egregiously regressive as postwar Administrations and Congresses have allowed it to become. When enacted in 1937 the tax applied to wages and salaries up to \$3,000 per year. STATISTICAL ABSTRACT 294, Table 403. The median wage or salary income for white employees in 1939 (the closest year for which this figure is available) was \$1,112. HISTORICAL STATISTICS 168, Ser. G 169-190. In 1962 it was \$5,462. *Id.*; CONTINUATION AND REVISIONS 25, Ser. G 169. A combined white-nonwhite figure is not given. The data for nonwhite shows that if it were, the propor-

Yet it is difficult to blame the Johnson Administration for choosing it. Current thinking on tax policy practically compels such a choice. Investments are considered sacrosanct, and what non-investment income remains to be taxed is almost all in the lower brackets. Ordinary earned income among the prosperous is already subject to very high rates—taxable income above \$20,000 enters the 48 per cent bracket with the rate rising eventually to 70 per cent.⁶⁶ High salaries cannot be milked much further without making the tax virtually confiscatory and even a confiscatory tax would not materially increase revenues. If all taxable income above \$26,000 had been taken away in taxes in 1963, for example, the additional revenue would have amounted only to \$717 million,⁶⁷ less than one per cent of federal spending for that year.⁶⁸ Medicare alone will cost about four times that amount.⁶⁹ Since their preconceptions impelled them to look only to earned income, President Johnson's advisers were forced to look primarily to those whose earned incomes are small.

The prognosis is therefore that if government spending rises to meet growing needs, the wage and salary earner will have to carry the burden. Increasingly the acquisition or inheritance of investment property will become the only road to substantial personal wealth. The effect can only be to turn wealth-motivated talent away from executive, technical and professional occupations and toward positions that offer an opportunity to acquire and manipulate investments for personal gain.

Conversely, if government expenditures fail to rise to meet public needs, it may well be because wage and salary earners will balk at the sacrifice. Their resistance can be expected to stiffen as the comparative affluence of the propertied classes becomes more obvious. If taxes are to meet the growing needs of the nation without becoming a grossly disproportionate burden on wage and salary earners, they must bear more heavily on incomes derived from investments.

tionate growth would be even greater than that shown by the white-only data. *Id.* If the maximum salary or wage to which the tax was applicable bore the same relation to the median salary or wage now as it did in the late 1930's, the tax would now apply to wages and salaries up to \$14,740. In fact, it was only recently raised to \$6,600. *See* authorities cited notes 62-63 *supra*.

66. IRC § 1.

67. TAX FOUNDATION, INC., FACTS AND FIGURES ON GOVERNMENT FINANCE 108, Table 84 (13th ed. 1964-65).

68. Federal expenditures in 1963 were \$92.6 billion. STATISTICAL ABSTRACT 392, Table 526.

69. 1965 U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS 2227.

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II. Adapting the Income Tax to the Situation of the Public Shareholder

A. Publicly Held Stock

1. Shareholder Control

Tax equity, however, is not the only consideration. The tax privileges of share ownership have traditionally been supported by the fear that heavier taxes would deter risk-taking, reduce investment and thus slow the rate of expansion of the entire economy.⁷⁰ To judge whether any such results would follow from a heavier tax on the appreciation of publicly held stock, one must examine the characteristics of such stock and the corporations that issue it.

Most publicly traded stock represents ownership in a very large company. Although there are over a million active taxpaying corporations,⁷¹ fewer than two hundred report a third of all corporate profits.⁷² The largest five thousand account for about 70 per cent of the corporate economy by almost any measure one cares to use.⁷³ Nearly all of these large companies have thousands⁷⁴ (in one case, millions⁷⁵) of shareholders. The stock of companies with many shareholders is traded either on the New York Stock Exchange, which alone handles 70 per cent in dollar value of all the publicly traded shares in the country,⁷⁶ or on one of the lesser national or over-the-counter exchanges.

These conditions serve to separate the ownership of public corporations from their control. Typically the shareholders are too numerous and scattered and too briefly associated with the company to exert any

70. *E.g.*, KENNEDY 89-90; H.R. REP. No. 2333, 77th Cong., 2d Sess. 29 (1942); H.R. REP. No. 1337, 83d Cong., 2d Sess. 5-6 (1951); circular letter to customers of Merrill, Lynch, Pierce, Fenner and Beane, Feb. 23, 1951, quoted in SURREY & WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 715-16 (1955 ed.).

71. U.S. TREASURY DEPT.-INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1961-62, UNITED STATES BUSINESS TAX RETURNS 176, Table 22, col. (1).

72. STATISTICAL ABSTRACT 498, Tables 684-685 (1963 figures).

73. STATISTICAL ABSTRACT 497, Table 683: In 1962 the 5222 largest—those with assets of \$25 million or more—accounted for more than 69 per cent of the total assets and 70 per cent of the total profits. It is interesting to note that their share of sales was much lower—only 45 per cent. *Id.* Undoubtedly the difference is accounted for by the higher degree of vertical integration characteristic of the larger firms, *i.e.*, they do more to, and therefore add more value to, their input before it is sold as output, as is evidenced by their much higher rate of profit per dollar of sales. *Id.* at 500, Table 688.

74. There is a list of 125 firms with at least 50,000 shareholders in Standard and Poor's publication, 37 THE OUTLOOK 609 (1965). More than twenty million individuals own stocks. STATISTICAL ABSTRACT 476, Table 652.

75. AT&T had 2,674,141 shareholders on December 31, 1964. STANDARD AND POOR'S CORPORATION, CORPORATION DESCRIPTIONS 8919 (June-July 1965).

76. *See* note 55 *supra*.

real influence on corporate policy.⁷⁷ The powers vested in them by law have passed without a struggle to a professional class of executives which claims for itself the exclusive power to manage.⁷⁸ Public shareholders still go through the motions of "electing" boards of directors, but except in rare instances they have no alternative to the management slate, which almost invariably wins.⁷⁹

2. Use of the Equity Market

Among large, publicly held corporations only the regulated utilities obtain a significant portion of their investment capital by issuing stock.⁸⁰ Almost all the rest finance their expansion entirely from retained earnings and depreciation charges and by borrowing. From 1947 through 1956, corporations other than utilities obtained only about 1.25 per cent of their capital by issuing stock. The aggregate figure including utilities was 5.7 per cent⁸¹ for the full ten year period and in one recent year dropped as low as 1 per cent.⁸²

Even these figures considerably overstate the use of the equity market by public corporations, because they reflect new incorporations, which must use stock and debt in reasonably balanced amounts⁸³ and cannot draw on depreciation or retained earnings. There is no precise breakdown for public corporations alone, but one indication of their reluctance to raise equity capital is the infrequency of new share offerings for which holders of outstanding shares listed on the New York Stock Exchange⁸⁴ obtained preferential subscription rights. Subscription

77. A. BERLE AND G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 1-9, 84-90, 138-41 (1937 ed.); A. BERLE, *POWER WITHOUT PROPERTY* 63-64, 73-74 (1959); G. MEANS, *THE CORPORATE REVOLUTION IN AMERICA* 158 (1962); see Manning, *Book Review*, 67 *YALE L.J.* 1477 (1958); J. LIVINGSTON, *THE AMERICAN STOCKHOLDER* (1958); Harbrecht, *The Modern Corporation Revisited*, 64 *COLUM. L. REV.* 1410, 1413 (1964).

It is interesting to note that legally shareholders of public corporations usually seem to have more power to control corporate policy than do shareholders of smaller, "close" corporations. In the latter it is precisely the potentially very real power of the shareholders, who are few in number and typically personally interested in the corporation's affairs, that necessitates the legal curbing of their power by devices such as voting trusts, shareholder agreements, long-term management contracts and the like, devices that are usually not necessary in publicly held corporations. See O'NEAL, *CLOSE CORPORATIONS* §§ 1.07, 1.12 (1958). Apparently the idea of shareholder democracy is not thought well of at any level of business.

78. *Id.*

79. A. BERLE, *supra* note 77, at 104-06; LIVINGSTON, *supra* note 77, at 47-48, 151-65.

80. A. BERLE, *supra* note 77, at 40. For a discussion of the legal limits of utilities' borrowing, see Cook & Cohn, *Capital Structures of Electric Utilities Under the Public Utility Holding Company Act*, 45 *VA. L. REV.* 981 (1959).

81. U.S. DEPT. OF COMMERCE, *SURVEY OF CURRENT BUSINESS* 10, Table 2 (Sept. 1957).

82. *STATISTICAL ABSTRACT* 502, Table 693.

83. See, e.g., *Colony, Inc.*, 26 *T.C.* 30 (1956), *aff'd*, 244 *F.2d* 75 (6th Cir. 1957), *rev'd on other grounds*, 357 *U.S.* 28 (1958).

84. Holders of these shares account for more than 70 per cent of the value of all publicly traded stock in the country. See text accompanying note 55 *supra*.

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rights are a great convenience for public corporations entering the equity market because they avoid the difficulties of setting a price for new shares which will not unfairly dilute the value of outstanding stock. Yet in 1964, not an atypical year, only eight of the 1,247 companies listed on the exchange granted such rights, and seven of the eight were utilities. The price of the offering of the single non-utility was less than three thousandths of one per cent of the total value of the shares then outstanding on the exchange.⁸⁵ One of the other seven was American Telephone and Telegraph, whose immense size and uniquely absolute monopoly power render it a special case.⁸⁶ Ignoring it, total offerings pursuant to subscription rights for utilities as well as nonutilities listed on the exchange were still only about four hundredths of one per cent of the amount outstanding.⁸⁷

It is not difficult to understand the preference for borrowing over equity as a means for obtaining capital from external sources. Large corporations can borrow at low interest rates. Interest payments on loans⁸⁸ are tax deductible, while dividends are not. And because stocks lack a "maturity date" upon which they will be redeemed for a fixed sum, their prices fluctuate much more widely than the prices of bonds. Stocks therefore are characteristically a riskier investment, especially in the short run, and the shares of even the stablest corporation sell for much less than its bonds, relative to after-tax earnings.

B. *Effect on Investment*

A tax may reduce investment in three general ways:

1. In an economy which is fully employed, funds may be diverted away from private investment into private consumption or government spending if a large share of the fiscal burden is imposed on taxpayers with a high propensity to save.

2. By decreasing after-tax profits, the tax may reduce the incentive to invest.

3. If tax liability is imposed only when an investment is liquidated—as is the case, for example, with the present income tax on capital gains—investors will be reluctant to liquidate one investment in order to place their funds in another (the "lock-in" effect), and investment generally may be discouraged.

85. The lone company was J. I. Case. NYSE FACT BOOK 1965, at 9, 16.

86. See note 181 *infra*.

87. NYSE FACT BOOK 1965, at 9, 16.

88. IRC § 163.

1. *Diversion of Investment Funds*

When the economy is operating at less than full capacity, the volume of investment is not likely to be reduced by shifting some of the tax burden to the wealthy. In fact, a more progressive tax structure is likely to be a positive inducement for businesses to invest, as it increases the disposable income of less wealthy people, who characteristically have a higher propensity to consume. But under conditions of full employment, the economy cannot have more real consumption unless it is willing to accept less private investment or less government spending. The attempt to raise consumption without compensating reductions in the other two sectors leads to inflation—more money will be spent, but higher prices will keep the real total of consumption, private investment and government purchases the same. Thus, increased taxation of shareholders relative to other taxpayers might threaten business investment because most shares are held by the wealthy, whose high propensity to save in a fully employed economy permits resources to be devoted to business investment and government spending. If an appreciation tax were to shift disposable income from them to earned-income recipients with a presumably greater inclination to consume, private investment would necessarily be reduced, unless the government abstained from an appropriate amount of its own spending.

But the effect on consumption of an appreciation tax may be considerably less than the traditional high-income/high-savings doctrine suggests, and the range of responses open to the government to offset any increased consumption includes options other than reducing private investment. Today there are important kinds of savings in our economy which may even bear an inverse relation to personal wealth. More than half of all net personal financial savings now take the form of payments to pension trusts or insurance companies.⁸⁹ It is a reasonable guess that the amount of such payments would grow even faster if more after-tax income were shifted to wage, salary and other earned-income recipients. Savings by businesses (depreciation charges plus retained earnings) are regularly two to three times as much as individual savings.⁹⁰ Businesses presumably would save more if individuals saved less, because increased individual spending would add to business receipts. Thus, the reduction in savings of the personal-accumulations variety caused by the appreciation tax would be offset to some extent by its enhancement of other kinds of savings.

89. 1966 ECONOMIC REPORT OF THE PRESIDENT 229, Table C-17.

90. *Id.* at 230, Table C-18.

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Moreover, there are several ways in which the government could avoid any drop in total savings and still increase the taxation of stockholders. The appreciation tax could be accompanied by a reduction in the rates applicable to high-bracket ordinary income. Earned-income recipients would then be placed on a par with public shareholders in their ability to save, and the population's overall propensity to consume kept the same. Or individuals in the lower brackets could be encouraged or required to save more. For example, the Social Security retirement system might be substantially expanded, private pension plans offered more tax privileges and other stimuli, or consumer credit (a form of negative savings) restricted. Alternatively, the government could reduce private consumption by raising taxes or leave more room for private investment by curtailing its own spending, *i.e.*, reduce the fiscal deficit. Even if the choice were to accept a reduction in private investment rather than to reduce government spending or enhance private savings, the resulting shift of investment emphasis toward the public sector would be welcomed by the many economists who have compared the marginal returns on private and public investment.⁹¹

2. *Reduced Investment Incentive*

The second possible objection is that the proposed tax would reduce the incentive to invest. Here a distinction must be made between investment by a corporation and purchases of its shares. The incentive of certain individuals and financial institutions to purchase outstanding shares would indeed be reduced by a tax on the shares' appreciation. But it has already been demonstrated that the purchase of outstanding stock has no effect on a corporation, neither directly providing the necessary funds to build or purchase new production facilities nor adding to the ability of the corporation to build or buy them.⁹² The only change would be in the price of a company's shares. This price is sometimes alleged to affect a corporation's ability to borrow,⁹³ because lenders rely on the public's assessment of the corporation's financial position. But if this effect exists at all, it is entirely relative to the positions of other corporations. Thus, since the price-depressant effect of a tax on appreciation would affect all public corporation stocks, the varying values that the public placed on different stocks could still be observed by any lender who cared to look.

91. *See, e.g.*, Nelson, *The Simple Economics of Basic Scientific Research*, 67 J. POL. ECON. 297 (1959).

92. The necessary special treatment of newly issued shares is discussed at pp. 46-47, 56-57, 62 *infra*.

93. *E.g.*, Harbrecht, *supra* note 77, at 1419.

But what of the tax's possible effect on management's incentive to invest the funds of the public corporation? It might be thought that in the interest of its shareholders, management would hesitate to invest corporate funds because the increased value of the corporation's stock ultimately resulting from successful investment would be taxed as ordinary income. But shareholders will also be taxed at ordinary rates if management decides *not* to invest the funds of the corporation in new facilities, since profits paid out as dividends are taxed to the recipient as ordinary income. Any tax effect on management's decision would come close to a stand-off: shareholders would be taxed immediately on distributed profits at the same rate that they would be later taxed on reinvested profits.

But it might be argued that even something close to tax neutrality would be a step backward, because shareholders naturally prefer dividends even when corporate reinvestment would be more profitable, and the present very light taxation of appreciation relative to dividends provides a necessary counterpressure to that preference. The argument has several answers.

The preference is illogical, since dividends improvidently granted reduce the value of shares by more than shareholders gain from receiving them. So as the portion of the market held by mutual funds, pension trusts and other institutional shareholders continues to grow,⁹⁴ diminishing the role of the less sophisticated small individual holder,⁹⁵ the short-sighted dividend preference can be expected to decline.

More importantly, the proposed tax would probably actually reduce whatever net effect the dividend preference may have, because, contrary to widespread assumption, the privileges accorded to stock appreciation by existing law probably strengthen the preference more than they offset it. Shareholders now incur a tax on appreciation only if they sell or exchange their shares prior to death. They are thus provided a strong incentive to retain shares as long as possible and to meet their current cash needs entirely from dividends. But, as will be shown,⁹⁶ the tax privileges enjoyed by appreciation under existing law are also serving to inflate stock prices to the point where dividends average only 3 to 4 per cent of price. It is not surprising that under these circumstances some shareholders feel starved for cash and so prefer dividends to corporate re-investment even though dividends incur a higher tax. Under

94. See authorities cited note 35 *supra*.

95. See SPECIAL STUDY pt. IV, at 140.

96. See NYSE FACT BOOK 1965, at 47; and text accompanying notes 137-42 *infra*.

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the proposed tax system, shareholders would be in a much better cash position. Since public stock appreciation would be taxed annually, whether or not shares were sold, there would be no tax penalty on raising cash by selling a few shares occasionally, and since such appreciation would be taxed at the same rates and intervals as other forms of income, stock prices would no longer be inflated and dividends would probably average about 5 to 7 per cent of price.

Even if, contrary to expectation, the proposed tax were found to have increased the effect of the dividend preference, the government would not be powerless to restore the balance. The investment credit, temporarily suspended last year to check inflation, could be reinstated or expanded to stimulate corporate re-investment.

In any event, the argument that removing a tax pressure on shareholders would tip the scales against corporate reinvestment misconceives the nature of the large corporate enterprise. The scales are too heavily weighted in the other direction. The average return on investment realized by the larger corporations in the United States has varied between 8.7 per cent and 13.3 per cent after taxes since 1950.⁹⁷ That is considerably more than the average shareholder could earn on his money by investing it at comparable risk elsewhere. When the taxation of dividends is taken into account as well—the average dividend dollar is taxed roughly forty cents⁹⁸—the disparity in potential earning power between a dollar reinvested and a dollar distributed to shareholders is on the order of three or four to one. Faced with such odds in favor of re-investing, management would be acting wholly irrationally if it turned down satisfactory reinvestment opportunities in order to pay larger dividends. There is no better place in the entire economy from which to invest large sums than inside the large corporations themselves. They possess the expertise, the facilities, and, most important, the advantage of an established position in an industry or industries, all of which makes it relatively easy to put money to work at a profit.

Moreover, management could turn its back on these investment opportunities only at its peril. The alternative to growth is likely to be

97. ECONOMICS DEPARTMENT, FIRST NATIONAL CITY BANK, NEW YORK, AVERAGE ANNUAL RATES OF RETURN. The average has been even higher for manufacturing corporations. There, the high and low for the period, 1950-1964, were 17.1 per cent and 9.8 per cent. *Id.*

98. The median adjusted gross income level at which dividends are received is \$25,000-\$50,000. 1962 INDIVIDUAL INCOME TAX RETURNS 36, Table 3, col. 18. That level reported an average taxable income of \$26,000. *Id.* at 33, Table 1, cols. 1, 4. At that level an unmarried individual pays 50 per cent and a married individual 36 per cent. IRC § 1.

decline, not merely stagnation. One reason is technology. Advanced production techniques frequently produce goods more cheaply if, but only if, they are produced in greater volume. Thus the only way for a firm to stay as efficient as its rivals may be to expand along with them. Even staying at the same level of output may require increasing investment. Labor-saving devices may cut costs, and therefore have to be acquired for the firm to stay competitive, but require a much larger *investment* than the machinery they replace. Personal motivations are also at work. The path is shorter to high executive position in a growing company because growth makes room at the top. Growth furnishes much of the excitement in business, and an executive's compensation, reputation and personal sense of achievement, are closely related to his role in helping his company grow.

While the maintenance of an adequate level of investment can never be taken for granted, neither does it make sense to talk as though the wolf of stagnation were always at the door. Investment incentive needs watching but not constant nurture. Indeed, the government must occasionally act to *restrain* the pressures toward increased corporate investment to prevent an inflationary spiral.⁹⁹

3. "Locked-in" Investments

The proposed appreciation tax would eliminate the present system's "lock-in" effect, the third way in which taxation of profits may discourage investments. Income tax liability now attaches to stock appreciation only when shares are sold; investors may therefore hesitate to sell substantially appreciated shares even in order to re-invest their funds more profitably elsewhere. Because appreciation would be taxed annually under the proposed tax, whether or not shares were sold, investors would have no tax incentive to hold on to their shares indefinitely. The tax would thus ease the passages of funds back and forth between the stock market and areas of investment which still rely upon individually held capital, such as real estate and small business, and so make a real contribution toward maintaining a proper balance of investment resources throughout the economy.

C. A Proposed System for Taxing Appreciation

Public stock appreciation could be taxed annually. The shareholder would be taxed on the amount, if any, by which his stock increased in

99. See, e.g., Lippman, *Regulating the Boom*, Washington Post, March 17, 1966, section A, at 21, cols. 1-3; Wall Street Journal, March 21, 1966, at 1, cols. 3-6; Wall Street Journal, March 31, 1966, at 1, col. 6, and 12, cols. 4-6.

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value during the year, each year, for as long as he had it. If he sold it, he would be taxed on the amount by which the sale price exceeded its value for the previous year. A large amount of untaxed appreciation thus would never be permitted to accrue, and there would be no tax-imposed obstacle to selling the shares whenever a more attractive use for the invested funds appeared.

The common argument against imposing a tax on the increased value of an asset before it has been sold is the difficulty of assessing the extent of the increase. The exchanges, however, eliminate this difficulty for public stocks. A shareholder could not justly complain if in his opinion the market was too low a measure of the value of his shares for tax purposes, because the tax difference would be in his favor. He could not justly complain that it was too high either, because (unless he were a control shareholder, whose special problems will be discussed below) he could sell the shares and, with no tax penalty for liquidating his investment, make an extra profit on the market's apparent miscalculation.

Only those relatively few individuals or, more often, institutions, that hold such large blocks of a single stock that they cannot sell any large portion of it in a short time without depressing the market, might reasonably complain that the market price was an unfairly high measure of real value. Such unfairness should be minor. Every day brokers and large-portfolio administrators manage the problem of disposing of large blocks of stock at a price that is not very far below the market.¹⁰⁰ Even if it is assumed that the market would always exceed by a few points the realizable value of a large block of stock, the overestimate of appreciation during the first year the shares were held would be cancelled out when they were sold. Full freedom to average gains and losses over successive tax years would insure this. The problem might also be attacked directly. The same factors making it difficult to dispose of a large block except at a few points below the market might have been in operation when the block, or chunks of it, were acquired. The holder who could show that he acquired a block at less than the market price might be permitted to value it thereafter at the amount below the market at which it was purchased, to avoid paying tax on an artificially high measure of income the first year after the

100. The average turnover of mutual fund portfolios in 1965 was 19 per cent, compared to only 16 per cent for all NYSE-listed stocks. Many funds were substantially higher than even 19 per cent. *Wall Street Journal*, March 8, 1966, at 1, col. 6, and 28, col. 1.

purchase. Such an exception to the otherwise uniform valuation rules should be manageable if limited to very large blocks.

The relatively minor fluctuations of day-to-day trading could be adjusted for tax purposes with an appropriate formula for defining "official tax value." The average of the daily closing prices for the calendar year or perhaps for the last few months of the year might be used, for example. Exact figures could readily be computed and published by the Internal Revenue Service itself, or by the principal exchange on which the particular stock was traded. The officially computed values could be published shortly after the close of the year in leading newspapers, and supplied to brokers and banks.

For those public corporation stocks that are not listed on an exchange (in terms of dollar value, something less than 14 per cent of the total)¹⁰¹ the "bid" and "asked" quotations on the over-the-counter markets—an informal collection of brokers and dealers throughout the nation who buy and sell stocks not listed on an exchange¹⁰²—could serve the same function as the daily closing prices on the exchanges. Much of the uncertainty and roughness presently existing in the quotations could be ironed out by computerizing the operation of the market as an SEC special study recently recommended.¹⁰³ But the principal guarantee of a fair tax valuation for over-the-counter as well as listed stocks would be the use of a long-term average rather than any given daily quote; the value for tax purposes would thus never be higher than a price at which the stock could actually have been sold for substantial periods during the year.

Under some circumstances taxing stock appreciation annually would force a shareholder to sell a part of his portfolio to pay the tax on the whole. For example, in a good year during which the value of his shares rose an average of 15 per cent and paid dividends of 3 per cent, a shareholder in the 50 per cent bracket who was unwilling to borrow and had no other source of cash would have to sell shares equal in value to 5.2 per cent of his holdings. He would be left with a portfolio equal to 109 per cent of its pre-rise value, free of all future tax claims. It is immaterial that he might have preferred not to sell, even at an appreciated price. Tax assessments limit everyone's ability to invest, and there is nothing in the situation of the public shareholder to justify

101. The value of over-the-counter stocks is something "less than one-third" of those listed. *SPECIAL STUDY* pt. I, at 14. About half in value of over-the-counter stocks are stocks of corporations with 500 or more shareholders. *Id.* at 27.

102. *SPECIAL STUDY* pt. II, at 541.

103. *Id.* at 657, 669-70.

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giving him any special consideration. And any supposed loss from having to sell a part of his holdings to pay the tax on the rest in a market that supposedly failed to reflect the shares' "true" worth, as will be shown below, would have been offset, or more than offset, by his not having to pay tax on the appreciation of their full value.

To permit those public corporations which needed equity financing to raise capital by issuing more shares,¹⁰⁴ new shares might be granted the privilege of taxation at the present low capital-gains rates and only if they were sold or exchanged, for a substantial period after their issuance. Capital-gains treatment for about fifteen years would seem long enough to maintain the individual's (or financial institution's) incentive to make such an investment. Favorable tax treatment for new issues would mean that they would temporarily command a higher price than a corporation's previously outstanding stock of the same class. But the additional complication thus injected into the market would still be less than already exists with respect to bonds. Several issues, or "series," of bonds are frequently outstanding from a single issuer at one time, and the market has long since shown that it can adapt to them. The certainty that the favorable capital gains treatment would terminate in a set number of years would, of course, still represent a slight deterrent to investors, compared to the present promise of endless tax freedom. But the period of exemption from the appreciation tax could be made long enough to minimize any deterrence. Moreover, when the great bulk of outstanding public stock was being taxed annually at ordinary rates, newly issued shares carrying a fifteen-year immunity would look very attractive by comparison and probably would be more saleable than they are now. The proposed tax on appreciation, therefore, if the government chose to couple it with a sufficiently liberal exemption for newly issued shares, could even serve to stimulate the issuance of new stock.

D. *Special Problems of Control Stock*

The discussion to this point has assumed that in a "public corporation" *all* stock is so widely dispersed that its owners are impotent to control management. The assumption does not hold true for a relatively few¹⁰⁵ large corporations. The Ford Motor Company is an

104. Whether shares issued under executive stock option plans should be deemed "new issues" for this purpose is a question beyond the scope of this article. Such shares are issued in order to compensate executives to an extent that the tax laws would otherwise not permit rather than to raise capital.

105. It is difficult to establish how much stock is held by those who could, if the chips

outstanding example. As of 1964, the public held 51.7 million shares of its common stock, the Ford Foundation held 46.4 million shares of nonvoting Class A common, and members of the Ford family and the Edison Institute held all 12.5 million shares of the Class B common, which carried the privilege of electing a majority of the members of the board of directors.¹⁰⁶ Since the Ford family holdings give control, an argument could be constructed for exempting them from the proposed tax. But the better procedure would be to tax controlling shares the same as publicly held stock despite the admitted difference. Treating them as an exception would constitute a substantial privilege for a very few, very wealthy people and, as will be seen, an unnecessary privilege as well.

If their stock were treated as public for tax purposes, the controlling shareholders of a large corporation would have to choose among three ways of meeting their increased tax liabilities: (i) taking more money out of the corporation in the form of dividends, (ii) occasionally selling some of their stock, thereby gradually diminishing their control, or (iii) reducing their style of living. The second and third alternatives would leave the corporation itself unaffected and so are the more desirable for the good of the economy. The first would leave the corporation with less money to invest, and so would have a dampening effect on business expansion. However, there is no situation in which a control group would find it advantageous to choose that alternative.

Control of a large corporation is almost always exercised through ownership of much less than all of the outstanding profit-participating stock. The Ford family, for example, exercises unquestioned control of the Ford Motor Company by holding only 11 per cent of the participating common.¹⁰⁷ A group with only partial ownership would have

were down, really use it to control a large corporation. A 1949 study concluded that the 1 or 2 per cent of the "spending units" that held the most corporate stock held from 65 to 71 per cent of the total (the higher percentage includes beneficial interests in stock held in trust) and that the average holding of the group was, conservatively, \$305,000. BUTTERS, THOMPSON & BOLLINGER, *supra* note 29, at 380-82. \$305,000 worth of stock, even assuming that it is all in one company, is, of course, wholly inadequate to control a sizeable public corporation. The makers of the survey were unable to obtain an accurate measure of how many stockholders held portfolios valued at very much more than \$305,000, or of just how much stock such stockholders held, even though they utilized what they thought were very accurate procedures, and concluded from their failure that such "ultra wealthy" stockholders must constitute a "very small" group. *Id.* at 388.

106. MOODY, INDUSTRIAL PRICE MANUAL 2794-98 (1964).

107. As of 1964 the Ford Motor Company had outstanding 51.7 million shares of ordinary common stock, 46.4 million shares of Class A Common Stock and 12.5 million shares of Class B Common Stock. All of the Class A Common was held by members of the family or their affiliates and by the Edison Institute. All shares participate equally in dividends and liquidation rights but only the ordinary common and the Class B Common have voting rights, and the voting rights are such that the holders of the Class B Com-

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to match every extra dollar withdrawn in dividends for its own use with another dollar, or more likely many others, for the noncontrolling shareholders, and the resulting impairment of the corporation's earning power would be prohibitive. Even a group with near-total ownership would be acting irrationally if it chose the first alternative over the second in order to raise tax money. The second alternative would likely be far more profitable (as discussed on p. 643 *supra*) and it would not threaten the group's control because, by hypothesis, it would own far more shares than were needed for that purpose.

A controlling shareholder or member of a controlling group who felt compelled to sell some of his shares to raise tax money would ordinarily have to sell them on the market and so would fail to receive the additional value, or "premium," that control stock may command.¹⁰⁸ It is by no means obvious that the tax laws should be concerned to protect premiums. Their legality and social utility have been questioned.¹⁰⁹ But in any event the loss involved would be minimal or nonexistent.

A quick calculation shows that so long as a shareholder's sales do not reduce his holdings below what is necessary for control, any premium lost on a sale is at least offset by the savings realized on not having to pay tax on the appreciation of the premium on his entire holdings.¹¹⁰ However, the sale that crossed the control line might involve not just the loss of the premium on the shares sold but the destruction of the premium on those that were retained as well.

Professor William D. Andrews has recently examined in depth the reasons why control stock may command a premium and which of those reasons are legitimate.¹¹¹ He rejects any differential not based on a benefit that, if realized, would accrue equally to all the corporation's outstanding shares, on the grounds that any other kind of benefit would be inconsistent with management's obligation to manage for the uniform good of the company's stockholders.¹¹² The legitimate

mon are sure to control the board of directors. MOODY, INDUSTRIAL PRICE MANUAL 2797-98 (1964).

108. See generally Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965).

109. See Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); L. GOWER, THE PRINCIPLES OF MODERN COMPANY LAW 494 (2d ed. 1957).

110. The tax liability would equal the market value of the holdings times the percentage by which they appreciated times the applicable tax rate. At most, the shareholder would be forced to sell that much in value of stock, so his maximum loss on the sale would be that amount times the percentage of premium. On the other hand, since his tax liability was based on market value and the value of his stock, by hypothesis, exceeded that by the extent of the premium, his tax savings equalled the value of his holdings times the percentage of the premium, times the percentage of appreciation times the applicable tax rate—exactly the maximum amount he could have lost on the sale.

111. Andrews, *supra* note 108, at 522-27.

112. *Id.* at 524.

bases for premiums he describes are: (i) the ability of the buyer of control to put into effect his preferences in management policies or personnel, (ii) the ability of the holder of control to protect himself against unwanted changes in management or management policies introduced by someone else who might be in control if he were not, and (iii) the ability of the holder of control to watch for any deterioration of management capabilities and correct or replace the incumbent management if it should occur.¹¹³

The first basis would be impaired by a reduction in the size of the block only if a buyer of control would be more likely to pay a premium for control stock than for other stock. But in fact, buyers of control of public corporations, if they pay a premium at all, commonly offer it to all shareholders.¹¹⁴ Were they not to do so, they would risk liability to the shareholders who were not offered a premium¹¹⁵ and would violate what is apparently most businessmen's sense of fairness.¹¹⁶ If the shares being purchased were listed on the New York Stock Exchange, they would also violate the rules of the exchange.¹¹⁷ Under the circumstances, the possibility that a control block might receive an "exclusive" premium not equally available to noncontrolling shares seems neither substantial nor worthy of protection.

The second basis for a premium is in practice too small to be capable of objective valuation in a publicly held corporation. The wrest-

113. *Id.* at 526-27.

114. The most common method of obtaining such control by buying stock is the "tender offer." Wall Street Journal, February 11, 1966, at 1, col. 6. FTC, REPORT ON CORPORATE MERGERS AND ACQUISITIONS 9, 85-88 (1955). See also LIVINGSTON, *supra* note 77, at 47-48 (attempts to take control by proxy fights are very infrequent). The maker of a tender offer typically announces that he will pay a certain amount for all shares deposited with his agent prior to a certain date, if at least a stated minimum number of shares are deposited, and if more than that are deposited, to take a pro rata portion of each deposit. Wall Street Journal, Dec. 21, 1966, at 1, col. 5, and 10, col. 1. See also NEW YORK STOCK EXCHANGE COMPANY MANUAL § A-10. Takeovers effected by acquiring assets or by merging, of course, also distribute any premium involved among all shareholders equally.

115. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); see also JENNINGS, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); L. GOWER, *THE PRINCIPLES OF MODERN COMPANY LAW* 494 (2d ed. 1957); Andrews, *supra* note 108, at 515-45; Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212 (1958).

116. See JENNINGS, *supra* note 109, at 18 n.18.

117. NEW YORK STOCK EXCHANGE COMPANY MANUAL § A-10 (Redemptions-Tender Offers) at p. A-179 reads in part:

The Exchange believes it is important that all stockholders of a company be given an opportunity to participate on equal terms in any offer made which may affect the rights or benefits of such stockholders. This objective has been implemented by the company's listing agreement with the Exchange. As an example, a company agrees that it will not select any of its securities listed on the Exchange for redemption otherwise than pro rata or by lot.

The same considerations apply when a company invites its stockholders or stockholders of another company to tender their shares for purchase It is important, therefore, that all stockholders be given an equal opportunity to participate in such offers.

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ing of control from an incumbent controlling group other than by buying its stock (which was dealt with in connection with the first basis for a premium) is such a rare event among public corporations that a survey in the 1950's showed that the average large company could not expect to experience even the attempt to do such a thing more than once in 150 years,¹¹⁸ and such attempts are now even rarer.¹¹⁹

The third basis for a premium can also be ignored for our purpose because it would survive the dissolution of the control block. A controlling shareholder who saw that his piecemeal sales were diminishing the size of his block either would already have, or could place, his appointees on the board of directors, and under the conditions prevailing in a publicly held company nothing short of a catastrophe or a premium offer to all shareholders could thereafter dislodge them. Under all other circumstances the board would be self-perpetuating, and control would continue long after the control block had shrunk to noncontrol size. So taking into account all the possibilities, there is no point at which the gradual sale of a control shareholder's block would involve the uncompensated loss of a significant legitimate premium.

E. *Defining "Public Corporation Stock"*

Public corporations ought to be distinguished from other corporations for tax purposes simply by the number of shareholders: 500 would seem ample to assure the public character of the corporation. This is the number set by the Securities Act Amendments of 1964 for deciding which corporations must meet the proxy and reporting requirements of the Act.¹²⁰ The rationale of the "500 rule" is that the stock is certain to be publicly traded when it has so many stockholders, and the relationship between management and actual and potential shareholders has become so distant that regulatory safeguards are necessary to assure access to information about the company.¹²¹ (The Securities and Exchange Commission found 300 to be the appropriate number of shareholders¹²² but Congress chose the higher number.) Similar reasoning supports use of the same number for defining a public corporation in our sense. Taxation of stock appreciation also

118. LIVINGSTON, *supra* note 77, at 47-48; see also A. BERLE, *supra* note 77, at 164-65.

119. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

120. § 3, 78 Stat. 567 (1964).

121. SPECIAL STUDY pt. V, at 150-51; H.R. REP. NO. 1418, 88th Cong., 2d Sess. 3013, 3018 (1964).

122. *Id.*

rests on the existence of a market for public trading; and the dispersal of ownership, which prevents easy access to information, also diminishes shareholder control, a significant factor in our analysis of the public corporation.

The only other test which the Securities Act Amendments impose for a "public corporation" is gross assets equal to or in excess of \$1 million.¹²³ Such a test would be convenient for weeding out companies whose total appreciation probably would not produce enough revenue to make it worthwhile to tax them. However, nothing in the logic of taxing public corporation stock requires an assets test.¹²⁴

A second problem would be to avoid discouraging normal corporate financial activity through the application of the tax. A closely held corporation and its controlling shareholders might hesitate to make a public offering either of newly issued shares or of the controlling shareholders' stock. Shareholders of a closely held corporation might hesitate to sell out to, or merge with, a larger corporation if the bargain required them to receive publicly traded shares in exchange. Or two or more closely held corporations might hesitate to combine if the combined number of their shareholders was sufficient to constitute a public corporation. Of course, shares with a public market are substantially more valuable—all other things being equal—because they have a higher degree of liquidity. But in most cases, the advantages of high liquidity would probably not be enough to offset the unfavorable tax consequences of going public.

In order not to discourage the transition, shares might be exempted from the appreciation tax for a substantial period, say fifteen or twenty years, after they enter the category of publicly traded stock. The length of the delay period would determine the impact of the tax on the decision to go public: the longer the period, the smaller the effect on price of the impending tax liability. A sufficiently long delay period would reduce the impending tax's effect on price to the point where it was outweighed by the increased value attributable to going public. Fifteen or twenty years ought to suffice for such a result, since the liability of virtually all other publicly traded shares to the appreciation tax would render those with a temporary tax immunity especially desirable. The deterrent to going public could also be reduced by leaving sales of the shares during the grace period entirely free from taxation, even at the capital gains rates that currently apply.

123. § 3(c), 78 Stat. 567 (1964).

124. In the opinion of the SEC, nothing in the logic of the securities laws required it either. See *SPECIAL STUDY* pt. V, at 150-51.

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Transactions in the other direction would also have to be taken into account. A relatively small number of persons might seek to buy up all the outstanding stock of a public corporation, or the corporation itself might seek to redeem its shares from a number of shareholders. A public corporation might "spin off" a smaller corporation to a small group of its shareholders. Or a large publicly held concern could conceivably divide itself into two or more parts, each with a smaller number of shareholders. But each of these possible courses of action would seem distinctly less likely than its opposite. The second and third would require the corporation to divide its business into two or more parts, a difficult maneuver,¹²⁵ made especially troublesome by the need to assign shareholders to different parts of the company while maintaining the relative value of their holdings. All three courses would threaten management's power and therefore usually incur its opposition. The first would create or enlarge concentrated centers of shareholder power capable of challenging management's exclusive control, the second would reduce the scope of management's power by splitting off a portion of the business and the third would have the same effect by dividing the company. Finally, the second and third courses would normally threaten the profitability of the business itself, to the detriment of both management and shareholders. The component corporations would have less monopoly power than the single large company of which they once formed the parts, and if the spin-off or division cut across related product lines, they might also have fewer economies of scale.

Nevertheless, the tax rewards of ceasing to be public might outweigh all other considerations unless some provision were made to reduce them. Again, it would seem sufficient to delay the new units' relief from the appreciation tax for a substantial period beyond the status-changing event. Under the circumstances something like ten years should suffice. The period need not be as long as the period chosen for changes in the other direction because of the nontax considerations mentioned and because when the contemplated changes are in the nonpublic direction, delaying their tax consequences would have an especially powerful effect. First, it would reduce the present value of escaping from the appreciation tax by delaying the change of tax status. Second, it would subject the shares involved to very heavy taxation during the period of the delay, because their price would rise in anticipation of their freedom from the appreciation tax at the end

125. *E.g.*, *First Security Nat'l Bank & Trust Co. v. United States*, 382 U.S. 45 (1965).

of the period, and price rises during the period would continue to incur annual taxation at ordinary-income rates. Third, since the shareholders could not sell sizeable portions of their holdings in order to pay taxes on the remainder without dispersing ownership and thereby defeating the whole tax avoidance scheme, their high tax liabilities would have to be paid out of other assets. And finally, the third effect would reinforce the second. The necessity of limiting sales would drive the price of the shares higher and so impose even greater tax liabilities.

There might be an exception to the ten year delay for companies whose stockholders could show that there was no longer a readily available market for their shares and that the disappearance of the market was not a result of their own tax-motivated actions. The appreciation tax would be a real hardship for such investors since they could not conveniently sell shares in the company to meet the tax assessments. These corporations are also likely to be the ones which lack a sufficient volume of recent trading to measure their appreciation during the year. For the sake of avoiding the evaluation problem the Internal Revenue Service might be just as happy to forego the tax proceeds they would generate if covered by the appreciation tax.

Once established, delay periods could be used for a variety of regulatory purposes. For example, since current tax law strongly favors corporate mergers,¹²⁶ overall tax neutrality might be achieved by choosing a somewhat shorter delay period for corporate acquisition or combinations than for other methods of going public. If an acquisition or combination involving a sufficient number of shareholders to render the combined corporation public would result in the shares becoming subject to the appreciation tax in, say, only ten years instead of fifteen or twenty, shareholders' reluctance to incur the appreciation tax might just offset their eagerness to receive the more traditional tax benefits of combining corporate units, and would leave their decision, as it probably should be, unaffected by the totality of tax factors.

The difficulties that might arise from a too frequent or too easily manipulated change of status could also be alleviated by establishing

126. Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L. REV. 254 (1957). There are also powerful nontax pro-consolidation forces at work in the economy, see McCarthy, *ACQUISITIONS AND MERGERS* 11-13 (1963); Houghton, *Mergers, Superconcentration and the Public Interest*, in SUBCOMM. ON ANTITRUST & MONOPOLY OF THE SENATE COMM. ON THE JUDICIARY, *ADMINISTERED PRICES: A COMPENDIUM ON PUBLIC POLICY*, 88th Cong., 1st Sess. (1963) [hereinafter cited as *ADMINISTERED PRICES*].

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not one but two changeover lines: the higher one to operate to change a company's status from nonpublic to public and the lower to change it from public to nonpublic. A corporation that became public by virtue of an increase in the number of its shareholders could then lose the status only if the number was quite substantially reduced, and a similar result would follow from a change in the other direction.

III. New Shareholders and an Altered Market

Taxing public stock appreciation like ordinary income would also bring a fairer distribution of corporate profits. One per cent of the population now holds 70 per cent of the stock,¹²⁷ and so receives a like percentage of the profits, yet it is the public generally, not shareholders, that contributes most to the ability of public corporations to earn their profits.

The public contributes most importantly by supplying funds for investment. An overwhelming proportion of public corporations' equity capital comes from retained earnings.¹²⁸ A major source of these earnings is the power over price which any large, established unit has in a modern industrial economy.¹²⁹ Theoretically, the antitrust laws could eliminate such power by fragmenting business into much smaller units, but such a course is politically unfeasible and would probably beget more problems than it would solve.¹³⁰ A measure of monopoly power is therefore inherent in the kind of economy the nation has chosen. A consequence is that unless we decide to regulate the prices charged by every company as we regulate those of public utilities, prices will continue to be set high enough to provide the profits

127. Eighty-two per cent of individually held stock is held by or for the benefit of one per cent of the population. See text accompanying notes 27-34 *supra*. About 14 per cent of all common stocks are held by institutions other than common trust funds and investment companies (which are essentially just conduits for individual stock ownership). See note 34 *supra*. Eighty-two per cent of 86 per cent is 70 per cent.

128. See text accompanying notes 80-87 *supra*.

129. A. KAPLAN, *BIG ENTERPRISE IN A COMPETITIVE ECONOMY* 47-52 and ch. 8, at 154-69 (1964); A. BERLE, *supra* note 77, at 82, 89-90 (1959). And see A. SHONFIELD, *MODERN CAPITALISM: THE CHANGING BALANCE OF PUBLIC AND PRIVATE POWER* 371 and 372-73 n.46 (1965). (Only very large firms can support adequate research and development programs, and firms with such programs have a great competitive advantage, especially in obtaining defense work.)

130. The ability of business to carry out long-range research and development would be impaired, price stability characteristic of oligopolistic and administered markets would be eliminated, and the conformability of private business to conscious direction in the public interest would be reduced. SHONFIELD, *supra* note 129, at 371; A. BERLE, *supra* note 77, at 89; Barnes, *Considerations Concerning a Public Policy Toward Administered Prices*, in *ADMINISTERED PRICES* 44, 50-53; Adams & Lanzilotti, *The Reality of Administered Prices*, in *ADMINISTERED PRICES* 5, 17-18. See also *Wall Street Journal*, Aug. 24, 1966, at 1, col. 6, and 16, cols. 1-5 (copper users seek substitutes because of wide price fluctuations).

necessary to pay dividends *and* to supply necessary equity capital. There is nothing necessarily wrong with such a system. It provides capital at very low cost, and it provides the largest supply of investment funds to those organizations that have indicated by their success that they can use it most efficiently. But the system is now operating unjustly because it fails to return to a broad segment of the economy a proportionate share of the profits derived from the capital provided by all consumers.

In addition, the public pays for most research and development, which now provides the principal stimulus and support for corporate growth.¹³¹ Federal taxes pay 60 per cent of the costs of all industrial research and development.¹³² In fiscal year 1961-62 federal support totalled about \$10 billion,¹³³ nearly as much as the total profits of \$13.5 billion earned in 1962 by the 500 largest industrial corporations,¹³⁴ among whom it can be assumed were nearly all the direct beneficiaries of the support. By 1965 federal support had increased to \$15 billion and, in the words of the National Commission on Technology, Automation and Economic Progress, was "still rising rapidly."¹³⁵ The corporations that actually carry on the federally financed research and development often obtain an additional advantage at public expense in being allowed to retain and exploit whatever patentable inventions result.¹³⁶ The amount of research and development assistance corporations obtain from state governments and private endowments through the use of university and other nonprofit facilities has apparently never been measured.

Despite these public contributions, the present tax system effectively excludes all but a small portion of the population from a significant share of public corporation profits. By favoring income received in the form of appreciation, the system shifts most of the burden of financing federal expenditures on to wage and salaried income. Thus, recipients of such ordinary income are in the doubly unfortunate position of financing corporate expansion with uncompensated contributions of funds they might otherwise invest in these same corporations.

131. SHONFIELD, *supra* note 129, ch. III, at 40-60; NATIONAL COMMISSION ON TECHNOLOGY, AUTOMATION, AND ECONOMIC PROGRESS, *TECHNOLOGY AND THE AMERICAN ECONOMY* 103 (1966).

132. 12 NATIONAL SCIENCE FOUNDATION, *FEDERAL FUNDS FOR RESEARCH DEVELOPMENT AND OTHER SCIENTIFIC ACTIVITIES* 5 (1964).

133. *Id.*

134. STATISTICAL ABSTRACT 494, Table 677.

135. NATIONAL COMMISSION ON TECHNOLOGY, *supra* note 131, at 103.

136. See *Hearings before the Subcommittee on Defense Procurement of the Joint Economic Committee*, 88th Cong., 1st Sess. 55 (March 28, 29 and April 1, 1963).

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The present tax system imposes a subtler obstacle to broad stock ownership by inflating share prices beyond their worth to investors who are not already sufficiently wealthy to be in a high tax bracket.

When investment income is tax-exempt in whole or in part the underlying asset is on that account more valuable. Its additional value always varies directly with the height of the owner's tax bracket, because the higher the bracket the more tax he would have to pay if income on the asset were fully taxable. The value of the partial tax exemption for common stock appreciation also depends on how long the owner expects to keep his shares and how he expects eventually to dispose of them. Capital gains taxes on appreciation apply only if and when shares are sold or exchanged and are forgiven altogether for appreciation accrued to the time of death.¹³⁷ The partial tax exemption can thus be transformed into a total exemption if shares are held long enough or disposed of otherwise than by sale or exchange.

It follows that common stocks typically have a great additional value for the wealthy holder. He is in a high tax bracket, and since his wealth typically enables him to live without dipping into principal, he characteristically retains his shares for long periods and disposes of them by gift or bequest. Their additional value is distinctly less for a holder of moderate means. His tax bracket is only moderately high and he is much more likely than is a wealthy holder to dispose of his shares quickly and in a taxable manner. They carry no additional value whatever for an organization that is tax-exempt, because it in effect has a "zero tax bracket" and never pays a tax no matter how it disposes of its shares. Schools, foundations, religious institutions¹³⁸ and pension trusts,¹³⁹ among others, thus gain nothing from the tax privileges conferred on stocks.

The additional value which tax-exempt assets have for some owners means that they will bring a higher price: a "basic" price at which they would sell if their income were fully taxable plus a "premium" attributable to their tax-exempt status. In a market which includes purchasers for whom tax exemption has different values, a tax-exempt asset will sell at a premium no greater than the highest value the premium has for any purchaser. Normally it will sell considerably lower, because there are not enough highest-value purchasers to bid it near to the upper limit. Thus, municipal bonds whose interest is

137. IRC §§ 1001, 1002, 1014.

138. IRC § 501.

139. IRC §§ 401, 501(a).

exempt from federal income tax commonly sell for about a third again as much relative to the interest they bear as do taxable bonds of comparable risk, but they nevertheless are still worth about twice their price in taxable bonds to a taxpayer in the highest bracket.¹⁴⁰ The premium at which corporate stocks commonly sell cannot be so easily measured, because there is no class of fully taxable stock, analogous to taxable bonds, with which to compare them. The size of the premium can only be estimated.

Unlike bonds, for which the tax exemption always has the same value in the hands of a given holder, the value of the special tax treatment of common stocks varies not only with the tax bracket, expected holding period and intended manner of disposition of each given holder but also with the proportion of the stock's income which is in appreciation rather than dividends. For only the appreciation is essentially free from tax. "Growth stocks" thus should sell at relatively high premiums, whereas stocks with high dividends but low appreciation presumably sell at little or no premium. The difference in premiums between the two kinds of stocks, moreover, is much more than proportionate to the difference in their appreciation, because premiums on appreciation tend to "snowball." Too complex to be worked out in detail here,¹⁴¹ the snowball effect can be suggested thus: the greater a stock's reputation as a growth stock, the greater is the premium at which it will sell, but since the premium itself appears as a portion of the price of the stock, it too appreciates and so adds to the total amount of appreciation, which in turn justifies a higher premium, and so on.

These complications make it difficult to determine the premium for any particular stock, but they leave no room for doubt that in general premiums must be high. The capitalized value to a high bracket, long

140. Compare yields on high grade municipal bonds for 1960-1963, STANDARD AND POOR'S CORPORATION, 1964 SECURITY PRICE INDEX RECORD 203, with yields on high grade corporate bonds for the same period, *id.* at 183.

141. The premium which would exactly compensate a shareholder in a tax bracket r for not having to pay any tax on the appreciation of a share of stock that would sell at price P_t if appreciation were fully taxable, can be computed from the formula,

$$\text{Premium} = \frac{1}{\frac{(1-r)d}{P_t a r} - 1} \cdot P_t$$

The symbol a is the percentage annual rate of appreciation, and d is the annual dollar amount of dividends per share. Examination of the formula discloses that for holders in the higher brackets the size of the premium becomes extremely large as the ratio of the appreciation rate to the dividend rate is increased and that, in fact, for ratios beyond 3 or 4 to 1 for high bracket shareholders the formula "blows up." The latter means that for such shareholders, "growth stocks," no matter what premium they sell at, are a bargain.

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term shareholder of not having to pay an annual tax on a normally appreciating stock is substantial; and high bracket, long term shareholders constitute a large proportion of the market. A reasonable guess is that significantly appreciating common stocks sell today for something like one and a half to two times what they would sell for if their appreciation were fully taxable.¹⁴²

Premiums aggravate stock fluctuations as well as increase prices. Since they increase the less predictable appreciation element of a stock's value relative to its dividend element, the effect of premiums is to place total stock value on a less stable ground.

It might be thought that although an average income individual or tax-exempt institution obtains nothing of personal value in return for the premium he pays for appreciating stock, it costs him nothing either, because the premium, along with its appreciation, is returned to him when the stock is sold. But the loss which a premium inflicts on such a shareholder shows up in his dividends, not his appreciation. Suppose that Stock A sells for \$170 per share under the present system but would sell for only \$100 if its appreciation were fully taxed, and that its value doubles in ten years. Middle-income investor Jones could under the present system buy ten shares for \$1700, collect whatever dividends were paid and benefit from \$1700 appreciation after ten years. Under the full-tax system he could purchase seventeen shares for the same amount of money and benefit from the same amount of appreciation (\$1700) in ten years, but in the meantime he would have collected whatever dividends were paid on seventeen shares instead of ten. The premium under the present system costs him ten years' dividends on seven shares. A wealthy investor, too, could of course purchase more dividends for the same amount of money under a full-tax system, but for him the advantage of receiving them would be more than offset by having to pay more tax (or having to pay tax at all) on the same amount of appreciation.

It might also be thought that with average book-value appreciation of

142. For example, common stocks listed on the NYSE have recently sold for from 17 to 18 times earnings per share, which means that their "return" is between 5 and 6 per cent. STANDARD AND POOR'S CORPORATION, TRADE AND SECURITIES, CURRENT STATISTICS COMBINED WITH BASIC STATISTICS 58-59 (January 1966). Yet taxable corporate bonds, which are a more secure investment and far less speculative in the short run, provided returns of only slightly less than 5 per cent during the same period. *Id.* at 60-61. Tax factors aside, one would expect shares to have a distinctly higher return than bonds, to sell, say, at about 10 times earnings. The 17-to-18 times-earnings figure, moreover, is only an average, and "growth stocks" typically sell at a higher multiple of earnings than the average. See, e.g., 1 STANDARD AND POOR'S CORPORATION, INDUSTRY SURVEYS C-54 (February 24, 1966) (chemical stocks).

6 to 7 per cent per year¹⁴³ and dividends of 3 to 4 per cent,¹⁴⁴ public stocks are such a good investment even to low-bracket taxpayers that the effect of the tax system on stock prices cannot be blamed for the failure of middle income families to invest more in public stocks. But stock prices may reflect book-value appreciation only in the very long run. In recent times price fluctuations have taken as long as ten years to iron themselves out sufficiently for the average rate of growth to assert itself.¹⁴⁵ A family man with only moderate savings ordinarily cannot count on being able to wait that long: medical expenses, his children's education, retirement and other contingencies are all too likely to intervene. He is therefore inclined to invest in insurance, home ownership, a savings account or savings bonds. Institutional investors, which are the repositories for most of the wealth in the lower tax brackets, are also required by their fiduciary responsibilities to give substantial weight to the short-term uncertainties of the market.¹⁴⁶ The very wealthy, on the other hand, are able to hold shares with the assurance that they can ride out price uncertainties.

The relative advantages would be reversed if appreciation were taxed like ordinary income. The necessity of paying tax on all their profits would sharply reduce the desirability of public stocks to high income investors, and the elimination of premiums would increase their desirability to lower income and institutional investors. The result would be to distribute corporate wealth much more broadly. The lower and less variable price of public stock would make it a safer and more profitable investment for moderate-income individuals. Mutual-fund shares, and even direct holdings, would therefore become an important and profitable part of the personal savings of a much broader segment of the population. Insurance companies and other partially tax-exempt organizations would be stimulated to purchase more public shares and provide a better return on their investment. But especially, tax-exempt institutions, which stand to gain the most from the elimination of tax premiums, could increase their holdings substantially and distribute their augmented benefits to the entire population. Something close to the long-discussed "shareholder democracy" would finally be a reality, not in the impossible sense of direct popular control of management decisions, but in the

143. See note 24 *supra*.

144. See NYSE FACT BOOK 1965, at 47.

145. See authorities cited notes 23-24 *supra*.

146. See, e.g., Wall Street Journal, Dec. 21, 1966, at 1, col. 5, and 10, col. 1.

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entirely possible, and just, sense of the widest feasible participation in the benefits of the corporate economy.¹⁴⁷

The reduction in stock prices caused by the removal of their tax advantages should occur gradually, as a failure of prices to rise from their level at the time the tax became effective rather than as a drop from that level. The tax would, of course, apply only to a taxpayer's *net* gains during the year, and presumably a net loss in any year could be carried forward to be netted against net gains in succeeding years. Since the tax would apply only to price increases occurring after its effective date, there would be no tax-related reason for selling at a price less than that which prevailed on that date and therefore no tendency for the market to be driven to a lower level. Any drop that nevertheless occurred would inflict losses which could be used to render future market gains taxfree but which would be a dead loss if the taxpayer did not stay in, or soon re-enter, the market. The enactment of the tax thus ought to have a *supportive* effect on prices up to the level of the market on the effective date. A rise above that level, on the other hand, would trigger more than the usual volume of selling by shareholders in the highest tax brackets and so would proceed with less than usual speed. And the many years' pause in the upward movement of the market necessary to squeeze out tax premiums should permit the shift of share ownership to be carried out in an orderly manner.¹⁴⁸

The tax's effect of reducing the market's volatility¹⁴⁹ would have the

147. See A. Berle, *Property, Production and Revolution*, 65 COLUM. L. REV. 1, 17-18 (1965); *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433, 449 (1962).

148. The securities industry ought also to benefit from a tax on stock appreciation. The fees of brokers and investment advisers are commonly based upon the dollar volume of the sales they handle. SPECIAL STUDY pt. II, 25-30. Since the demand for newly issued stock would probably increase, the price of new issues relative to other investments should rise as should the frequency with which new issues are floated. Although the prices of outstanding stocks would be less relative to other investments than they are now, the effect of lower prices on brokers' commissions should be more than offset by the increased frequency of trading. The fact that the appreciation tax would be assessed annually would also tend to encourage a more rapid turnover. For the very wealthy, who can afford to spend a lifetime without dipping into their savings (see text accompanying notes 45-48), would no longer have a tax incentive to hold onto stock until a death in the family gives them a stepped-up basis. Mutual funds, which tend to serve the small investor (SPECIAL STUDY pt. IV, at 140), would also benefit from the redistribution in stock ownership brought about by the tax change.

149. The elimination of tax premiums would place stock prices on a more stable ground. In addition, the appreciation tax would have a stabilizing effect of its own. Whenever the price of a stock rose sharply, its holders would incur large tax liabilities, payable during the spring of the year after the rise occurred. Among the shareholders who have to sell stock to pay the tax, some would certainly sell early in anticipation of an April selling rush. Even shareholders with no shortage of cash to meet their tax liabilities would, if speculatively inclined, sell at or near the peak of the rise. Thus, every unusual rise would produce forces tending to reverse it, and the higher it went, the more powerfully would those forces operate. Similarly, any drop in stock prices would create "tax assets," that is, paper losses which for tax purposes could be offset against gains from other stock

benefit of reducing year-to-year fluctuations in the revenue from the tax itself. The several averaging steps involved in levying the tax would also have that effect. As we have seen, each year's "official tax value" would be the average of a stock's daily prices over some extended period during the year. Taxpayers presumably would be permitted to average their gains and losses on all their stocks during each year to determine their net gain or loss for the year. And they presumably would also be allowed to average their yearly net gains or losses over something like five successive years to determine their tax liability for each particular year. Finally, of course, total national revenue from the tax would be determined by the statistical average of the tax liabilities of all the individual taxpayers subject to the tax. Annual revenue would thus be based on four successive averages, and even its ultimate basis, the prices of particular stocks, would have been rendered less variable by the tax's smoothing effect on the market. The resulting amount would hardly fluctuate any more than other tax revenues which rise and fall with the general level of economic activity. And like them, any fluctuations would usually be in phase with the general level of economic activity and thus exert a helpful countercyclical effect.

The elimination of their tax immunities would make public stocks seem overpriced to most high-bracket taxpayers. As they switched out of stocks into other investments, prices might rise initially in the markets for both fixed-yield securities and high-risk investments, such as real estate and oil wells, that still offered tax immunities. But the rise, if any, would be short-lived. No permanently greater supply of funds available for such other investments would have been created, because for each high-bracket taxpayer who sold public stocks in order to be able to switch into other investments there would necessarily have to be a lower-bracket taxpayer who bought them and who would therefore have correspondingly fewer funds available for other investments.

In fact, if application of the new tax had any transitional influence at all on the price of investments other than public stocks, it would tend to decrease the demand for them as part of the deflationary pressure it exerted throughout the economy and so lower their price. Individuals and institutions holding substantial amounts of public stock tend to spend more. Its presence, like that of any reasonably liquidable wealth, provides protection against contingencies and savings for

holders, past, present or future. Shareholders on that account would be more likely to ride out a fall in the market, and the reduced tendency to sell would act as a restraining influence on a bear market.

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future needs and so frees the holder to spend more for current purposes. When the prices of public stocks tended to level out in response to the application of the tax, therefore, shareholders would tend to spend less, and the aggregate demand for all other kinds of investments would decline. If during the time it took to squeeze out the premium the economy happened to be in need of some deflationary pressure, the effect could simply be accepted; otherwise, appropriate fiscal and/or monetary inflationary measures would have to be taken to offset it. In either event, wealth would be shifted from public shareholders to others. The shareholders would lose because the prices of their shares would not rise as rapidly as they had in the past. Others in the economy would gain, either because the goods and services they purchased would be cheaper (if the deflationary pressure were accepted) or because they had more money (if taxes were lowered, bank credit expanded or other inflationary measures taken).

The tax would have no permanent effect on the prices of investments other than public stocks. The price of any investment is set by four factors: the public's assessment of its probable rate of return and of its risk, its tax treatment and the going interest rate. The new tax could possibly have an effect only on the fourth factor, but if it did, the government could offset the effect through the operations of the Federal Reserve System, one of whose principal functions is to control interest rates.¹⁵⁰ Thus, any change in the general price level of other investments which occurred subsequent to the imposition of the tax would represent a Federal Reserve policy choice that the change should occur, not an unavoidable effect of the tax.

It is, of course, impossible to predict every effect of a proposal marking so radical a departure from the status quo. Transitional effects are especially difficult to foresee, because they would depend greatly on the popular reaction to the tax. The stock market is a notorious ground for the fulfillment of self-fulfilling prophecies. If enough people believed that the tax would tumble the market, or even feared that it might, then it would. It might therefore be advisable to accompany the enactment of the tax with a set of discretionary tax-cutting and market-supporting measures; their existence alone would alleviate fears and so avoid a market crash. In the end, however, sanity would no doubt prevail. Much of the volatility, and some of the glamour, would be taken out of the stock market, and public stocks

150. See note 179 *infra*.

would settle into their place as one more source of income among the many available to an individual or organization with savings to invest, taxable just like interest, rents or pensions.

IV. The Chimera of Double Taxation

A. *Taxes and Profits*

The proposed tax would radically redistribute the burden of the federal income tax and ultimately bring about a wider dissemination of the profits of big business. Hence, it will be vigorously opposed. One certain objection¹⁵¹ is "double taxation"—the alleged unfairness of taxing stock appreciation as individual income when it is already subject to the 48 per cent levy on corporate income. Supposedly, corporate profits are reduced by about half before the shareholders benefit from them. According to this argument, even the present application of the individual income tax to dividends constitutes "double taxation." Applying it also to appreciation would complete the injustice. But in fact, the 48 per cent corporation income tax is not reducing corporate profits by anything close to that amount, because the corporate economy has long since shifted all, or at least substantially all, the tax forward to the consumer in the form of higher prices.¹⁵²

For many years, it was economic orthodoxy that the burden of the

151. See, e.g., Humphrey, *How the New Tax Bill Can Promote Prosperity*, LIFE, Mar. 15, 1954, at 37-43; D. HOLLAND, *THE INCOME TAX BURDEN ON STOCKHOLDERS xi and passim* (1958) (entire book written on assumption that shareholders bear at least half of the corporation income tax); D. SMITH, *FEDERAL TAX REFORM, THE ISSUES AND A PROGRAM* 189-203 (1961).

152. The discussion that follows assumes for simplicity that the principal method of shifting the corporation income tax, by raising prices, is the only method. There are others. As will be argued below, a long-range failure to shift the tax to consumers may result in not just an impairment of shareholders' profits but also of labor's; i.e., a failure to shift the tax to consumers may result in a partial shift to labor. To an indeterminate but probably substantial extent there is also shifting back to the government—a shift that operates as a reduction of the effective tax rate. The laws permitting the value of an asset to be depreciated for tax purposes more rapidly than it actually declines, e.g., IRC § 167-70, operate to defer taxes and so give a corporation the use of money that it would otherwise have to pay currently to the government. Such money, since the obligation to repay it at the deferred day of tax reckoning is dependent upon there then being sufficient profits to permit repayment, is essentially that most valuable kind of money—equity money, available for high-risk investments. Estimating its value conservatively at 10 per cent per year, the value to a corporation of being able to defer the first 5 years' tax on the profits of an asset with a useful life of 10 years until the last 5 years of its life is about one-fourth the amount of the entire tax. The effective rate on the asset is thus reduced from 48 per cent to 36 per cent, 12 per cent being "passed back" to the government. Cf. *Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318 (5th Cir. 1966) (FPC may require natural-gas company to pass on to consumers savings from accelerated depreciation permitted by IRC § 167). Because this and other methods of shifting also exist, the method of raising prices does not have to bear the whole burden of keeping profits at their pre-tax level.

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corporation income tax fell on the corporation and its stockholders.¹⁵³ If the firm were assumed to be maximizing profits, supposedly the normal behavior in both competitive and monopolistic markets, it followed that the tax could not be shifted. The profit-maximizing output of the firm is determined by its marginal revenue and marginal cost for additional units of production, which in turn are dependent upon the demand for the firm's output and the cost of inputs. Because neither demand levels nor input costs seemed to be affected by a "mere" profits tax, economists traditionally thought that the profit-maximizing level of output would be unchanged by the imposition of the tax. The hapless entrepreneur could do no better than to continue at his pre-tax level of output, turning over part of his profits to the government.

Modern economic theory, however, is more optimistic about the ability of corporate business to shift the corporation income tax forward to consumers. Obviously, if businesses are not in fact maximizing profits—in the sense of equating marginal revenue and marginal costs—they may be able by raising prices to shift forward part of the tax,¹⁵⁴ and there is increasing agreement that businessmen work for

153. To avoid misunderstanding, I want to emphasize that my concern is *only* with the shifting that occurs *from shareholders* (which is to say, from corporate equity capital), not from capital generally or even from corporate capital generally. Thus, the conclusion drawn by Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962), that the corporate income tax is in substantial part not shifted from capital (generally) is not directly pertinent here.

But it can be made pertinent. Professor Harberger's conclusion rests on the premise that the market for capital throughout the United States is sufficiently fluid, or "perfect," that the return net of risk and tax on *all* kinds of capital tends toward uniformity in the long run. *Id.* at 215-17. So his conclusion that capital generally bears the burden of the tax is tantamount to saying that the tax is "spread out" over all the capital in the economy, uniformly reducing returns everywhere. Since the total amount of capital is approximately four times the amount of corporate equity capital (*see* STATISTICAL ABSTRACT 407, Table 549 (debt capital); 490, Table 671 (relative amounts of corporate and noncorporate business); 495, Table 679 (corporate equity capital)), even if his conclusion that none of the burden of the corporate income tax is shifted from capital generally is correct, corporate equity capital itself will bear only a fourth of it. That is, about 75 per cent shifting *from shareholders* does occur.

However, Professor Harberger's reliance on the premise undermines even his own initial conclusion. It follows from the premise that if the return on any kind of capital has been reduced by the corporation income tax, so has the return on debt capital, and by the same amount. But if interest rates are lower than they would be absent the tax, it must be because the tax has influenced the thinking of the Board of Governors of the Federal Reserve System, which controls the level of interest rates. However, Professor Harberger's demonstration contained no reference to government monetary policy.

154. An oligopolistic industry might not be producing at a profit-maximizing level either because the members fear that antitrust eyebrows will be raised if they make a concerted effort to find the profit-maximizing level of output and prices, or because side-payments among firms would be required to obtain agreement upon the price which would maximize industry-wide profits. *Cf.* W. FELLNER, *COMPETITION AMONG THE FEW* (1949).

goals other than profit maximization.¹⁵⁵ But even in an economy of profit-maximizers, the corporate income tax is passed on if the proceeds of the tax finance additional government spending which, in turn, causes sufficient inflation to restore the old level of net corporate profits.¹⁵⁶ This result is consistent with profit-maximizing, because the rise in total spending has changed the companies' demand functions. The result is no different than if a general sales tax had been imposed instead.

But one need not resort to economic theory to get a rough picture of how taxes are commonly shifted in two sectors of the economy which together include most of the public corporations. The government commissions that set prices for the regulated industries¹⁵⁷ are required by law or custom to set them high enough for companies under their jurisdiction to earn profits equal to some fixed proportion, usually about 6 per cent, of their invested capital. An income tax on profits is regarded as an additional cost, which the regulated companies are allowed to cover by raising prices. Where the regulated company has a complete, or nearly complete, local monopoly on whatever it sells, it faces no effective restraint on its power to raise prices and so will do so to the full amount allowed. Even where regulated competition exists (for example, between railroads and trucks), the result is ultimately the same, because the commissions will, if necessary, force both competitors' prices up to prevent either from making "uncompensatory" marginal profits at the other's expense.¹⁵⁸ Regulated industries

155. See, e.g., E. PENROSE, *THEORY OF THE GROWTH OF THE FIRM* (1959).

156. In a time of rapidly rising aggregate demand, the ability of the corporation to shift the burden of the corporation income tax will be enhanced by the fact that wages and salaries are likely to rise less quickly than commodity prices. If all prices were completely flexible, input costs would move up as rapidly as output costs, and shifting could not occur so readily.

157. E.g., COLO. REV. STAT. § 115-3-1(1). See generally NICHOLS, *RULING PRINCIPLES OF UTILITY REGULATIONS, RATE OF RETURN* ch. 1, §§ 1 and 2, at 1-7 (1955).

158. NICHOLS, *supra* note 157, ch. 1, § 1, at 1, and ch. 24, § 4, at 435; Cook & Cohn, *Capital Structures for Public Utilities Under the Public Utility Holding Company Act*, 45 VA. L. REV. 981, 997-98 (1959). The actual process of rate setting is more complicated than the text indicates, but the result is the same. Rates are set with reference to a "base" that normally equals, or is closely related to, gross investment. For example, a utility with assets of \$100 million, debt of \$60 million and shareholder equity of \$40 million, might have its rates set so as to guarantee a return of 6 per cent on \$100 million, not \$40 million. Utility managements therefore commonly try to borrow as much as they safely can at interest rates below the rate of return on their "base," in order to increase profits on shareholders' equity. Cook & Cohn, *supra* note 158, at 981, 998-1001. However, it can easily be demonstrated that an increase in rates sufficient to keep the return on the "base" at 6 per cent despite an increase in taxes will also keep the return on shareholders' equity at the same level as before the tax increase. See, e.g., *All Freight from Eastern Ports to the South*, 251 I.C.C. 361 (1942); *All Commodities, L.C.L., between Maine, Massachusetts, and New Hampshire*, 255 I.C.C. 85 (1942) (regulated competition).

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account for 12 to 16 per cent of the corporate business in the country.¹⁵⁹ Most of the prices set by large corporations outside of the regulated industries are "administered," that is, set by deliberate private decision.¹⁶⁰ One company announces a price, which the others then parallel or lower. The process ends when all prices reach the level of those of the lowest-priced company having significant market power. But since every company wants to keep its profits as high as possible without inviting new competition or serious public disapproval, prices normally end up high enough to provide what the industry consensus regards as a reasonable return on capital for most companies in the industry.¹⁶¹ And since here too taxes are regarded as costs, the "reasonable" return is net of taxes and thus the same whatever the tax rate.¹⁶²

The evidence points to the conclusion that the shifting forward of the corporation income tax has been substantially complete. Although the necessary data are not available for earlier periods,¹⁶³ in which there was no corporation income tax, the double taxation argument is seriously damaged if it can be shown that, between the nineteen-twenties and the present, corporations have been successful in shifting the great increase in corporation taxes.

During the late twenties, the federal corporation income tax ranged from 11 to 13½ per cent;¹⁶⁴ from 1951 to 1965, the tax was between 48 and 52 per cent.¹⁶⁵ In addition, state corporation income taxes were rare in the twenties but had become common in the fifties.¹⁶⁶ The

159. In 1962, assets of utilities accounted for about 12 per cent of all corporate assets, and profits of utilities accounted for about 16 per cent of all corporate profits. *STATISTICAL ABSTRACT* 498, Table 684, and 499, Table 687.

160. KAPLAN, DIRLAM, & LANZILLOTE, *PRICING IN BIG BUSINESS* 130 (1958). See *ANN. REP. OF THE COUNCIL OF ECONOMIC ADVISORS* 88 (1958), printed as part of the 1966 *ECONOMIC REPORT OF THE PRESIDENT* ("The exact diagnosis [of inflation not caused by excessive demand] remains a matter of some disagreement among economists. But almost all agree that an important part of the explanation lies in the fact that, in many industries, unions or managements or both possess considerable discretionary power to set wages and prices, . . .").

161. See Means, *Pricing Power and the Public Interest*, and Means, *The Reality of Administered Prices*, in *THE CORPORATE REVOLUTION IN AMERICA* 77-96, 213-22, 226 (1962). See also KAPLAN, DIRLAM & LANZILLOTE, *supra* note 160, at 130.

162. Means, *Pricing Power*, *supra* note 161, at 221-22.

163. See *HISTORICAL STATISTICS* 581, 582-85, for other relevant data.

164. CCH 1966 *STAND. FED. TAX REP.* ¶ 153.

165. TAX FOUNDATION, INC., *supra* note 67, at 110-11, Table 86.

166. UNITED STATES ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *TAX OVERLAPPING IN THE UNITED STATES* 25-26 (1964). Thirteen states had a corporation income tax before 1929. Thirty-seven plus the District of Columbia now do. From 1959 to 1963 one state enacted a corporation income tax, 12 raised their rates, two raised their rates twice and one repealed its tax. See also TAX FOUNDATION, INC., *supra* note 67, at 174-75. The combined effect of federal and state corporate income taxes is compared for 1929, 1939, 1949, 1959, 1962, and 1963 in *id.* at 43, Table 26. See rows entitled "Corporate profits before tax" and "Corporate profits tax liability."

depression of the thirties was a period of abnormally low corporate profits. If depression rates of return were used as a base, the postwar corporation income tax would seem to be the handmaiden of a great increase in profits on equity capital.¹⁶⁷ The late twenties, on the other hand, provide a conservative comparison. If the after-tax rate of profits on equity capital is as high today as it was then, surely the much higher corporate income tax today cannot be having an appreciable effect.

The First National City Bank of New York has kept records which reveal the average ratio of corporate profits to net assets every year since 1925 for manufacturing corporations and every year since 1928 for all corporations.¹⁶⁸ The records are accurate;¹⁶⁹ they cover about 90 per cent of the corporate economy,¹⁷⁰ and the firms they represent are almost all publicly held corporations.¹⁷¹ They are, therefore, ideal for our purposes.

These records disclose that corporate profits after taxes relative to investment today are slightly *higher* than they were when the corporation income tax took a much smaller portion of before-tax profits. According to First National City, the average after-tax rate of return was 10.4 per cent from 1950 through 1964, and 10.3 per cent from the years 1928 and 1929.¹⁷² *Thus, despite a near quadrupling in the level of the federal corporation income tax and the imposition of numerous state corporation income taxes, the after-tax return on shareholder investment is at least as high today as it was in the twenties.*¹⁷³

But historical comparisons are unnecessary to refute the assertion that the current corporation income tax rates of about 50 per cent are

167. See HISTORICAL STATISTICS 580-81. Profits as a percentage of shareholders' equity can be computed by dividing the amounts shown in Ser. 95 by the sum of the amounts shown in Ser. 81-85.

168. ECONOMICS DEPARTMENT, FIRST NATIONAL CITY BANK, NEW YORK, AVERAGE ANNUAL RATES OF RETURN.

169. Lewis, *Corporate Profits*, FINANCIAL ANALYSTS' J. 40-41 (July-August 1964).

170. *Id.*

171. *Id.*; ECONOMICS DEPARTMENT, FIRST NATIONAL CITY BANK, *supra* note 168. The First National City Bank records are made up from published reports of corporations to their stockholders, which strongly weights them toward publicly held corporations.

172. ECONOMICS DEPARTMENT, FIRST NATIONAL CITY BANK, *supra* note 168. And as this is being written, unofficial estimates place 1965 profits at a level 16 per cent higher than 1964 profits. Wall Street Journal, Feb. 17, 1966, at 1, col. 6, and 8, col. 2. See also Hall, *Direct Shifting of the Corporation Income Tax in Manufacturing*, 54 AM. ECON. REV. SUPP. 258, 271 n.9 (1964) (average rate of profit after taxes on gross investment in 1919-30 and 1936-40 was 5.94 per cent and in 1941-59, 5.97 per cent).

173. The recent empirical study of Krzyzaniak and Musgrave supports this conclusion. The authors developed an econometric model of the corporate economy of the United States and, on the basis of this model, determined that the corporation income tax had in fact been slightly over-shifted. M. KRZYZANIAK & R. MUSGRAVE, *THE SHIFTING OF THE CORPORATION INCOME TAX* (1963).

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reducing corporate income by anything close to 50 per cent. The double taxation argument involves an assumption that "normal" corporate profits are twice those actually being earned. Under that assumption, the rate of profits on shareholders' equity in manufacturing corporations during the first half of 1965 would have been 26 per cent, instead of its actual 13.0 per cent,¹⁷⁴ the average rate for the four largest automobile manufactures in 1963 would have been 39.8 per cent,¹⁷⁵ and for General Motors alone in 1963, 46 per cent¹⁷⁶—nearly enough profits to buy another General Motors every two years! Rates of return as high as these would be an absurdity in a mature industrial economy. Yet the "double taxation" argument forces its proponents to predicate them as the norm.

The "double taxation" argument also assumes a revolution in federal monetary and debt-management policies that, to say the least, would be unlikely. Corporate profits do not exist in a vacuum. The market for capital in the United States (and, increasingly, in the entire western world) is sufficiently fluid that abnormally high returns in one sector ultimately bring higher, or are reduced by lower, returns in other sectors.¹⁷⁷ Witness, for example, the strikingly quick and forceful manner in which higher interest rates drew money away from stocks and thereby lowered stock prices during the spring and summer of 1966.¹⁷⁸ So sustained corporate profits at twice their present levels would operate to draw interest rates, too, up to commensurately higher levels. If the Treasury and the Federal Reserve failed to take remedial measures to increase the availability of credit, to keep interest rates down,¹⁷⁹ rates would rise to levels never before seen in the United States in modern times. Among other results, the cost of carrying the national debt would be multiplied and the ability of state and local governments to borrow would be seriously impaired. But if, as seems more likely, the Treasury and the Federal Reserve did take remedial measures, the resulting increased supply of money and lower interest rates would in time bring down corporate profits too.

One other quantitative measurement indicates that the corporation

174. FTC News Release S-2076 (Sept. 13, 1965).

175. FTC, REPORT ON RATES OF RETURN FOR IDENTICAL COMPANIES IN SELECTED MANUFACTURING INDUSTRIES, 1954-63, at 47, Table 9-3711.

176. *Id.*

177. Harberger, *supra* note 153, at 215-17.

178. N.Y. Times, Sept. 4, 1966, at E-1, cols. 1-2; Tobin, *Check the Boom*, *The New Republic*, Sept. 3, 1966, at 10.

179. See ROBINSON, BOEHLER, GANE & FARWELL, FINANCIAL INSTITUTIONS 673-75 (3d ed. 1960).

tax has not reduced profits. Data compiled by Professor Simon Kuznets of the National Bureau of Economic Research show that from about the turn of the century to 1930, the share of equity (as opposed to debt) in long-term corporate external financing averaged 35 per cent, that in the twenties it reached a relatively high average of 43 per cent and that almost immediately after the Second World War, it dropped to a 1946-1953 average of 21 per cent.¹⁸⁰ The decline has not reversed itself since the period covered by the study. Except for the atypical AT&T offering in 1964,¹⁸¹ the share of equity in corporate financing has been decreasing almost yearly since 1953.¹⁸² Indeed, if midyear prognostications held true, net corporate bond issues for 1965 totaled \$8 billion and net equity issues \$800 million—a mere 10 per cent portion for equity, even disregarding the additional diluting effect of institutional borrowing other than through bonds.¹⁸³

The drop in equity financing is too enduring to be merely a chance deviation.¹⁸⁴ Nor does it seem chance that the history of the corporation income tax almost exactly parallels that of the debt-equity ratio. The tax was first enacted in 1909, remained at a modest level until the Second World War, then shot up sharply, and has remained high since.¹⁸⁵ The increases in state income taxes since the war have reinforced the impact of the federal tax.

A simple example illustrates how the passing-on of the corporation tax could account for the parallel development of the tax and the debt-equity ratio. The Jones Corporation, operating in a tax-free business world, contemplates a one-million-dollar expansion program upon which it expects to realize a return in excess of costs of \$100,000 per year. In determining how much of the investment it should borrow and how much it should finance by selling stock (we are ignoring the

180. S. KUZNETS, *CAPITAL IN THE AMERICAN ECONOMY* 278, 381-86, 417-19 (1961).

181. AT&T is atypical because as one of the wealthiest natural monopolies in the world it has a strong political incentive to have as many shareholders as possible. For an indication of how the support of its shareholders can serve its interest against the FCC, the agency that regulates it, see *Wall Street Journal*, Feb. 8, 1966, at 1, col. 1. See also *THE NEW YORKER*, Feb. 5, 1966, at 33.

182. Gorman & Shea, *Capital Formation, Saving and Credit*, *SURVEY OF CURRENT BUSINESS*, May 1965, at 14-15; *Wall Street Journal*, August 20, 1965, at 1, 11; *STATISTICAL ABSTRACT* 502, Table 693. The figures given in the cited authorities include the "Comsat" offering, which should be ignored because it was not for the purpose of raising capital for an existing company.

183. *Wall Street Journal*, August 20, 1965, at 1, col. 6 and 12, col. 6.

184. Professor Kuznets explores several possible explanations and remains unsatisfied that they are sufficient to account for the trend. KUZNETS, *supra* note 180, at 276-82, 418-19.

185. *TAX FOUNDATION, INC.*, *supra* note 67, at 110-11, Table 86.

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possibility of using internally generated equity funds), Jones will take into account three basic factors: the cost of borrowing, that is, the interest rate it must pay; the risk of borrowing; and the "cost" of equity money. The last factor is determined for externally obtained equity money by comparing the price at which the company can sell shares of its stock to the return it is already earning on its invested equity funds; the object is not to dilute the earning power of existing shares by selling new shares too cheaply, and, if possible, to increase their earning power.

Suppose that Jones can borrow up to \$500,000 from its bankers at 6 per cent and decides to do so to the limit, leaving the remaining \$500,000 to be financed from equity. It can then expect an interest cost of \$30,000 per year and a return on equity of \$70,000, or since \$500,000 of equity funds are involved, a rate of return on equity of 14 per cent. If that rate of return is materially better than the price-earnings ratio of Jones' outstanding stock, the chances are that it can raise the additional \$500,000 by selling new shares, without diluting its established earning power per share. If it is less, the investment will not give existing shareholders a profit and should probably not be undertaken. A measure of the risk of borrowing half the million dollars needed is that the expected return in excess of costs of \$100,000 per year will exceed interest charges by \$70,000; if actual earnings fall short of expected earnings by more than that amount, the company will be forced to meet its obligations by dipping into receipts from other operations. The \$70,000 is sometimes called the "earnings coverage."

If a 50 per cent corporate income tax were imposed and generally not passed on in the form of higher prices, the three factors would remain the same. The expected after-tax rate of return on the equity portion of the investment would drop to 7 per cent, but since, by hypothesis, the rate of return on *all* corporate equity investment throughout the economy would have dropped by a like amount, stock buyers would be just as eager to buy Jones' shares now at its lower expected rate of return as they were prior to the imposition of the tax, and the number of shares that would have to be sold to raise the \$500,000 would be no greater than it was before.

But if we assume that the corporate economy generally has been able to pass on the tax in the form of higher prices, the second of the three factors—the risk of borrowing—undergoes a striking change. The generally higher prices prevailing would have increased the total expected

return of Jones' investment from \$100,000 to \$170,000.¹⁸⁶ That amount less \$30,000 interest, less 50 per cent (for tax) of the balance, leaves \$70,000 after taxes as the return on equity—the same as before. Thus, actual earnings could now fall short of expected earnings by \$140,000—twice as much as the previous “earnings coverage”—without Jones Corporation having to meet its obligations out of receipts from other operations. The first and third factors again remain the same. In such a situation, the company and its bankers would be foolish not to re-assess the risks involved and substantially increase the amount of the loan. By doubling “earnings coverage,” the corporation income tax has enabled a given amount of equity to carry with it a much larger amount of debt, at no greater risk. It is no wonder that the 50 per cent corporate levy in effect since about the Second World War has profoundly influenced the course of corporate finance. The SEC has even given official recognition to the tax's impact in this respect by allowing public utilities to carry higher debt ratios.¹⁸⁷

B. *The Effects of Reduced Profits*

The “double taxation” argument has a second weak point, independent of any alleged reduction in corporate profits. The conclusion that the application of the individual income tax to the shareholder would be unfair presupposes that stockholders are uniquely disadvantaged by any reduction in corporate income resulting from the corporation income tax. But if the corporate tax were repealed, the additional after-tax income would ultimately have to be shared with other income recipients and/or reduced by lowering the prices of corporate products. Sustained extraordinary profits would almost certainly bring on irresistible union demands for wage increases. White-collar employees would participate in the increase too, in part because management would want to maintain what it considered a proper ratio between white-collar salaries and wages in the plant, and in part because when profits are high, management can take some of the credit and reward itself accordingly. About 44 per cent of the national

186. This is an approximation for the sake of simplicity. Actually, expected earnings would not have had to rise quite so much in order to bring the after-tax rate of return on equity up to what it was before the imposition of the tax, because the tax's effect of reducing the risk of borrowing would have encouraged corporations to borrow more heavily, which in turn would have increased equity's “leverage” and, consequently, its rate of return.

187. Cf. Cook & Cohn, *Capital Structures of Public Utilities Under the Public Utility Holding Company Act*, 45 VA. L. REV. 981, 1001-06 (1959); Cook, *We've Got the Most Enterprising Utility in This Country*, FORTUNE, May 1964, at 138, 182.

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income is received as corporate wages or salaries.¹⁸⁸ Thus, if the corporation income tax is really reducing corporation income, about half the working taxpayers in the country have grounds for joining shareholders in the cry of "double taxation." But in the important industries at least—those whose prices figure prominently enough in the statistical price indices for the government to take notice when they rise—it is academic to talk of the possibility of much higher profits than now exist anyway. The recently institutionalized federal surveillance of all important price changes¹⁸⁹ would ultimately require that widespread extraordinary profits be shared with consumers through a price reduction or, more likely, through the slower process of holding prices steady while wages increased.

Finally, even if the corporation income tax has reduced corporate profits and the reduction has in turn reduced shareholder income more, proportionately, than other kinds of income, it still does not follow that every shareholder has a just cause for complaint if he is also subjected to an individual income tax. The corporate tax rates have been at their present level since about 1940. Shares that have been bought and sold since 1940 have therefore changed hands at a price that reflected their presumably lower after-tax earnings. The individual who has purchased his shares since 1940 is therefore earning as much on *his* investment as he would had the tax not existed.¹⁹⁰

On the other hand, the individual who has owned his shares since before 1940 has probably been unhurt by the present tax structure even if the corporation income tax has not been completely passed on. If it is conceded that half of the burden of the corporation income tax has been passed on to consumers or others—and the comparative profit figures leave no reasonable doubt that at least that much must have been shifted—it can be shown that a shareholder who has held shares since before 1940 and has been in at least the 50 per cent tax bracket during most of the intervening years has by now benefited more from the present tax structure than he would lose from the enactment of a tax on appreciation.

A 52 per cent corporation income tax that is about half passed on

188. In 1962 national income was \$453.7 billion, of which \$198.7 billion was compensation of corporate employees. NATIONAL INDUSTRIAL CONFERENCE BOARD, *THE ECONOMIC ALMANAC*, 1964, 115, 131.

189. See *Guideposts for Noninflationary Price and Wage Behavior*, 1966 ANN. REP. OF THE COUNCIL OF ECONOMIC ADVISORS 88-93. See also *Government Considers Cut in Structural Steel Buying as Part of Effort to Push Back Bethlehem Price Rise*, *Wall Street Journal*, Jan. 3, 1966, at 3, col. 1-3.

190. GOODE, *THE CORPORATION INCOME TAX* 26 (1951).

would, by definition, reduce \$100 of corporate profits to \$74. Corporations generally distribute about two-thirds of their after-tax profits as dividends.¹⁹¹ About \$49 to \$50 out of the \$74 would therefore be paid as a dividend, and a shareholder in a 50 percent bracket would be taxed another \$24 to \$25 upon its receipt. The \$24 to \$25 retained by the corporation and reinvested would not be further taxed. The total reduction brought about by the combined effect of the corporation and individual income taxes on the shareholder's \$100 of corporate profits would thus be about \$50—exactly the same as he would have paid in taxes had there been no corporation income tax and he had instead been taxed directly on his full share of the company's profits. A similar computation would show that if the shareholder's topmost tax bracket had exceeded 50 per cent he would have had *more* left after taxes under the present system than if he had paid only his individual rate on his entire share of the company's profits. Prior to 1963, all taxable income above \$16,000 for a single person and above \$32,000 for a married couple was taxable at 50 per cent.¹⁹² Since corporate stock is very highly concentrated among the wealthy¹⁹³ and since that stock which has been held for long periods is even more highly concentrated than stock generally,¹⁹⁴ it is reasonable to conclude that almost all stock that has been held continuously since 1940 has been held by taxpayers with incomes that usually placed them in brackets of 50 per cent or higher. Such stock, therefore, has contributed more after-tax income to its owners during the past twenty-five years than it would have if their share of corporate profits had been taxed directly as individual income—that is, *more* than if there had been no "double taxation." And a simple calculation shows that the extent of the benefit in nearly all instances has been enough to outweigh any detriment that would now occur if a tax on stock appreciation were enacted.¹⁹⁵

191. From 1958 through 1964 corporations earned \$170.7 billion and paid \$110.0 billion in dividends. STATISTICAL ABSTRACT 496, Table 682.

192. 1962 INDIVIDUAL INCOME TAX RETURNS 188.

193. See text accompanying notes 26-40 *supra*.

194. See note 49 *supra*.

195. Pre-1963 rates went as high as 91 per cent, see 1962 INDIVIDUAL INCOME TAX RETURNS 188, but the calculation will be carried out for a taxpayer in only a 60 per cent bracket. Assuming a half-passed-on corporation income tax, \$100 of corporate profits is reduced to \$74, and \$50 paid out as dividends is subject to a 60 per cent individual income tax and so reduced to \$20. The shareholder's after-tax income is thus the sum of the \$24 retained by the corporation after its taxes plus the \$20 left in the shareholder's pocket after he has paid his own taxes on his dividends, or \$44. Taxed directly and only once on all his profits at a 60 per cent rate, the shareholder would have had \$40 left. So he benefited

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V. Conclusion

The principal justification for favorable tax treatment of corporate stock appreciation is that an investment in stock constitutes an investment in production facilities. But once a share is issued, the investment in production facilities is complete and can hardly justify a tax immunity for as long as the share is outstanding. It is said, however, that a market for new stock must be continuously maintained by promising it the same tax freedom as is accorded the old. Even this secondary argument is weak when applied to public stock. The value of outstanding public shares is immense, and public corporations have demonstrated not only that they can, but that they prefer to obtain capital without issuing new stock. It is at least questionable that the preservation of an insignificant and disdained market is worth the loss of about \$15 to \$25 billion in annual revenue to the government and the destruction of virtually all correspondence between tax liability and ability to pay. In any event, the choice is unnecessary. Fixed-term immunities on new issues would maintain the market in spite of a tax on outstanding shares. Such a system would, in fact, increase the attractiveness of new shares in the total market.

The other possible justification for favorable tax treatment of stock is that it represents an effective instrument of corporate control. But no shred of operational control remains in the public shareholder, and the little, largely formal, power he still has over the election of directors and the disposition of facilities on a sale or merger would be unaffected by the removal of his tax privileges. What the public shareholder actually has is only a bare claim on corporate income—no more than an “uncashed check” payable to bearer in the amount of the latest market quote. On established principles, in the absence of the mystique of “investment,” the shareholder’s claim would clearly be taxable as current income.

\$4 per year. Using a discount rate of only 6 per cent, \$4 per year from 1940 through 1965 would amount to \$300 today.

Now assume that the individual income tax is made applicable to appreciation as well as dividends. \$100 of corporate profits would be reduced to \$74 by the unpassed-on portion of the corporation income tax, just as before. The entire \$74 would now be taxed to the shareholder at the rate of 60 per cent, however, rather than only that portion distributed as dividends. The retained portion would be manifested as an increase in the value of his stock, and be taxed as appreciation. So his individual income tax would be 60 per cent of \$74, or \$44.40. His \$100 of corporate profits would suffer a total reduction of \$74.40: \$26 from the corporation income tax plus \$44.40 from the individual income tax. That is \$10.40 more than he would have had to pay had there been no corporation income tax and he had instead been taxed directly and only once on all of his portion of the corporation’s profits. The present value of \$10.40 per year from now to eternity discounted at 6 per cent is \$173. The loss is thus only slightly more than half the gain already realized.

The results of the present tax treatment of corporate stock ownership are easy to see: the prices of public stocks are inflated and the great majority of shares are held by the very rich, who benefit most from their favorable tax treatment. The wealthy have been allowed to bypass the "progressive" individual income tax, because they are able to cast a large portion of their income in the form of stock appreciation. Those with earned incomes are virtually left to bear the burden of the tax alone, at a time when the earned-income occupations of administrator, scientist and professional are needed more than ever before and when the public corporation and its related financial institutions are rendering the individual holder of accumulated wealth almost economically superfluous. Whatever concentration of individual wealth is considered desirable could be more fairly maintained by taxing public stock and high earned income alike and, if necessary, lowering the rates on both.

The administrative difficulties of taxing public stock appreciation seem surprisingly few. The national exchanges already supply both the price information that would make annual taxation feasible and the ready market that is one of the principal justifications for it. Computers could hold and marshal the needed market data and produce it at year end for public use. The necessary exceptions for new issues and corporate reorganizations are relatively simple and seem workable.

Perhaps most significantly, the recognition that public stock appreciation is taxable income would effect an unprecedented redistribution of large-company stock. For the first time, those with moderate incomes would hold large numbers of public shares. Purchases by institutional trusts and funds that confer their benefits on a broad section of the population would be further stimulated. The nation as a whole, which through government grants and the money spent on corporate products, has for decades paid for nearly all corporate research and expansion, would finally begin to receive a fair share of the profits.