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# THE MEANING OF THE CHANGES WITHIN THE FRAMEWORK OF SUBCHAPTER C AND THE IMPACT ON PROPOSALS FOR INTEGRATION OF THE CORPORATE AND INDIVIDUAL TAX

EDWIN S. COHEN  
ALVIN C. WARREN, JR.  
WILLIAM D. ANDREWS

*The final segment of our conference deals with the meaning of changes within the framework of Subchapter C, the impact of the Senate Finance Committee Staff proposals on integration of the corporate and individual tax, particularly as to distribution reforms, and the type of corporate tax that might be desirable in a world in which individual consumption taxation replaced the present income tax system.*

*Professor Edwin S. Cohen, opens this part by noting his experiences with the 1956 Advisory Group on Subchapter C, then warns against an easy acceptance of repeal of General Utilities and other aspects of the Staff Proposal. He believes that the problem can be more fruitfully discussed in the context of an integrated form of tax, where double tax burdens are ameliorated.*

*Professors Warren and Andrews first discuss two proposals for restructuring the tax consequences of corporate distributions — the integration of the individual and corporate income taxes, as a means of eliminating double tax burdens and other inequities, and the American Law Institute Reporter's Study. Professor Warren il-*

*illustrates the methods for eliminating the double tax. He offers rationales for integration including the economic distortion that results under the current system from the deduction for interest in debt-financed investment with no deduction at the corporate level for equity-related dividend payments.*

*Warren observes that integration proposals have not heretofore been favorably received because of a combination of sophisticated factors, including the fact that some corporations, particularly utilities and financial institutions, already pay little corporate tax. He further states that the acquisition proposals of the Finance Committee staff are also not inconsistent with adoption of integration, with the corporate tax converted into a sort of withholding tax with substantial simplification possibilities. Professor Warren aptly demonstrates the impact of the accelerated cost recovery system on the integration proposals: "Coupling preferential treatment of income with full deductibility of interest is sometimes called 'tax arbitrage.'"*

*Professor Andrews, the Reporter for the ALI Study, notes that the ALI project adopted the "acquisition" proposals, most of which are adopted by the Finance Committee staff report, but that the "distribution" proposals were not formally adopted by the Institute, though supported by Professor Andrews himself.*

*While the ALI report did not address the desirability of integration, Professor Andrews points out that the Reporter's study on distributions must be reckoned with in considering integration. By way of examples, he illustrates how the tax law creates a bias against newly contributed equity capital. He concludes his presentation by describing the consumption tax alternative and its relationship to the corporate tax — potentially on a cash-flow basis.*

# IMPACT OF PROPOSED CHANGES IN SUBCHAPTER C

EDWIN S. COHEN\*

I have spent a lot of time struggling with the problems of revising Subchapter C, going back to 1949 when the American Law Institute first started on its federal income tax project. I spent many long weekends debating Subchapter C with Professor Stanley Surrey (Professor at Harvard Law School); with Bill Warren of Columbia Law School (later Dean of Columbia Law School); and with Tommy Tarleau (first Tax Legislative Counsel of the Treasury Department in the 1930's and 1940's, former Chairman of the Tax Section of the American Bar Association, and New York practitioner). We debated these issues weekend after weekend in the old Kent Hall at Columbia University and at Cambridge. Almost every Sunday morning there arrived a special delivery letter with a new draft of some section of Subchapter C. This occurred to such an extent that I sent Bill Warren a special delivery Christmas card designed to wake him up early on Christmas morning in response to all the times I was awakened with these special deliveries arriving early on a Sunday morning.

Those of you who have debated with Stanley Surrey for any length of time will understand why I'm now only five foot four and a half inches in height. I assure you when this debate started in 1949 I was 6 feet tall. I was worn down four inches by Stanley during the four years we debated Subchapter C, and the other four inches in the four years I spent at the Treasury Department. But they were delightful experiences. We produced a draft revision of Subchapter

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C by about 1952 or 1953. Then President Eisenhower took office and ordered a full-scale revision of the tax law. This effort produced the Internal Revenue Code of 1954. Our draft was submitted to the Treasury and considered by the Treasury and the Congressional staff. Finally, a proposal was introduced in March of 1954. The proposal passed the House within several weeks without adequate opportunity for review. Then the Senate made substantial changes in the House revision of the Subchapter C revisions. The Bill became law in August.

Because the Subchapter C section was somewhat unsatisfactory, when Wilbur Mills became a Ways and Means Subcommittee Chairman in late 1956 he set up the Advisory Group on Subchapter C and empaneled seven people who met for months on end. By the end of 1957 we produced a draft report containing a suggested revision, together with a draft statute, much as has been done recently by the staff of the Senate Finance Committee. Our draft report was publicly available for comments for about a year when we filed our final report. Meantime the American Law Institute further considered the subject, and I believe Larry Stone was one of the young graduates of Harvard at that time who worked on the project.

We have seen that while none of those proposals were enacted in full, much of the work found its way into the statutes. I think the present section 302,<sup>1</sup> regarding redemptions, came largely from that work, as did section 306<sup>2</sup> on stock dividends, section 318<sup>3</sup> on the attribution rules, section 355,<sup>4</sup> and a number of other provisions, but we've never had a wholesale revision of Subchapter C. The work of the American Law Institute and that of the Senate Finance Committee staff in the last few years has gone back over that whole area, and they've done a remarkably fine job in an extremely difficult area. We are all grateful to them.

It seems to me that the overall problem with revising Subchapter C, and one that the Congress will soon face, is that this process is much like trying to climb a tree. You go up the trunk of the tree, and pretty soon you have to decide whether to take the first branch off to the right or the first one off to the left. Eventually, you work your way out towards the end of a limb, where you find that when you look back you can see that somebody's going to saw off the limb. It isn't easy to change your course at that point. You really have to go back down to the trunk of the tree and start over again.

That's the nature of the problem with this *General Utilities*<sup>5</sup> mat-

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1. I.R.C. § 302 (1982).

2. I.R.C. § 306 (1982).

3. I.R.C. § 318 (1982).

4. I.R.C. § 355 (1982).

5. *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

ter; you veer off in one direction or the other, depending upon how you deal with *General Utilities*. I think that in the 1950's we were inclined to think that the problems largely stemmed from the fact that when a corporation completely liquidated while holding appreciated property, the property will likely pass to the shareholders with a stepped-up basis. Our conclusion was that we should have a system more akin to section 333<sup>6</sup> (with a number of changes) in which the basis would not be stepped-up but the shareholders would take the property with a substituted basis.

The latest ALI project and the Finance Committee project led by Andre LeDuc start in the other direction and say, "Let's have the property come out to the shareholders at a basis of fair market value, and to compensate for that let us have a recognition of gain at the corporate level, whether there's a distribution in kind or whether the property is sold to third parties and the proceeds are distributed."

Now I find that — as others have already said, as John Nolan has said, as Dick Shaw and Dudley Lang have just said — to be a rather extreme solution, and my guess is that the Congress will not in the near term adopt it, because of the objections that will have been made against it.

I testified, as Lester said, last October before the Senate Finance Committee on behalf of the Chamber of Commerce of the United States, which has some 225,000 members, of which over 200,000 would be considered small closely held businesses. Many are unincorporated, but quite a lot are incorporated. I presented a case to the Committee similar to those that have been put to you in the last two days. A person started a small drugstore business 30 or 40 years ago by building a drugstore on a piece of land purchased for \$10,000. After a period of 30 to 40 years, when he is about to retire, the land is now worth \$110,000. So there's an unrealized gain of \$100,000. You can probably get more attention from some of the members of the Senate Finance Committee if you use an illustration of a farmer who bought his land for \$10,000 and found that it appreciated over a period of years to \$110,000. But I thought in fairness I'd start with a drugstore operator first and then bring in the farmer later.

Other cases may not be as appealing; but if the farmer had not incorporated his farm and decided to sell later with a \$100,000 capital gain, he would pay under existing law a tax of \$20,000. But as

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6. I.R.C. § 333 (1982).

indicated earlier, if he had put the farm in a corporation, incurring the double tax, the tax (assuming it is a capital gains tax at both the corporate and shareholder level) would be \$42,400. This is a tax more than twice as great than would be due if he had not incorporated.

I find it difficult to believe that the Congress is going to accept that result in the near term. As some have said, if this were to be the case the lawyer's advice is likely to be, even more than under present law not to put appreciated property in a corporation, but keep it out and lease it to the company. I find it to be a more complex method, both for the IRS and for the taxpayer, because of the difficulty of knowing what the fair rental value should be.

If the owner comes down to the question of sale of the property to others, it seems to me that he'll try to sell to a corporation that would be willing to elect a carry-over basis so there would be no corporate tax on the sale. How to identify that corporation would not be easy; we might have problems of locating loss corporations to purchase the property, though I don't think the SFC Report says anything about selling to loss corporations. There would probably have to be a prohibition against the purchasing corporation being a charitable or educational organization, or otherwise the University of San Diego and other tax-exempt institutions would be buying up corporations because it wouldn't mind using a carry-over basis.

Now I think the practical effect of the proposal would be that once land or other assets went into corporate form, it might never come out of corporate ownership, because sales to individuals could not be made with a carry-over basis. Sales to individual buyers or partnerships would mean that there would have to be a double tax; and as I think Dudley or Dick mentioned earlier, the market price of the corporate stock may be lowered because you may have a more limited group of buyers that would be in a position to buy the assets in a fashion that would make the double tax inapplicable.

One of the things that I think we ought to give attention to, if this system is to be enacted, is what kind of relief from the double tax will be provided? Some of those possible forms of relief have been mentioned, but I think others are possibly available and we ought to think of them because maybe with appropriate relief Congress could be convinced to adopt the system. The one the staff has proposed seems to me to create a number of problems. I discussed their proposal with Andre and with others on his advisory group, so I know that there are significant arguments in favor of it. However, I found the proposal somewhat difficult. As I recall it, the proposal last October was that if the sale or liquidation occurred before April 1, 1984, there would be no corporate tax. If it occurred in the last eight months of this year, there would be a 4% corporate tax, and if it

occurred after the end of this year, there would be at least an 8% corporate tax, increasing gradually to 28% thereafter.

This approach puts advisors in a dilemma, because their first advice to a client who owned stock of a company with appreciated property would be to liquidate the corporation before this proposal goes into effect. But then the answer would be that the shareholder may have a tax to pay on the liquidation — a 20% tax to pay on his liquidation gain without having the funds with which to pay the tax. Moreover he might not be in a position to operate the business as an individual.

Another aspect would be that if he waited until he died, under present law (though some object to this rule in section 1014<sup>7</sup>), the basis of his stock would change to market value at the time of his death, and his estate or his heirs could liquidate the company after his death without a corporate tax and without a shareholder tax. But if he did not die before this new regime went into effect, his heirs would suffer the burden of a corporate tax.

Facing the above result, the best tax advice to him might be suicide, because if he died before the proposal went into effect, all would be well. He might look at his children with some misgivings, especially if there were any guns around the house. I'm not inclined to think that system of relief is desirable.

Another system of relief would be to give the shareholder a credit for the corporate tax paid, and while that has been previously rejected as being too complicated, if we have an integrated form of tax, as Bill Andrews and Al Warren will discuss in a few moments, we may have to struggle with that problem anyway. Many of us have written about integration of the corporate and individual tax with respect to ordinary dividends, but how to integrate the tax with respect to liquidating distributions deserves more attention. It may be that we'd have this problem anyway if we are to have some form of corporate shareholder integration.

Another solution that has been favored by committees of the American Bar Association Section of Taxation is to exempt from the corporate tax all capital assets that have been held more than three years. I think that would eliminate most of the problems, but one can ask, "Why three years?" Maybe because three years is mentioned in section 341<sup>8</sup> with respect to collapsible corporations. I gather there may be a consensus developing in the Bar Association

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7. I.R.C. § 1014 (1982).

8. I.R.C. § 341 (1982).



that if you eliminate from corporate tax all assets which when sold would produce long-term capital gain, the Bar Association might find these proposals acceptable. However, if such an exception were made, the difficulty with the proposal overruling *General Utilities* on liquidation would be that the only thing we would be changing in practical effect might be the sale or distribution of inventory kept on a first in, first out basis.

I hope that in the days and weeks ahead, as a result of careful consideration such as in conferences like this one, where the issues are brought out and discussed, the Congress will move ahead and we will try for some system which will not insist upon the double tax on liquidation. I think there is so much that is good in these proposals that I would hate to see them fail to be enacted because of resistance to the double tax in cases such as we discussed. We do have to remember that there are a lot of other proposals coming next year, including proposals for increases in revenue which have been mentioned by our two able luncheon speakers.

It is hard to say how the Subchapter C changes will fare in that regime. As a matter of fact, it's hard to say what will happen in a Congress at any time. I recall that in 1969 in the Senate Finance Committee when we were in Executive Session, and there was confusion as to what amendment was to be voted upon next, one of the senators turned to me and whispered, "Bismarck once said no man should ever see how either laws or sausages are made." I am sure that we will do better than that in the corporate tax revision.

# CORPORATE INTEGRATION PROPOSALS AND ACRS

ALVIN C. WARREN, JR.\*

## INTRODUCTION

My comments are divided into two parts. First, I will describe proposals to integrate the individual and corporate income taxes. Second, I will discuss the effect of the accelerated cost recovery system (ACRS) on those proposals and the ALI Report<sup>1</sup> on corporate distributions.

## INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES

### *The Proposals*

In the mid and late 1970's, there were a number of proposals to integrate the individual and corporate income taxes, including a proposal by the Treasury Department which, while never officially made public, was widely circulated among tax lawyers. These proposals, while called integration, did not eliminate the corporation as a taxable entity. Rather, they eliminated the additional tax burden on corporate earnings. Proponents of these plans, such as myself,<sup>2</sup> tended to call them integration; those who were more skeptical tended to style the proposals "dividend relief." Similar European systems often go by the name of "imputation."

There are basically two methods of eliminating the double tax

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1. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982).

2. See Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

burden on corporate earnings. The first, and arguably most straightforward, would be to permit a deduction at the corporate level for dividends paid out to individual shareholders. The second and more commonly proposed method involves continuing the tax at the corporate level, but giving shareholders a credit for corporate taxes paid, with the credit available when corporate earnings are distributed to shareholders.

A simple example will illustrate how shareholder credit integration would work. Consider a corporation that earned \$100 in taxable income and paid \$46 in corporate taxes, levied at the rate of 46%. After taxes, the corporation would have \$54, which could be distributed to its shareholders. If the corporation made a distribution of \$54 under the integration proposal, the receiving shareholder would "gross-up" that \$54 to a pre-tax distribution of \$100, just as wage-earners now gross-up after-tax wages to pre-tax wages, when computing the income tax due. The individual shareholder's tax rate would be applied to the gross dividend, and a credit would be available for the \$46 paid in corporate taxes. If the shareholder were a 50% taxpayer, there would be a \$50 gross tax, against which the shareholder could take a credit for \$46, requiring \$4 in taxes from the individual shareholder. Having paid that amount, the shareholder would be left with \$50 in cash and would be in exactly the same position he would have been in, had the investment been made on an individual account rather than through a corporate entity. As long as the credit was refundable, all taxpayers would be treated as they would have been treated had they invested individually. As a result, the separate and additional burden of the corporate tax would be eliminated.

### *Rationales*

There are two rationales for moving from the current double tax system to an integrated system: the first is a conceptual or structural rationale; the second, and more important from my perspective, is an economic rationale. The conceptual or structural rationale begins with the premise that only human beings ultimately pay taxes, so that when thinking about fundamental reform of our tax system, we should focus on which human beings will bear any particular tax burden. An integrated system would make the corporate tax a structural part of the individual income tax, in that the corporate levy would become merely a withholding mechanism for the individual income tax.

The economic rationale for integration is that the current tax system interferes with business transactions in a variety of ways, particularly with respect to alternative methods of financing corporate investment. The most familiar part of this interference results from the

deductibility of interest payments and the nondeductibility of dividend payments. The interrelationship of the tax provisions affecting alternative methods of financing corporate investment is, however, considerably more complicated than that. This is a matter that Bill Andrews will discuss when he describes the ALI Report.<sup>3</sup> The important point for my present purposes is that integration, like the proposals in the ALI Report, would eliminate the unfortunate effects of current law with regard to various methods of financing corporate investment.

### *Major Structural Issues*

Given the basic integration proposal and the rationales offered by its proponents, there were two major structural issues that were widely discussed in the 1970s. First, a choice had to be made between the dividend deduction method and the shareholder credit method. In general, these discussions yielded a preference for the shareholder credit method, in part because that method was thought to give the tax system more flexibility with regard to the treatment of exempt and foreign shareholders.

The second structural issue results from the fact that not all corporate income is fully taxed. If, in my earlier example of \$100 in corporate income, only fifty of those dollars were fully taxable, and the other fifty were for some reason not taxable at all, the corporation would have paid only \$23 in corporate taxes, leaving \$77 to distribute to shareholders. At that point, a systemic or structural decision would have to be made as to whether the preferred character of the corporate income would be passed through to shareholders or eliminated when those earnings were distributed.

Analysts who advocated pass-through tended to argue that the rationale for integration was to treat individuals who earned income through corporate solution in the same manner they would have been treated had they earned that income individually. If shareholders would have benefited from the preference as individual investors, they should also benefit from preferences for corporate income. That result could be accomplished structurally by requiring the corporation to maintain records of preferred and taxable income and reporting those amounts to shareholders on distribution.

Analysts like myself who favored elimination of preferences on

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3. See Andrews, *The ALI Reporter's Proposals on Corporate Distributions and Corporate Taxation with a Personal Consumption Tax*, 22 SAN DIEGO L. REV., 333 *infra*.

distribution argued that most corporate tax preferences, particularly the accelerated capital recovery provisions, had to be understood as responses to the prevailing system, which involved an additional level of corporate tax. In this view, elimination of the additional level of corporate tax would also remove any reason to continue those preferences when the corporate earnings were distributed out of corporate solution.

A variety of techniques could be used to implement this view. Those of you who work in the foreign area know that a number of our trading partners, particularly in Western Europe, have accomplished this result by a device that goes under a variety of names, but is essentially a special withholding tax. When there is a distribution from the corporation to the shareholder, this special withholding levy assures that the appropriate corporate-level tax has been collected for the credit assumed at the shareholder level. In the U.K., the levy that serves this function is called the "advance corporation tax."

### *Fate of the Integration Proposals*

Now just a word on the fate of these proposals. They never got very far in terms of the legislative process in the 1970's. That can be explained by a number of factors, but one is particularly interesting because it surprised a number of interested parties. Integration proposals, which would have eliminated the additional burden of the corporate tax, were strenuously opposed by many American corporations, particularly utilities and financial institutions that already paid very little in the way of federal income tax. Their argument was — and I will put it much more crudely than they did — that removing the additional burden of the corporate tax would not benefit them, and that reform should leave corporate taxpayers favored under existing law in a similarly favored position after reform. This argument was put in terms of fairness: preferred tax treatment had already been reflected in efficient capital markets by the creation of a premium for share prices of the benefited companies. Current investors had therefore already paid for the tax benefits, because the original beneficiaries of preferential treatment had long since sold out. Given capitalization of preferential treatment in the capital markets, the argument concluded that it would be unfair to enact tax reform which would cause the relative value of these shares to fall, harming investors who had paid the premium demanded by the market, without somehow protecting those shareholders.

To the extent there is new interest in the integration proposals, as several other speakers have suggested, this position is something that will have to be reckoned with in the development of proposals.

## EFFECT OF ACRS

Integration and the ALI Report would both reduce or eliminate the biases under existing law that Bill Andrews will describe, as well as the double tax burden of our current system. Since these proposals were developed, Congress has substantially accelerated the recovery of capital costs by enacting ACRS.<sup>4</sup> I now want to address the assertion sometimes made that because ACRS has eliminated much of the corporate tax base, there is no longer any need for comprehensive reform of the taxation of corporate distributions.

*Elimination of the Corporate Tax Base by ACRS*

There are two steps in the analysis used to reach the conclusion that ACRS, in conjunction with the investment tax credit, effectively eliminates the corporate tax. The first step is that present value of the investment tax credit and ACRS deductions gives the investor in five-year property the equivalent of the tax benefit that the investor would have had from currently deducting the investment. The Senate Finance Committee Report on the 1982 changes in ACRS suggests that this result was intended.<sup>5</sup>

The second step in the analysis is that expensing (or the equivalent in present value under ACRS) is itself equivalent to exempting from tax any income produced by the expensed asset. An example may be helpful. Suppose that you had \$100 and the rate of return on invested capital was 10%. You would be happy to invest in a tax-free investment that returned 10%, so your \$100 would be worth \$110 after a year. But you would be equally happy to invest in a fully taxable investment, the cost of which was currently deductible. If you were a 50% taxpayer, you could make a gross deductible investment of \$200 with your \$100, because the deduction would immediately reduce your current taxes by \$100. The next year your investment would be worth \$220, and you would have no basis because the costs had been fully expensed, so you would have to pay the Treasury \$110 in taxes if you disinvested, leaving the same \$110 that you would have had, had you invested in the tax-free investment.

The example depends on simplifying assumptions and does not take into account the reaction of capital markets, but the general point is valid: assuming tax rates stay the same, a current deduction for a capital expenditure accomplishes roughly what would be ac-

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4. I.R.C. § 168 (1982).

5. S. REP. NO. 494, 97th Cong., 2d Sess. 122-26 (1982).

completed by exempting the return on the capital investment. That equivalence was reflected in the ACRS rates adopted in 1982, with the result that the effective tax rate on income produced by new corporate investments in five-year property was reduced to zero, assuming that the discount rate chosen to equate ACRS and the investment tax credit with expensing was accurate.

### *Tax Arbitrage*

If that were the end of the story, one could easily conclude that there was no longer any need for what we have been discussing as distribution reform. However, when Congress adopted this very accelerated depreciation, it did nothing about the interest deduction. With respect to ACRS property, we are in approximately the same position we would be in with respect to tax-exempt interest if section 265<sup>6</sup> did not exist. Nothing in current law prohibits coupling the effective exemption of income accomplished by ACRS for five-year property with full deductibility of interest on debt incurred to finance the purchase of such property.

Let us return to my example of acquiring \$200 worth of deductible property and financing half of it with the tax savings. If you borrowed the other half at 10%, you would have no out-of-pocket investment. The next year, the property would be worth \$220, so you would owe the federal government \$110 and your lender \$110, if we ignore, for a moment, the effect of the interest deduction. The result so far would be appropriate, because you would receive no economic benefit from borrowing at an interest rate of 10% to invest at a 10% rate of return. Once the interest deduction is taken into account, however, you will receive an after-tax benefit — \$5 if you are a 50% taxpayer — from a transaction that would be a wash, apart from taxes. My example is, of course, an extreme one and for simplicity involves a deductible asset, rather than an ACRS asset that yields tax benefits equal in present value to a current deduction. But the general conclusion is valid: coupling accelerated cost recovery provisions, which result in less than full taxation of the income produced by the ACRS property, with full deductibility of interest can result in after-tax profits on investments that would not be attractive on a pre-tax basis. Coupling preferential treatment of income with full deductibility of interest is sometimes called “tax arbitrage.”<sup>7</sup>

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6. I.R.C. § 265 (1982).

7. See, e.g., Bradford, *The Economics of Tax Policy Toward Savings*, in 2 *THE GOVERNMENT AND CAPITAL FORMATION* 11, 43-44 (G. von Furstenberg ed. 1980); Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 *WAYNE L. REV.* 991 (1984).

*The Future*

A major policy issue for the future of the corporate tax is the extent to which tax arbitrage will be permitted. That issue is related to our current subject because full interest deductibility means that the bias in favor of debt finance that Professor Andrews will describe continues to exist, even after the enactment of ACRS. Thus there continues to be a need for distribution reform.

My own preference would be to see the problem as Congress having made a mistake with respect to the treatment of assets in enacting ACRS, so that we should move back toward economic depreciation (under which tax arbitrage is not a problem) and then adopt integration or the ALI Reporter's proposals. An alternative would be to take the treatment of assets as given and attempt to limit the deductibility of interest, as is done by section 265 with respect to investments in tax-exempt bonds. Whether the preferable remedy lies with assets or liabilities, the most important point to understand is the essential inconsistency of current law.





# THE ALI REPORTER'S PROPOSALS ON CORPORATE DISTRIBUTIONS AND CORPORATE TAXATION WITH A PERSONAL CONSUMPTION TAX

WILLIAM D. ANDREWS\*

## INTRODUCTION

These comments fall in three separate parts. First, I will describe the American Law Institute (ALI) Reporter's proposals on corporate distributions.<sup>1</sup> These may be viewed as alternatives to the integration proposals discussed by Al Warren.<sup>2</sup> Second, some brief comments about the impact of ACRS on these proposals to compare with his comments about the impact of ACRS on integration.<sup>3</sup> Finally, on a different tack, there are some brief remarks about what should be done with the corporate income tax generally if the individual income tax were re-focused as personal tax on consumed income or an income-based personal consumption tax.

## THE ALI REPORTER'S PROPOSALS

This is going to be very difficult for me. I am used to presenting these proposals and arguing for them over a two- or three-day pe-

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1. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982) [hereinafter cited as ALI REPORT].

2. See Warren, *Corporate Integration Proposals and ACRS*, 22 SAN DIEGO L. REV. 325, *supra*.

3. Warren, *supra* note 2, at \_\_\_\_.

riod, and that does not seem to be quite what is planned, so I will try to refrain from arguing. I will remit you to the ALI Report for that, and just try to lay before you a summary of what you will find there if you go look at it.

The ALI study started out to look at all of Subchapter C. We decided there were ripe opportunities for simplifying reform of acquisition transactions, so we sorted those issues out and addressed them first. Ultimately, the American Law Institute adopted proposals concerning acquisition transactions, and those have been indirectly the subject of discussion for a large part of our two days here. The ALI Report is available, although at this point the Senate Finance Committee staff report<sup>4</sup> is the most recent study of those ideas, and is perhaps where one should begin a current study.

But acquisitions are not the whole subject; one is left with the big question of how we should tax corporate distributions. In particular, just to define the matter by reference to issues under existing law, what are we going to do about the debt/equity problem? You have a corporation sitting there, not being acquired by anybody, but it is making distributions. It claims they are payments of interest, deductible at the corporate level. Under certain circumstances the government will say no, they are nondeductible dividends. What should we do about that imbroglio?

The other main issue would be the shareholder issue: what to do about nondividend distributions? As we all know, dividends bear a double tax: they are taxed to the corporation and then, without any deduction to the corporation, they are taxed again to the shareholders. What should be done about all the issues of dividend equivalence raised under present law by the ordinary-income treatment of dividends and dividend-equivalent distributions?

At this point I must insert two disclaimers. First, the ALI project did turn to these issues (the "distribution issues") and study them. The Reporter produced proposals concerning them, the consultants spent a lot of time on them, and the tax advisory group had discussions of them. However, the Institute refrained from adopting any proposals concerning distributions, and neither the tax advisory group nor the consultants took any formal positions approving or disapproving the Reporter's proposals. Therefore I am the only person in the world on record as favoring these proposals, and they are entitled to no greater weight than what critical examination will show them to deserve on their own merit. The Reporter's proposals concerning corporate distributions have been published as an appendix in the final report on the corporate part of the current ALI project,

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4. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983).

but it must be clearly understood that they are not proposals of the Institute.

Now the second disclaimer I need to make really grows out of this observation: I think it is reasonably clear that integration would tend to eliminate the distribution issues. To put it differently, integration is a sweeping solution to the distribution issues. If you had integration, I do not think the debt/equity problem would continue. One could say we already have integration with respect to debt capital, and if you introduced it with respect to equity capital, the distinction between debt and equity would become relatively insignificant. I think the problem of distinguishing between dividend and nondividend distributions would likewise tend to disappear.

The disclaimer I need to emphasize at this point is that even in the Reporter's study itself, the ALI did not address the question of the desirability of integration. We simply defined the scope of our study not to include the possibility of integration. We assumed continuation of the classical system of double taxation of corporate earnings and addressed ourselves to improvement, perfection, and refinement of that system. This should not be interpreted as a rejection of integration; we did not evaluate integration. Some of the people connected with the project were very involved with the development of integration proposals outside the ALI project, and I think they remain convinced that integration is the direction to go. Others of us have had different degrees of skepticism about integration. However, no effort was made in the ALI project to work out these differences.

Now, having made that disclaimer, let me say I think that the ALI Reporter's study on distributions has nevertheless become something that one has to take into account in considering integration, because what it shows is an alternative way of dealing with some of the same problems. I will get back to that in a few moments.

#### THE EFFECTS OF THE PROPOSALS ON CORPORATE DISTRIBUTIONS

All right, now, how can I best describe to you the content of these proposals? We ruled out integration as beyond the scope of what we were going to consider, but on the other hand, we did not go back and say we will write a version of what the Treasury ought to come out with under section 385.<sup>5</sup> We also, did not review the rules of section 302<sup>6</sup> and consider how they ought to be revised. The com-

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5. I.R.C. § 385 (1982).

6. I.R.C. § 302 (1982).

mentary in fact includes a brief discussion of possible revisions in the dividend equivalence rules,<sup>7</sup> but they are not part of the Reporter's proposals.

We decided to take a little broader view of the matter by trying to step back to ask what are the intrinsic problems besetting the present system. Even though we outlawed integration as a solution to begin with, we found ourselves talking about the same problems to which integration is addressed, and trying to see what could be done about them within the context of the classical system.

When we tried to define the problems that way, we got back to thinking in terms of biases or distortions that are reasonably familiar because they are described in the literature leading up to integration proposals, although in the end we have insisted upon stating or defining the biases a little differently. I want to just go through our thinking by taking what is familiar first and then going on to what is often overlooked.

What is familiar is the comparison in cost-of-capital terms between debt capital in a corporation, and newly contributed equity capital. The argument is that the present corporate tax discriminates against equity capital by raising its cost through imposition of a corporate income tax. Let us just go through some numbers.

Assume that a corporation has an opportunity to invest \$1,000 at a before-tax yield of 10%. The question now arises, depending upon the way the corporate investment is financed, how much of that return can be paid back to the investor. If you raised the \$1,000 by borrowing, then you could pay the full \$100 a year back to the investor. You would have \$100 of taxable corporate income from the investment, but it would be offset by a \$100 interest deduction for payment of the yield over to the investor. There would not be any corporate tax increase if the interest you pay equals what you earn on the investment of the borrowed funds, and it is therefore sometimes said that the corporate income tax does not create any bias (or interpose any wedge) with respect to debt financing of corporate investment.

On the other hand, if you were to raise the \$1,000 by selling stock, and if you got a before-tax yield of \$100 on the corporate investment of these funds, then you would have to pay \$46 of that return in corporate tax. The remaining \$54 to distribute to the stockholders would only be a 5.4% return on their investment. Therefore, the tax stands in the way of making what we would think were presumptively desirable investments. The matter is frequently stated in terms of what you would have to earn if the stockholder demands a 10% return to make his investment; you would have to earn 18.5% at the

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7. ALI REPORT, *supra* note 1, 417-27.

corporate level to pay 10% to the investor, because you would have to earn \$185 to have \$100 left after you have paid the corporate tax.

This analysis is quite correct as far as it goes, and indeed it points up one of the problems that we ended up wanting to address. But it omits any consideration of what is statistically, numerically, and in every other way, the most important way of raising equity capital, which is not by selling shares but by accumulating earnings that might otherwise be distributed. Consequently, we tried to push the analysis forward with respect to accumulated equity. Now let us just pursue that in the same terms. Suppose a corporation has an opportunity to make a \$1,000 investment that will return \$100 a year. How will that translate through to the return at the investor level if the \$1,000 is raised by not paying out a dividend, *i.e.*, by reducing dividends from what they might otherwise have been? If one just looks at the \$100 return, the answer seems to be the same; the \$100 which is received as a return on the investment will be subject to tax of \$46 and that will leave only \$54 to distribute. But what is the \$54 to be compared with? It presumably should be compared to the return on another investment with the same cost. But what is the cost to the investors of the corporate investment in this case? I think the answer is — for those of you who like algebra — the principal amount of the investment divided by  $(1 - t_i)$ , where  $t_i$  is the individual income tax rate. Or to put it in terms of the example and a couple of hypothetical tax rates, if the investor were a 50% tax bracket taxpayer, then withholding \$1,000 in dividends from him would only cost him \$500 in terms of what alternative investment he might have made if you had paid him the dividend.

If you now consider a return of \$54 per year on a \$500 investment for whatever length of time it lasts, you will discover that it is not less than 10% at all, but a little more! It is indeed 10.8%, or slightly better than the rate of return that would have been realized if the investment had been debt instead of stock. Of course this comparison is quite sensitive to the tax rate involved. If the shareholder's tax rate were 40%, the cost to him of his corporation retaining \$1000 of earnings would be \$600, and a return of \$54 on \$600 would be only 9%. Finally, if I assume a 46% stockholder, the cost to him of the corporation withholding \$1,000 will be \$540, and an after-tax yield of \$54 on an after-tax investment of \$540 will be exactly 10%.

The outcome of this particular set of comparisons is that if the corporate tax rate equals the individual shareholder's tax rate, the investment return will not be distorted by the imposition of the cor-

porate income tax system. Perhaps a better way to state it would be that the return is indeed subject to the adverse bias of a corporate income tax, but that there is an offsetting bias in favor of the arrangement due to the deferral of individual tax associated with the accumulation of earnings.

If you read the ALI Report you will find examples of this analysis applied several ways. I guess one way to summarize it is to say something a little like Larry Stone's remark this morning: it is not a totally logical system but maybe it works better than we had any right to think it would, because there is this considerable area of compensating biases in which the additional burden of the corporate income tax tends to be offset by a favorable bias under the individual income tax.

The compensation is not perfect by any means. In particular, as individual rates vary from the corporate rate it does not work. Integration, I think, is the only way to achieve anything like complete elimination of bias for people whose tax rates are substantially below the corporate rate.

But even if we confine attention to shareholders whose tax rates approximate the corporate rate, there are two very substantial uncompensated biases, and these are what the Reporter's proposals address.

The first substantial bias is against the raising of capital by issuing shares. Even though accumulation of equity tends to have offsetting tax advantages that make it comparable to debt financing, there are situations in which corporations do raise capital by issuing shares, and there is no reason why the tax law ought to be biased against that. So we end up with the conclusion that when correctly conceived, there is a bias against newly contributed equity capital.

The other substantial uncompensated bias has to do with rates of tax on distributions. If you work back through the analysis indicating how the cost of equity capital raised by accumulating earnings might come out quite close to the cost of debt capital, you will find that it depends not only on some parity between corporate and individual tax rates on earnings, but also on a substantial constancy of tax rate on distributions. The arithmetic assumed the same rate of tax on the later distribution as would have been imposed on a present distribution, and without that assumption it will be much more favorable to pursue whatever course of conduct involves the lower rate. Under our present law there are a number of ways that distributions may be made in nondividend form. These are subject to much lower taxes than dividends, and there is a very substantial uncompensated bias in favor of such distributions. This may appear as a bias in favor of accumulation if delay is perceived as facilitating the making of nondividend distributions. However, sometimes it will

work the other way; a sale of stock, for example, may present an opportunity for making nondividend distributions prior to the accumulation of earnings, and then the tax law will be biased against accumulation.

This analysis has been made in pretty abstract terms; how closely does it correspond with actual corporate behavior? Without going into great detail, I would submit that it corresponds very well. It is a fact that most corporations raise the overwhelming majority of their equity capital by accumulation rather than share issues, except in the public utility area. It is a little hard to understand why, by anyone's mode of analysis, but public utilities do in fact go on paying dividends even while they are simultaneously raising capital by the issue of new stock.

Other corporations for the most part raise equity capital over the long run by setting their dividend rate in relation to their earnings to provide for desired levels of growth. In close corporations that often means the highest permissible percentage of accumulation. In publicly held corporations, it is an amount that corresponds with what they see as their long-term capital needs. Share issues are basically used only to take care of situations where that just will not work.

What about nondividend distributions? Does corporate behavior generally reflect a bias in favor of nondividend distributions? Perhaps that is a more complicated question. If we talk about close corporations, we certainly do find behavior reflecting the bias. Indeed, the name of the game in close corporation tax planning is to be sure that as much as possible comes out in nondividend form. If that means waiting until later, that will be the goal. If, on the other hand, there is an opportunity to take funds out now on a nondividend basis as compared with dividends later, I think we are all familiar with the fact that well-counseled taxpayers will try to take them out now, when the opportunity presents itself, at nondividend rates.

Public corporations are much harder to judge. Public corporations continue paying substantial dividends, and in some people's view they overlook opportunities to reduce taxes by purchasing their shares or engaging more widely in nondividend distributions. A number of economists are quite interested in why that occurs, and are not satisfied with any of the answers that have been offered to that question. I think there is also some sense that the willingness of public corporations to go on subjecting their shareholders to ordinary income taxes on dividends may be changing. Also if one recognizes corporate acquisitions for cash or debt as a form of nondividend dis-



tribution, then I believe there is room to think that the tax system may be one substantial factor inducing an increase in such transactions.

The proposals are addressed directly to the uncompensated biases just as I have described them. The first proposal has to do with newly contributed equity: It would seek to relieve the bias against newly contributed equity by giving a limited interest-like deduction for dividends paid on newly issued stock. Unlike proposals for integration by way of dividend deduction, the ALI Reporter's proposal would be limited to an interest-like rate of return on the amount invested. The rationale is simply to give equal treatment to a new stock issue and a debt issue. If you issue debt you get an interest deduction; if you issue stock this proposal will give you the same deduction, as long as you are making some distribution taxable to the recipient. Most people well-informed about this proposal came to the conclusion that if you could not have general integration, then this proposal would be a welcome improvement. I should think subsequent experience with the difficulty of doing anything rational under section 385 might be read as confirming that conclusion, and I would hope that if we are not going to have general integration people will come to see this as a useful proposal.

The second proposal deals with the other major uncompensated bias, which has to do with nondividend distributions. It is equally sweeping. It says, in effect, the system will only work right if there is a comparable tax burden on every distribution. It is not sufficient to equalize burdens on dividend-equivalent distributions; all distributions, even if quite unlike dividends in their effect on shareholders, must bear similar tax burdens. This includes complete redemptions and acquisitions of other corporations, and anything else that has the effect of taking money out of corporate solution and freeing it from the prospective burden of the corporate income tax. It may not be feasible or appropriate to impose the same form of tax on all these distributions as on a dividend. In particular, the tax rate of the distributee will often not be the right rate, especially for a distribution which terminates his interest. But some tax burden comparable to that on a dividend is needed.

The proposal is to deal with nondividend distributions by subjecting them to an excise tax payable by the corporation at a rate designed to approximate the overall rate on dividend distributions. Another possibility, discussed in the ALI Report, is to tax continuing shareholders as if the distribution had been pro rata, with the continuing shareholders using their share of it to buy out the distributee. The governing objective should be to reduce the dichotomy in tax burdens between different forms of transactions that people may want to engage in, even if there are substantial differences between

those transactions that require differences in the form of tax imposed.

Finally, there is a highly technical third proposal. It deals with intercorporate dividends and other aspects of intercorporate investment. Quickly summarized, if you go out and acquire the stock of another corporation for cash or debt, these proposals say that payment of the purchase price is a nondividend distribution on which you have to pay the excise tax or whatever other burden is attached to distributions. Thereafter, it is perfectly appropriate to have an intercorporate dividend deduction or consolidation or whatever to eliminate anything more than a single level of corporate taxation. But then what about a mere portfolio investment in shares of another company? Should that be treated as a nondividend distribution? It could be so treated, but everybody seems to agree that it would be much more practical to treat portfolio investment as portfolio investment, exempting its purchase from the tax on nondividend distributions, but also denying it the benefit of any deduction for dividends received. In effect, portfolio stock would be treated as representing funds doubly in corporate solution; but this would tend to offset the effect of the individual shareholders who sold out, getting their funds out of corporate solution without a dividend tax or anything like it. There is not time now to explore the implications of this proposal in any detail, but I would like to close by pointing out that there are several provisions in the presently pending tax bill to deal with perceived abuses in the application of the dividends-received deduction to portfolio shareholdings, and by suggesting that the ALI Reporter's proposal on this subject would represent a much less ad hoc way of dealing with the problem.

### THE IMPACT OF ACRS

Let me start by saying I agree substantially with Al's analysis of the relation between integration and ACRS,<sup>8</sup> and I think the relation is essentially the same between ACRS and the ALI Reporter's distribution proposals. There is, however, another little wrinkle that I am just going to throw out. The ALI Reporter's proposal on contributed capital is to allow a deduction for dividends paid, akin to the interest deduction. The proposal says the deduction should be subject to whatever limitations there are on the interest deduction. In other words if the proceeds of a stock issue are invested in tax-exempt

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8. See Warren, *supra* note 2, at 329.

bonds, then the deduction should be denied just as it would be by section 265<sup>9</sup> if it were an interest deduction. Some people talk about responding to the problem that Al has described by imposing a limitation on the interest deduction when the proceeds are invested in ACRS property. If one were to move in that direction, then under the ALI Reporter's proposal, the same limitation would be called for with respect to the equivalent deduction for contributed equity.

The wrinkle I want to point out is this. Our analysis of the matter showed that even without any deduction for dividends there is a compensating advantage for equity financing through accumulation of earnings. If that is right, then the net effect would be the continuance of the double advantage of ACRS and individual tax deferral whenever investments in ACRS property are financed with accumulated earnings, although you had eliminated the comparable double advantage in the case of external financing by denying interest deductions and new equity dividend deductions. However, I do not think there is any ready way to take away the double benefit in the accumulated earnings case, which brings us back to the same conclusion Al has expressed, that it is ACRS itself that needs to be reexamined rather than the interest deduction.

#### CORPORATE INCOME TAXATION WITH A PERSONAL CONSUMPTION TAX

All right, the last topic is going to be touched on very, very quickly. The question is, what about a corporate income tax in a world where individuals live under a personal consumption tax. I think all there is time to do is try to state very briefly what a personal consumption tax is, and then make just a few remarks about a corporate income tax under it.

A personal consumption tax, or expenditure tax, would be a tax on the consumed or spent part of income, but not on the saved part of income. It would be a tax on consumption rather than income, but not measured by consumption transactions or sales transactions or value added transactions. It would be an income-based consumption tax; a tax whose computation would be based on personal income, but with a subtraction for savings.

Consider a simple case: a person earns \$100 and saves \$20. His taxable consumed income then would be \$80, computed by subtracting \$20 from \$100. Because the tax is based on aggregate consumed income of an individual or household, the tax could be graduated, as is the present personal income tax, to whatever degree is desired.

Deducting savings and taking dissavings into income is a much

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9. I.R.C. § 265 (1982).

more familiar idea now than a few years ago, because it is just what we do now with respect to individual retirement accounts (IRAs). A consumed-income tax would do it on a more comprehensive basis, in which all investments would qualify for IRA-like treatment, and all disinvestments would enter equally into the tax base.

The most important respect, I think, in which a comprehensive personal consumption tax would be drastically different from IRAs and a piece-meal approach toward a consumption-based tax, is that it would be comprehensive with respect to debt, too. Therefore, if a person earned \$100 and borrowed \$20 during a particular year, and invested \$20 in his IRA, his taxable consumed income would remain at \$100. He would get a deduction for the investment in the IRA, but he would have to include in his taxable consumed income the proceeds of the loan, the result being that he would be taxed on the full \$100 that apparently was consumed. It would follow that the repayment of the loan would be deductible in full, principal and interest alike.

So it would be a personal income tax except that all business and investment transactions would be treated on a simple cash flow basis. Deduct whatever you spend on business or investment when you spend it, and take it back into income when you take it out of the business or investment. Do not worry about whether it is a capital expenditure or a current expense, since they are treated exactly alike. If you spend it on business or investment, then it is not available for your current consumption and you can deduct it. If and when you get it out, it is taxed.

Why would anybody modify the income tax in this manner or adopt a tax of this form? One factor is equity or fairness; some people think that a tax on consumed income is essentially fairer than a tax on income spent or saved. That is the subject Al Warren and I debated in the articles cited by Lester at the beginning of this session.<sup>10</sup> I still think that I was right, but Al argues the case for a total income tax very skillfully, and this is clearly an arguable matter.

A second factor is efficiency, together with the other things economists are concerned about. There is an argument that a consumption tax is more efficient because it does not discriminate between spend-

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10. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Andrews, *Fairness and the Choice Between a Consumption-Type and an Accretion-Type Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975).

ing and saving, as a total income tax does. There is another argument that depends on the practicality of implementing both taxes; it is that the consumption tax is more efficient because it is easier to achieve equality of treatment of different investments under that form of tax. The reason it is easier to achieve equality of treatment is that cash flow is easier to measure comprehensively than is appreciation in value.

Some economists would apparently support a move toward a consumption tax on the ground that it would encourage capital accumulation. That is a tougher matter to judge. Theoretically, it is clear that a switch to a consumption tax might have exactly the opposite effect, just as the elimination of the income tax altogether might make people work less since they do not need to work as hard to support a particular standard of living. I am not sure that the data is conclusive with respect to the question of which way saving would be more likely in fact to vary.

Finally, there is the matter of simplicity and administrability. This is where I started and still primarily stand. I think it would be wonderful to have at least a part of our major general revenue tax free of the problems of telling a capital expenditure from a current expense; free from the problems of trying to figure out how fast a business asset wears out; free from the distortion that results from taxing people on savings that they put in their savings accounts but not taxing them on unrealized appreciation in their stock or the savings in their pension plans. I think it would be better to treat them all alike even if that involves not taxing savings at all. Imagine how tax shelters would be treated under a consumption tax: they would be taxed on a simple cash flow basis. You could deduct every nickel you put in, when you put it in, and pay tax on every nickel that comes out, when it comes out. The result of that would be that the tax shelter would be effectively taxed at exactly the same rate as any other investment — zero — not at enormous negative rates of tax as under existing law.

Subchapter K? Read it out of the Code. Eliminate it. If all you are interested in is what people have to spend, then all you need to keep track of is what they put in and what they get out.

And, finally, Subchapter C? Subchapter C deals with taxes on corporations and on shareholders. As to the latter, again it is very simple. You give shareholders a deduction for whatever they invest, and you include in their tax base whatever they get out, whether by way of dividend or other form of distribution, or even from a sale of shares to new investors.

But what about the corporate tax? What place has the corporate tax under a consumption tax regime?

I suppose the first thing to say is that if you had had a personal

consumption tax generally from the beginning rather than an income tax, then there might seem to be no occasion for a corporate tax at all. The pure solution for the corporate tax under a consumption tax, therefore — the thing that might be thought of as equivalent to full integration under an income tax — would be just to have no corporate tax at all. This is because whatever comes out of the corporation will be accounted for and taxed forthwith at the individual level as a result of the distribution, and whatever stays in corporate solution represents saving and ought not to be taxed anyway.

But in the world we live in, you have the same problem as with respect to integration under the income tax; that is to say do you want to give up the revenue and confer the windfall involved in just repealing the corporate income tax? Some people would answer that question in the negative. So what do you do? The best answer to that is spelled out in a book by the Meade Commission in England,<sup>11</sup> for those of you who want to pursue it. Essentially that answer is to put the corporate income tax also on a cash flow basis. In absolute terms, the effect would be a continuance of an additional burden on corporate earnings. But I think, as with the ALI Reporter's proposals under the income tax, that it turns out to be possible to minimize the marginal distortions of the tax while preserving its present distributional effects.

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11. INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* (1978) (report of a committee chaired by J. Meade).

