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The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems

Leon Gabinet*

Ronald J. Coffey**

Recent discussions of tax reform have included suggestions for the abolition of the corporate income tax and the attribution of corporate income to the shareholders. Restricting acceptance of these suggestions is the holding of Eisner v. Macomber, which not only adopted a tax theology based upon the separate status of corporations and shareholders but also required the realization of income prior to recognition. The authors demonstrate the implications of an economic concept of income by showing the relationship of a firm's economic income to the economic income of the firm's individual owners. One implication of their analysis is that a tax at the corporate level is unnecessary, because the economic income of shareholders includes the income-period wealth effect changes associated with firm ownership. The authors suggest that Macomber and subsequent cases may most favor an integration of the corporation-shareholder tax system that abolishes the corporate-level tax and computes the shareholder's income on an economic income basis. On the other hand, it is concluded that Supreme Court authority still cuts strongly against integration systems that simply include a pro rata share of corporate earnings in shareholder income, and that these latter forms of integration are at odds with an economic income analysis as well.

I. INTRODUCTION

The system of federal income taxation of corporations and shareholders has been characterized as one of the most controversial elements of the American tax system. As evidenced by its preeminence on the agendas of tax institutes and conferences, it is at least one of the most frequently debated aspects of the tax system. In recent months it has generated renewed interest not only as an object of general tax reform but also as a factor relating to the recent woes of our financial markets. Some commentators have favored the complete abolition of the tax on corporate "in-
come" (as that value is calculated in tax law today) and the attribution of all such income pro rata to the shareholders. Others have suggested less extreme approaches, including a drastic reduction in the corporate tax rate, a tax credit to shareholders for corporate income taxes paid, and a deduction from corporate income for dividend distributions.

Our purpose in this article is to consider two major issues which necessarily arise in connection with any scheme for the abolition of the corporate income tax or the integration of the double-level system. First, there is the question whether some form of undistributed "income" (not necessarily as that value is calculated for tax purposes today) of a corporation can be attributed and taxed to its indirect owners, the equity holders. Second, there is the question of the extent to which distributions from a firm to its owners should be subjected to taxation simply because they have been severed from the firm's asset pool. Underlying our discussion of these issues is the assumption that sound income tax policy may require the imposition of a tax on all or some part of "income," as that term is generally understood by economists, but that nothing other than economic income should be subjected to tax. Accordingly, we shall attempt to develop a theoretical framework involving the concept of the economic income of a corporation and relating that concept to the economic income of the owners of the corporation, both with respect to the timing of income and the manner of computing the income to be taxed. The object of such an analysis is to provide a basis for resolving the two major issues which we see as central to any plan for the integration of the corporate and individual income taxes.

4. These intermediate measures will achieve the same types of results anticipated from a complete abolition of the corporate income tax, but to different degrees and with varying effects on the so-called neutrality and equity objectives of taxation. See generally McLure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532, 549-61 (1975).
6. See L. KIMMEL, supra note 1, at 110.
8. See topic IV. A. infra. Although this fiscal attitude is not (with some implicit exceptions) currently popular in the context of corporate-source income, its plausibility has, perhaps, been attenuated in some ways by Supreme Court interpretations and fears of impracticability. In noncorporate-source income settings, on the other hand, economic income (subject to realization requirements) seems to enjoy theoretical primacy. See G. BREAK & J. PECHMAN, FEDERAL TAX REFORM 5-6 (1975). This article presumes a policy preference for the use of economic income as the tax base in corporate-source systems, though portions of the discussion also offer substantive support for that view.

To some extent, we do adopt a tax "theology," but only tentatively. See Surrey, Reflections on "Integration" of Corporation and Individual Income Taxes, 28 Nat'l Tax J. 335 (1975). It
No discussion of our present system of taxing corporate income and no discussion of the revision of that system can avoid a consideration of the landmark case of *Eisner v. Macomber.* Despite the protestations of many commentators that *Macomber* has lost its early vitality, it remains the most important statement of the Supreme Court on the relationship between the income of a corporation and the income of its shareholders. Moreover, since the decision was based on an interpretation of the word "income" in the sixteenth amendment, it raises important constitutional limitations with respect to the taxation of corporations and shareholders. Therefore, our discussion will focus on a comparison of the results which *Macomber* appears to require with those arising from an economic view of income and the relation between the economic income of corporations and their shareholders.

Finally, we shall review various plans or systems for the integration of the individual and corporate income taxes with respect to their conformity with the concept of economic income and their relation to the *Macomber* view of the corporation-shareholder relationship. This discussion will include an analysis of our present double-level system of taxation, proposals for integration at the shareholder level, such as the credit system, and proposals for integration at the corporate level, notably the split-rate system and the deduction for dividend distributions.

## II. The Historical Background and Budgetary Inertia

Our current system of corporate taxation, which imposes rates of 20% and 22% on the first and second $25,000 increments of taxable income, respectively, and a rate of 48% on all corporate net income in excess of $50,000, may be traced back to 1909. With the enactment of the Re-

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should be understood, however, that we are fundamentally discussing the implications of the economic concept of income on various taxing systems, if a primacy for economic income as the tax base is accepted.

We hope that our analysis might aid the thought processes of those who must determine whether the concept of economic income should be given strong normative significance in systems of corporation-shareholder taxation. At any rate, as a matter of interpretation, the word "income," as applied to the corporation-shareholder system, need not conjure economic concepts any less easily than alternative notions.


11. I.R.C. § 11(a)-(d).

12. Rev. Act of 1909, ch. 6, § 38, 36 Stat. 11, which imposed a one percent surcharge on net corporate income in excess of $5,000.
venue Act of 1913, dividend distributions were included in the gross income of shareholders, thereby establishing the "double-tax" pattern which has persisted to the present day. In 1936 there was an interesting and short-lived attempt at integration of the two taxes. President Roosevelt recommended a graduation of the top corporate rate from 15% to 42.5%, with the limitation that the higher rates would apply only to undistributed profit.

Thus, for example, a corporation with net income of $100,000 and dividend distributions of $50,000 would pay a tax of $17,500, whereas a corporation with the same net income and dividend distributions of only $15,000 would pay a tax of $35,000. A vociferous protest from the business community prevented the enactment of this proposal, but Congress did enact a compromise proposal whereby the corporate tax remained at 15% and a surtax was imposed on undistributed profits at rates graduated from 7% to 27%, depending on the amount of profits retained. Even this compromise was doomed to an early demise. In 1938, the surtax was reduced to 2½%. Thereafter, in the 1939 Code, the surtax was completely eliminated, and Congress returned to the present system of double taxation.

As the rate of tax increased, the tax became a highly effective and important revenue measure. In 1948, the tax take from corporations amounted to $9.9 billion—just a little less than 25% of all federal tax revenues other than payroll taxes. In 1973, the corporate income tax accounted for approximately $32 billion and continued to provide about 25% of all federal revenues.

The taxation of corporate income at high effective rates is in large measure an outgrowth of the tax atmosphere of the 1930's, when revenue needs were great and high effective tax rates on business were politically popular and deemed to be in the nation's best interests. Certainly, the country's revenue needs have not abated since then. World War II, the Korean War, the Cold War, the Vietnam War, and desperately needed domestic programs have kept federal revenue requirements high. Because of these revenue needs, and in view of public acceptance of the notion that business—particularly corporate business—is peculiarly capable of bearing a high tax burden, the idea of abolishing the corporate income tax has not attracted, and cannot be expected to attract, a groundswell of public support.

18. See L. Kimmel, supra note 1, at 19.
19. See Break & Pechman, Relationship Between the Individual and Corporate Income Taxes, 28 NAT'L TAX J. 341, 349 (1975). (The authors' estimates are taken from the Brookings Institution's Tax File.)
Nevertheless, the idea is gaining support among economists, tax commentators, and a variety of others who are concerned with our system of taxation.\(^{20}\) It is the difficult task of those who support abolition of the tax to provide the analysis of and rationale for their position. Since that position is not the politically appealing one, this analysis and rationale will have to survive the closest scrutiny if the abolition of the corporate tax is to succeed.

It should be stated at the outset that the proponents of integration fully realize that simply doing away with the corporate income tax would cost the Treasury a great deal of revenue. It is estimated that the Treasury will receive $61 billion in 1976 from the current double-level tax system,\(^{21}\) and, clearly, the amount generated by the current system is eliminated from federal tax revenues, it will have to be made up in some other way. If, for example, a full imputation integration scheme were adopted in which the tax at the corporate level was abolished and the shareholder was taxed on his pro rata share of corporate income (as calculated under our present system), it is estimated that the tax on shareholders would yield $42 billion.\(^{22}\) An additional $12 billion in revenue could be raised if the federal government would take the drastic step of taxing exempt organizations on their pro rata share of corporate income.\(^{23}\) Assuming that these projections are reasonably accurate, the loss to the Treasury would still amount to $7 billion. However, it is quite unlikely that Congress would consider taxing the dividend income of colleges, universities, foundations, churches, qualified pension and profit plans, and virtually all private philanthropic, religious, and educational organizations. The loss to the Treasury, therefore, is apt to be an unmanageable $19 billion.

The full imputation-of-earnings scheme is sometimes accompanied by the proposal that each shareholder be required to pay a tax on the annual appreciation in the value of his shares to the extent that such appreciation exceeds his pro rata share of the undistributed earnings of the corporation.\(^{24}\) This proposal raises valuation difficulties, particularly as to stock of closely held corporations, in addition to problems caused by the requirement

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22. Id.

23. Id.

that income must be "realized" in order to be subject to tax. It is similar to the tax treatment of partners who are required to pay tax on their respective shares of partnership distributable earnings, whether or not distributed, but partners are not taxed on unrealized appreciation in the value of their partnership interests over and above undistributed partnership earnings. (We use the term "earnings" throughout this article as a rough designator for accounting-type net income or net profits, or as a coarse equivalent of taxable income in today's sense.)

Another approach to integration of the two taxes is the exemption of dividend distributions from the corporate tax. This form of integration would subject only undistributed corporate earnings to the corporate tax, but would continue to tax the shareholder on dividend distributions. The estimated cost of this proposal would range from $18 billion to $27 billion, depending upon whether corporations change their dividend payout policies. The $27 billion loss would occur only if dividend payouts were doubled; an $18 billion loss would occur if there were no change in payouts at all. Whether Congress adopted either a full or a partial integration scheme, the revenue loss would be considerable. To compensate for this loss, the rates of other taxes would have to be increased or new sources of revenue found.

III. TRADITIONAL RATIONALES FOR INTEGRATION

The reasons advanced for the abolition of the corporate tax and its integration into the individual income tax are of two kinds. The first type is based primarily on the need for neutrality—the need to preserve the alloca-

25. See topics IV. B., C. infra. Our later analysis involves the notion that the "firm contribution" to the firm owners' individual economic income is, generally speaking, the algebraic combination of the amount actually severed from the firm's asset pool (that is, distributed to its owners) and the change in the present value of the net worth (owners' segment) of the firm, computed by capitalizing the projected future returns to be generated by the firm's assets as they exist after the current distribution. See topic IV. A. infra.

Eisner suggests explicitly, though McLure does not, a deduction for depreciation in the owners' share in the net worth of the firm. A system calling for taxation of shareholders on undistributed current net profits, plus increases in net worth in excess of such current profit, is not justified by our arguments because the change in net worth (on a capitalization of future returns basis) may be greater or less than the absolute dollar amount of such profits. For example, even if a $100 net profit is earned this year and retained, there may be an increase in the net worth of the firm of only $90. To tax the firm owner on $100 (as a minimum amount) is to tax him on more than the current period wealth-change effects of his ownership. If earnings for the current period are retained, the wealth-change implications for the owner are accurately measured simply by measuring the change in net worth of the firm by a capitalization of future returns, without separate reference to the current period's profits.

27. See Break & Pechman, supra note 19, at 345.
tional efficiency of the economy. The second class of reasons relate to the equity of the tax system.  

A. The Economic Efficiency Arguments

The economic arguments supporting abolition of the corporate tax are generally based upon two sets of conclusions. First, the double-level corporate income tax results in overtaxation of distributed corporate income. It taxes corporate income more heavily, in the case of corporate firms with relatively high dividend payout rates, than income from other sources, including noncorporate business firms. This has the effect of placing the high-payout corporation at a disadvantage as regards the primary sale of equity and internal project decisions. The corporate firm may be forced to fi-

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28. See G. BREAUX & J. PECHMAN, supra note 8, at 4–13. We review, but do not discuss in detail, the arguments advanced by economists and other observers of the tax system. A careful and systematic restatement and analysis of these arguments appears in the now famous Report of the Royal Commission on Taxation (Carter Commission Report), which was published in 1966 and which contains a complete appraisal of the Canadian income tax system. Since the Canadian system of taxation prior to 1972 is essentially similar to our own, most of the material contained in the Carter Commission Report is fully applicable to our own system. The Canadian system of modified integration is discussed in text accompanying notes 121–23 infra.

29. Tax effects aside, the equity of firms offering the same expected dollar return at the same risk level (taking into account the firms' underlying asset projects and the terms of their equity under applicable business associations laws) would normally command the same price in the marketplace. The double-level tax has the effect of reducing the projected dollar return to equity investors of the high-payout corporate firm. But the risk or uncertainty associated with that dollar return determines the rate at which it is capitalized. Since risk, which is derived from nontax sources, would remain unchanged, the high-payout corporate firm's equity would command a lower price than that of its noncorporate counterpart. See McLure, supra note 20, at 258–59. This conclusion is supported by considerable systematic thinking in the field of financial economics. See, e.g., E. FAMA & M. MILLER, THE THEORY OF FINANCE 170–75 (1972). Consequently, whenever corporate equity must compete with a noncorporate financial investment opportunity of the same risk level, but offering a greater after-tax dollar return, corporate equity will “lose,” so long as it is assumed that investors are generally risk-averse. A weak statement about this “inferiority” is that the corporate equity price will be lower than its noncorporate competitor in order to equalize rates of return. In this sense, it can be said that corporate equity will be sold at a lower price and will raise a smaller amount of proceeds than noncorporate investment of the same risk class. McLure, supra note 20, at 261–62. In the primary (issuer-sale) market, this principle really suggests the much stronger conclusion that corporate equity simply should not be bought. The cost and projected dollar returns of the underlying operating asset project of the issuing firm dictates both the specific dollar amount which the firm must collect as proceeds from the sale of its equity and the specific dollar amount of future return which can be expected by investors on their purchase price. The issuing firm is not free to lower the price at which it sells equity.

The next question is whether doubly-taxed corporate equity ever competes in the market for financial assets with noncorporate investments possessing the same risk level but a higher dollar return. If such competition does not exist, it would be difficult to say that corporate equity is disadvantaged vis-à-vis some other form of financial investment of the same risk level. The competition does not seem to exist between the equity of a general partnership and the equity
of a corporation, even though both types of firms engage in the same underlying real asset project, because the unlimited liability contract terms (set by business association law) of general partnership equity makes it a riskier financial investment than the limited liability contract terms of corporate equity. The case for competition is stronger in the financial investment market between corporate equity and limited partnership equity, where both firms engage in the same underlying asset project. Even here, however, it is arguable that the contract terms of limited partnership ownership make it more risky than corporate equity because shareholders have greater supervisory control than do limited partners. The differences in this respect, however, are becoming less and less palpable. See Uniform Limited Partnership Act, Prefatory Note at 1–2, § 302, Comment, § 303, Comment (1976 version).

There are additional financial investments which may compete with corporate equity at a given risk level. In the firm equity category, a general partnership interest in a firm whose underlying asset project is different from, and less risky than, that of a corporate firm may have the same effective risk (the combination of underlying asset risk and contract term risk) as the corporate firm's equity. If the corporate equity offers an inferior after-tax dollar return as compared with the general partnership interest, the corporate equity will not be purchased in the primary markets. Firm equity will still be purchased, in the form of partnership interests, but assuming that the risk preferences of investors remain the same, investable wealth will be attracted to the partnership firms whose underlying asset projects are less risky than those of corporations. At any given risk level, firm equity may also compete with financial investment, the proceeds from the sale of which do not lead to the formation of real capital. Again, if the expected dollar return of the latter is superior, primary sales of corporate equity will be blocked. Under this last assumption, however, investable wealth may be diverted into sectors of the economy that do not increase the social wealth total—a matter of no mean economic significance.

With regard to internal project decisions, corporate management, in pursuing its objective of maximizing share value, decides whether to invest in underlying asset projects by determining whether the present value of the future cash return to investors exceeds the cost of those projects. Managers of high-payout corporate firms are aware that the dollar return received by the equity holder will be reduced by the double tax. Thus, in order to achieve a present value of future dollar return equal to the purchase price of any project, managers must capitalize that return at a lower rate than that which would suffice if there were no double tax. This rate of return may be lower than that demanded by the marketplace. See E. Fama & M. Miller, supra at 276–319; W. Sharpe, Portfolio Theory and Capital Markets 94 n.1 (1970). See also J. Peckman, Federal Tax Policy 117–18 (1971). If so, the managers must either not engage in those production activities or face the prospect of lower market values for outstanding shares. Of course, this assumes that managers consider the effects of internal investment decisions on the value of their equity when making those investment decisions. See E. Fama & M. Miller, supra, at 74–75. If managers are insulated from shareholder supervision, and need not go to the equity markets, they may adopt some other criteria for pursuing real capital projects. It must be noted that the observations of this and the preceding paragraphs of this footnote relate to a period of disequilibrium, when capital is moving from the corporate sector to the noncorporate sector. See McLure & Thirsk, A Simplified Exposition of the Harberger Model 1: Tax Incidence, 28 Nat’l Tax J. 1, 14 n.29 (1975). See also text accompanying notes 31–35 infra.

At a given risk level, corporate equity may not compete with any other financial investment opportunity. This possibility, even in a world of finite securities, lacks intuitive appeal, but, should it exist, the reduction of dollar return on corporate equity, created by the double tax, still makes such equity look less attractive as compared with consumption.

There is yet another troublesome policy aspect of double-level taxation which discourages corporate equity investment. Limited shareholder liability is arguably intended to make corporate equity, as contrasted with its unlimited liability counterparts, a lower risk (and, of course, lower return) investment, so that it will suit the risk-return preferences of more wealth holders. This assumes that absolute risk tolerance varies inversely with wealth and that levels of personal wealth vary inversely with the number of persons possessing them. By lowering the dollar
nance with debt rather than with equity, and investable wealth may be devoted either to financial investment other than corporate equity or to consumption. These shifts in the use of wealth are viewed as artificial or inefficient because they are a result of methods of taxation.

McLure and Thirsk, following Harberger, have systematically elucidated the social welfare losses created by a tax on capital (a factor of production) in the corporate sector alone. In severely condensed form, the analysis proceeds as follows:

1. The imposition of the double-level tax on corporate payouts is a tax on the income of the capital factor (real capital purchased with the proceeds from the firm's sale of financial investment or with cash flow) in corporate production. The double-level tax results in corporate-source income being taxed at a higher rate than income from other sources, except where corporate earnings are retained and value increases are taxed at capital gains rates to high marginal bracket taxpayers.

2. In response to the initial lower net (after-tax) yield on capital in the corporate sector, capital moves, during a period of disequilibrium, to the noncorporate sector, until a new set of returns on corporate and noncorporate capital is established. This move returns to investors in corporate equity, the tax law makes corporate equity an inferior investment at any given risk level as compared with noncorporate investment producing non-double-taxed returns. And, as indicated in the fifth paragraph of this footnote, even if such competition does not exist, the double tax may reduce the return on equity to such a low point that it would not entice wealth holders to switch from consumption to investment. Hence, assuming that all investors, rich or poor, are risk-averse, the corporation law objective of broadening the appeal of equity contributions to firms is subverted.

30. A high-payout corporate firm may seek to elude the effects described in the foregoing footnote by shifting its capital structure to debt. But the tax doctrine of thin capitalization will penetrate the form of some portion of the debt and relabel it equity. As a practical matter, certain production activities cannot be financed with debt (of a kind which would not be characterized as equity and whose yield would escape double taxation) without unacceptably increasing the firm's exposure to insolvency in both the bankruptcy and equity senses.

Even if an all-debt corporation could successfully elude the tax collector's power to recast debt as equity, the debt of such corporation would be riskier than the debt of a firm with equity. See E. Fama & M. Miller, supra note 29, at 186. Thus, such a corporation would be foreclosed from dealing with a class of potential debt purchasers whom noncorporate firms could attract as a function of their ability to choose freely, without tax compulsion, a particular debt-equity balance.

If movement to debt results in a lowering of the total value of a corporate firm's securities (contrary to a considerable body of economic theorizing of the Modigliani-Miller school), the attempt to elude the nonneutrality of double taxation would be offset by counterallocational effects. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 332-33 (1976). Besides, a tax policy that forces a corporation to load up on debt frustrates the objective of shareholder limited liability, namely, encouraging the sale of firm equity. See the last paragraph of note 29 supra.

ment occurs because of the previously described "disadvantages" regarding the primary sale of corporate equity and internal corporate decisionmaking. 32

3. After the movement of capital to the noncorporate sector, the return in the noncorporate sector is driven downward, and returns to owners of capital are equal. That is, the net (after-tax) return to owners of corporate capital is the same as the noncorporate return, both gross and net, since there is no double tax in the noncorporate sector. At this point, corporations are no longer prejudiced in the primary sale of their equity or in the making of internal project decisions. This is so because corporate capital earns a higher gross (before-tax) return, after the movement of capital out of the corporate sector, than it did before the movement. 33

4. But during and after the period of disequilibrium (the capital movement period), capital is reallocated to the noncorporate sector. This reallocation is a misallocation, in traditional economic social welfare terms, because it results in the production of fewer units of corporate products, at higher prices, than would be produced if the tax had not been imposed or if the tax had been neutral (i.e., not caused a reallocation of factors). The number and price of product units that would prevail, absent a tax that causes reallocation of factors of production, is viewed as the efficient state, or condition of highest social welfare, because they are the levels of unit volume and price that best represent the preferences of product consumers and suppliers of capital, absent tax disturbances. 34

There is still another separate and distinct effect which the double-level tax has on allocation of resources. The initial reduction of the net rate of return on corporate capital and the post equilibrium reduction of the gross and net rates of return of noncorporate capital may encourage wealth holders to avoid investing and to choose consumption instead. 35

The second set of conclusions regarding neutrality or economic efficiency are related to the first. Since undistributed earnings are not taxed to shareholders and capital gains are preferentially treated, corporate firms may seek to avoid the partiality of the double tax by accumulating earnings instead of making dividend distributions. 36 From the point of view of investors, there

32. See McLure & Thirsk, supra note 29, at 8–9. See also the first four paragraphs of note 29 supra.

33. See McLure & Thirsk, supra note 29, at 9, 14 n.29. This new equilibrium position of corporate firms accounts for our caveat that corporations are in an inferior position, as regards the primary sale of equity and internal project planning, only during periods of disequilibrium. See note 29 supra, fourth paragraph.

34. See McLure & Thirsk, supra note 29, at 20–22.

35. See id. at 3 & n.7; McLure, supra note 4, at 541 n.44.

36. Of course, not all of the double-tax effects can be escaped by accumulations, even where accumulations are not subject to penalty levies, because the capital gains tax must eventually be paid.

It is interesting that Miller and Modigliani, in arguing the irrelevance of dividend payout policy, doubted the ability of a corporate firm to improve the value of its equity by accumulat-
is an incentive on the part of high bracket shareholders to invest in firms paying relatively small dividends.\textsuperscript{37} Because of these low payouts, more of corporate earnings will be reflected in appreciated share values (at worst, doubly taxed at some combination of corporate and individual capital gain rates) than in dividends (doubly taxed at some combination of corporate and individual ordinary income rates).\textsuperscript{38} This preference may create a distortion in the manner of financing in favor of internal funding, and it may also add to the attraction of wealth available for financial investment away from low-growth industries.\textsuperscript{39}


...Some, however, do not accept the Miller-Modigliani teaching that the value of a corporate firm's shares should not be detrimentally affected, corporate tax law notwithstanding, by the firm’s payout policy. See \textit{id}. For a discussion of the competing views, see J. Loré & M. Hamilton, \textit{The Stock Market, Theories and Evidence} 113–22 (1973). For them, there is the chance that a policy of accumulation could offset prejudicial tax effects, but they, unlike Miller and Modigliani, must also deal with the possibility that share value may be depressed by such a policy. Again, attempts to evade tax-created allocational impact may be frustrated by opposing nontax reactions.

...Further, if retentions do occur solely in response to tax considerations, as a firm struggles to free itself of the double-level tax prejudice, the capital retained may not be devoted to production capacity, as in the case where a firm becomes overcapitalized and saves by lending to others in transactions that do not lead immediately to the formation of real capital. Such savings is offset by the consumption of the borrower and does not lead to production and an increase in social wealth. See A. Alchian & W. Allen, \textit{Exchange and Production: Competition, Coordination and Control} 428 (1977). Thus, a tax incentive against dividend distributions could exhibit still another type of nonneutrality.

37. Here the argument is that, theoretically, the equity of a low-payout corporate firm can actually achieve, by virtue of a double-level tax system, superiority over noncorporate financial investment in the eyes of taxpayers who have high marginal tax brackets. It is argued that low-payout corporate firms may be able not only to neutralize the effects of the characteristics of the double tax system but also to turn those characteristics to their advantage. But this view is subject to the Miller-Modigliani argument that no tax-effect-neutralizing benefits can be reaped by accumulating, and to the contention that, even if some reduction of tax prejudice could be achieved, unfavorable countervailing nontax repercussions of a low-payout policy might be expected.

38. See McLure, \textit{supra} note 20, at 259. As the preceding two footnotes indicate, however, such tax-motivated behavior will occur only where there are clearly tax-engendered advantages and no offsetting nontax disadvantages created by adopting a low-payout policy.

39. See \textit{id}. It is unclear whether, by use of the phrase “low-growth,” McLure means to say “low risk.” If such be his intent, he might be suggesting that low-payout firms are high risk firms and that the tax laws, if they force corporate firms to adopt low-payout policies, may favor allocation of wealth available for financial investment to high risk enterprises. We are not convinced that low-payout practices, if induced by a tax system, would be engaged in exclusively, or even predominantly, by high risk firms. See the fourth paragraph of note 36 \textit{supra}. Retentions may force a firm to a low risk, low return status. Moreover, there is some doubt that capital gains preference devices are the most effective way of attracting wealthier taxpayers in our society to invest in the riskier securities available in the economy. See Mantell, \textit{The Effects of Tax Exemption of Capital Gains on Demand for Risky Investment}, 15 Q. Rev. Econ. & Bus. 93 (1975); Stiglitz, \textit{The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking}, 83 Q.J. Econ. 283 (1969).
It might be thought that the foregoing conclusions depend heavily upon the assumption that the corporation cannot shift the corporate income tax either forward to consumers in the form of price increases or backward to suppliers and labor in the form of lower prices for goods and services. If there is no management-originated shifting, presumably the tax is borne initially by the shareholders, whose dollar return on financial investment is necessarily diminished by the amount of the corporate income tax, and ultimately, as we have seen, there is a movement of the capital factor which leads to a loss of social welfare. But can we assume that misallocation of resources will not occur if the tax is shifted, say, onto consumers?

Before answering the foregoing question, we should first point out that there is no agreement among economists or businessmen as to the incidence of the corporate income tax.\(^4\) According to older thinking, it is assumed that, in a competitive product market atmosphere, there are "marginal producers" which make no economic profits (no more than "normal" profits) and, it is further assumed, which pay no taxes at the corporate level. These marginal corporate firms experience no increase in costs by way of taxes and therefore need not raise their prices. If these marginal producers do not raise their prices, the economically profitable (taxpaying) firms in the same market cannot raise their product prices, because (assuming no price change by the "marginal producer" competitor) an increase in price would cause the marginal revenue of the taxpaying firm to ultimately drop below its marginal costs.\(^4\)

Economists of the opposing viewpoint argue that the real world does not necessarily operate according to classical economic models. No one is quite certain what factors affect prices and wages, but there is respectable authority for the proposition that the costs of the marginal producer are not the critical factor.\(^4\) The development of oligopolies and administered prices has seriously eroded the notion that a marginal producer can affect prices in an industry in which several large firms account for all but a small percentage of production. Consequently, the incidence of the corporate income tax remains an unsettled issue.\(^4\) There may be instances in which the tax is either partially or entirely recouped through price increases, but in general

\(^{40}\) For an analysis of the authorities, and particularly of recent economic studies, see Klein, The Incidence of the Corporation Income Tax, A Lawyer's View of a Problem in Economics, 1965 Wis. L. REV. 576. See also J. Pechman, supra note 29, at 111–16.

\(^{41}\) See L. Kimmel, supra note 1, at 19–20.

\(^{42}\) See id. at 21–31.

\(^{43}\) "With the present state of knowledge, we do not know whether the tax is shifted or not; there is certainly no conclusive evidence that it is fully or partially shifted." J. Due & A. Friedlaender, Government Finance 331 (1973).
one cannot predict under what circumstances recoupment will occur. There is little said in the literature about the possibility of "backward" shifting, say, to labor. Perhaps this is because it is assumed that the price of the labor factor is, realistically, quite rigid downward. If the corporate tax is shifted forward to consumers, it is said to be a crude and, very likely, regressive form of sales tax. If the tax is shifted backward to labor, it is said to function as a capricious and indefensible payroll tax.

Even if, as some suggest, price-setting corporate producers are able to raise prices in the short run in an attempt to shift the incidence of the double-level corporate tax burden away from shareholders, and even if we assume that the price rise does in fact shift the incidence of burden, may we also assume that there is no loss of economic efficiency from misallocation of resources? The answer appears to be that we may not. Misallocation can occur in connection with a variety of different incidence patterns prevail-

44. Professor Lester Thurow suggests that it is impossible to make quantitative measurements of shifting. Thurow, The Economics of Public Finance, 28 Nat'l Tax J. 185, 187-89 (1975).
45. McLure & Thirsk, supra note 29, at 17.
46. See McLure, supra note 20, at 261. The words "crude" and "capricious" presumably refer to tax equity considerations. Crudity and capriciousness stem from the unsystematic and potentially regressive aspects of these convoluted "shifting" taxes. We are unable to know or to measure just what their effects will be, and yet we sanction them even though one of their aspects may well be regressivity.

The shift-to-consumers assumption may also have misallocation of resources (i.e., nonefficiency or loss-of-social-welfare) significance, however. See McLure, supra note 4, at 546-47; J. Pechman, supra note 29, at 121.
47. See McLure, supra note 4, at 546; J. Pechman, supra note 29, at 112-13.
48. A price increase may not completely shift the post-short-run burden of the tax. For an analogous study of this problem involving an excise tax on corporate products in the context of competitive general equilibrium, see McLure & Thirsk, supra note 29, at 17-20.
49. See McLure, supra note 4, at 546-47; J. Pechman, supra note 29, at 121. Using partial equilibrium monopoly analysis, one economist states the effects as follows:

Suppose that a specific tax is levied on the monopolist firm. . . . The tax is a variable cost and shifts the average and marginal costs upward by the amount of the tax. Faced with new cost curves . . . , the monopolist cuts output . . . and raises price . . . in order to maximize profits.

The monopolist is able to pass a part of the specific tax to the consumer through a higher price and a smaller output. At the same time the monopolist's profits will be smaller after the tax than before. . . . Total receipts of the monopolist at various outputs are unchanged by the tax, but total cost at all outputs will be greater. Profits at all possible outputs will be smaller than before, and maximum profits after the tax will necessarily be smaller than they were before. . . . It appears that a specific tax on the monopolist's product would reduce welfare rather than increase it.

R. Leftwich, The Price System & Resource Allocation, 252-53 (1976). Though the quoted analysis deals with a specific tax on a monopolist's product, it is adaptable to the double-level corporate tax system because the latter is not a lump sum tax or a tax on pure economic profits alone. See R. Lipsey & P. Steiner, Economics 483-84 (4th ed. 1975). It is levied on the normal profits of the corporate firm and becomes a variable cost which affects long-run marginal costs and prompts the pricesetter to raise his prices to maximize profits.
ing after the short run. While a knowledge of the incidence of the post-short-run burden is, in and of itself, of vital importance to a tax equity analysis, one must look further to identify the economic efficiency levels associated with various incidence conditions. More important to the social welfare issue (in straight economic terms) is the initial impact of the tax, its influence on the movement of, and change in, gross returns on factors of production, and its effect on product output and prices. The test for efficiency involves an assessment of the post-short-run position of gross factor returns, output, and prices, as compared with the levels of those parameters in the sans-tax state.

The misallocations of resources that may accompany the double-level corporate tax could be substantially eliminated if all production activities could be freely shifted from the corporate to the noncorporate form. Indeed, much of the discussion of misallocation assumes that certain products can be made only by firms operating in the corporate form. The reason why certain types of firms cannot convert to the noncorporate form may be implicit in two observations. First, some production activities may require a minimum dose of equity financing in order to avoid both bankruptcy and equity insolvency during their natural operational cycles. This requirement alone, of course, would not explain a compulsion to adopt the corporate form, since equity (in the sense of permanent investment entitled to residual, nonfixed returns) can be sold by noncorporate firms. But, as we have noted, the equity of a general partnership is riskier than corporate equity, assuming the same underlying asset project for both, because the contract terms of general partnership equity do not provide for limited liability. General partnership equity, with respect to the higher risk production activities in our economy, may thus lie outside the risk preferences of many wealth holders, whose willingness to buy equity may be the key to the formation of capital in such riskier firms. Hence, our second observation: Business associations law may disallow, outside the framework of the corporate form, the packaging of total firm risk so as to construct an equity investment that meets the risk tolerances of a group whose participation in investment might expand the amount of equity securities demanded. In other words, as regards certain production activities, only a corporate firm can tailor its financial capital structure so as to minimize, in light of investor risk preferences, the difference between equity desired by such firms and equity supplied by wealth holders.

50. McLure and Thirsk demonstrate this fact within the context of an excise tax on corporate-firm products. See McLure & Thirsk, supra note 29, at 14-20, 22-23.

51. Indeed, one of the cases where there is no inefficiency caused by the double-level corporate tax is also a situation in which the entire post-short-run burden of the tax is borne by corporate equity. See id. at 12 for a discussion of the case where capital cannot move from the corporate to the noncorporate sector.
A blemish in the foregoing argument is created by the possibility that equity can be raised in the limited partnership form. The contract-risk aspect of limited partnership ownership is arguably about the same as that of corporate equity. On the other hand, it can be said that limited partnership equity is riskier, by virtue of its contract terms, because limited partners do not have the same supervisory prerogatives as those given to shareholders of a corporation.\(^5\) Lack of liquidity, too, is a risk-type attribute associated more with partnership equity than with corporate equity, at least in the sphere of publicly held firms.\(^5\)

Even if, by creative tailoring, limited partnership equity could be given the same contract-risk attributes of corporate equity, there would still be two powerful reasons why firms of the type we have been discussing\(^5\) would not be set up in, or be converted to, the corporate form. First, unlike directors of a corporation, the managers of a limited partnership will have unlimited personal liability for the acts of the firm. Second, the Internal Revenue Service will apply the double-level corporate tax to limited partnership equity which takes on too many corporate attributes.\(^5\)

The obstacles to transferring certain kinds of production activities from the corporate to the noncorporate form should not be confused with the immobility of capital between corporate and noncorporate sectors. The presence of barriers to a change in form is a principal ingredient of the economic inefficiency result. Immobility of capital between corporate and noncorporate sectors, on the other hand, would negate the possibility of inefficiency.\(^5\)

**B. Tax Equity**

The discussion of tax equity deals directly with the tax burdens suffered by individuals, classified according to (1) their roles in the economy (e.g., furnishers of factors of production (labor and capital), savers, wealth holders, and consumers (nonsavers and dissavers)), and (2) their ability to pay. In short, the equity objective of income taxation is to establish criteria for de-

\(^5\) See the second paragraph of note 29 supra.

\(^5\) It is not unusual for limited partnership equity to be distributed to the public and to thereafter be "traded" only sporadically, if at all.

\(^5\) That is, firms that require substantial equity investment and which, in order to raise that equity, must tap the wealth of persons at the lower levels of absolute risk aversion.


\(^5\) See note 51 supra.
termining who should relinquish some of their share of income to the government and in what quantities they should relinquish it.\textsuperscript{57} Judgments concerning tax equity, though they are "economic" in the general sense that they involve the imposition of burdens on economic agents, are not fully explicable in terms of systematic economic thought. This is so because equity decisions—for example, the rule that it is better to collect 10\% of a low income and 50\% of a high income, instead of taking a constant rate of both—imply the existence of a gauge or measuring device, other than the explicit signals of individuals exhibited in their voluntary exchanges and dispositions, by which we can say that the involuntary loss of a small amount of a low income is somehow about as "fair" as the involuntary loss of a larger amount of a higher income. The deeper implications of the fairness conclusion must be akin to a conviction that the psychological impacts on the high and low income recipients are about the same, or the judgment that, by some common denominator, society is better off by taxing progressively, irrespective of the personal feelings of the individuals taxed. These are matters about which many economists remain agnostically mute, except to point out inefficiencies of the sort treated above, which are susceptible of measurement in terms of voluntary transactions.

That is not to say that choosing an efficiently neutral tax will not have consequences with respect to incidence. Achieving welfare efficiency for any given tax will have particular incidence results.\textsuperscript{58} On the other hand, inefficiencies can exist under a variety of incidence patterns, and an inefficient tax may ultimately be borne by classes of individuals other than those upon whom it is ostensibly imposed.

The precept of "horizontal" equity states that recipients of income should not bear disparate income tax burdens simply because of the source of their income. The double-level corporate tax, to the extent that it is not successfully shifted to labor or consumers, is seen as violative of this principle, because it is borne primarily by those who receive income from furnishing investment in the corporate and noncorporate sectors. Where the concept of horizontal equity finds its origins is difficult to say. It is not immediately obvious why it is "unfair" to vary tax burdens according to income source. Providing incentives for the making of economic choices that generate the most desirable conditions in the economy may be an aspect of fairness. Encouraging consumption of current income (nonsaving) or of wealth (dissaving) may be a reasonable basis of classification, and this result might be achieved by increasing the burden on income from activities that constitute deferral of consumption. Similarly, it might be reasonable or fair to encourage deferral of consumption in favor of the formation of real capital by decreasing the tax

\begin{itemize}
\item \textsuperscript{57} See generally G. Break & J. Pechman, \textit{supra} note 8, at 5–7.
\item \textsuperscript{58} See McLure & Thirsk, \textit{supra} note 29, at 12–14, 17, 20–21.
\end{itemize}
on income from furnishing the capital factor of production. A discrimination between the income tax burden on labor and capital might occur in the foregoing instances, but it results from the objective of changing the relative levels of consumption and real investment, rather than from any preference between capital or labor income.

It might be argued, then, that the double-level corporate tax does not violate horizontal equity because it is a legitimate attempt to discourage real investment and to encourage consumption. Aside from the almost bizarre inappropriateness of such an economic policy under present circumstances, however, the double tax on the income of corporate equity seems an awkward and haphazard way of achieving the desired result. There are two principal shortcomings. First, where no firm-originated shifting to consumers occurs (via price increases), the tax still falls on both consumers and capital.\(^59\) Second, because of the partial (corporate only) nature of the tax, it is accomplished at a loss of social welfare.\(^60\) Of course, if shifting to consumers is substantially successful, the pro-consumption incentive objective of the scheme is largely thwarted. For these reasons, a double tax on the income of corporate equity seems ill-designed to achieve the plausibly fair objective of encouraging consumption, and the cavalier theoretical lack of concern for its effectiveness and side effects may be the true source of its "unfairness."

Any preferential tax rate for capital gains type income is also subject to criticism on horizontal equity grounds. Again, however, the incentive rationale is at least a prima facie basis for reasonable classification by income source. Our present corporation-shareholder tax system provides for capital gains treatment of corporate source "income" (as that term is defined today) in a variety of ways at both the corporate and shareholder levels. These special treatments must be either reconciled to the rule or branded as transgressions. We have suggested that incentives may well be admissible as an element of horizontal equity, but fairness would presumably require that there be a respectable a priori case for effectively achieving the incentive by the means chosen.

Judged by the standard of "vertical" equity—the notion that the income tax burden should increase progressively with the recipient’s ability to pay, as gauged by the size of his income—the double-level corporate tax is subject to several attacks. Under the assumption that the tax is not successfully shifted to labor or consumers, low income shareholders of the corporation bear a greater burden than high income taxpayers. This holds true irrespective of the corporate firm’s payout policy, although it is exacerbated in the low payout case.\(^61\) The burden that seeps into the noncorporate sector dur-

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59. See id. at 11.
60. See topic III. A. supra.
ing and after the period of disequilibrium is proportional on capital factor income, but, in the sense that it is not progressive, it violates the vertical equity concept. Further, to the extent that the corporate level portion of the double tax falls upon consumers or labor, by shifting or otherwise, the tax is likely to be regressive. It should be noted again that, just as a firm-originated price increase may not guarantee a complete shifting to consumers, there may be some tax incidence on consumers, even though the corporate firm does not initially raise product prices.62

Perhaps the most fundamental equity issue is the principle that a purported income tax should tax only "income." An identification of the nature, timing, and amount of income thus becomes critically important. We next address ourselves to these issues, at the firm and individual levels, and attempt to show the relationship, in economic income terms, between the income of the firm and the income of its equity owners.

IV. CORPORATE INCOME—WHAT IS IT? WHEN DOES IT OCCUR? AND WHO OWNS IT?

A. An Economic Income Analysis

It is odd that, despite the great wealth of material that has been written in recent years on fundamental issues of tax policy, there has been no systematic treatment of the corporate income tax in terms of the nature, timing, and amount of firm income, and the relation of these items to the income of individual firm owners. This is particularly strange in light of the fact that tax policy writers have relied heavily on economic concepts in fashioning systems of income taxation based upon the comprehensive tax base, upon consumption, and upon cash flow. One might have expected that intimacy with economic definitions of income would have produced some insights into the relation between economic concepts of corporate income and the corporate income tax, but there has been very little written on this issue.63 The primary concern of most writers has been the personal income tax, and,

62. See McLure & Thirsk, supra note 29, at 11.

63. The lack of material on this subject is probably due to the fact that lawyers and many accountants are simply not accustomed to thinking of corporate income, as determined for financial statements and for income tax purposes, in relation to formulations and definitions of income fashioned by economists.

In a related field, however, financial economists, engaged in the process of rethinking the goals of accounting, have explicitly explored the economic concept of firm income as a step in their analysis of the relationship between investor uses of information, the function of accounting systems, and alternate accounting systems. See, e.g., Revsine, Replacement Cost Accounting: A Theoretical Foundation, in 2 AICPA, OBJECTIVES OF FINANCIAL STATEMENTS 178, 183–85 (1974); Ronen, Discounted Cash Flow Accounting, in id. 143, 151–52; Sorter, Accounting Income and Economic Income, in id. 104–05.
while most of their conclusions require a redefinition of gross income which would greatly affect the treatment of unrealized gains on corporate securities, the issue of the double taxation of corporate income has remained at the periphery of their thinking and not at its core.⁶⁴

If we pursue the economists' conception of what constitutes income beyond its immediate implications for a comprehensive income tax base, we find that it has significant implications for corporate income taxation as well, quite apart from the general theme of the equity and economic efficiency effects of the double tax on dividends.

Economists have suggested generally that there is no economic significance in the distinction between an individual shareholder and his corporation. Consequently, to an economist, the position of a shareholder is really no different from the position of a sole proprietor in terms of his being a furnisher of capital. The individual's equity simply represents the "firm aspect" of his wealth—that is, the portion of his wealth which is diverted from consumption and devoted to production. Since the shareholder and the corporation are simply two views of a single economic condition, the shareholder is in reality the owner of his proportionate share of corporate income.

The concept of the identity between the corporate firm and its owners has been raised in the debates concerning valuation models in portfolio and capital market theory. The specific question in that context is what species of "return"—e.g. expected dividends, as contrasted with expected total cash flows to the firm—are capitalized to arrive at the present value of shares. In that controversy, there is considerable support for the proposition that total expected cash flows, whether or not they are to be distributed, should be determinative of value. This conclusion might be viewed as premised partially on the generalized notion that there is no material separation between the corporation and the stockholder.⁶⁵

Recently, Professor McLure, in discussing tax equity, stated:

It simply makes no sense to speak of vertical equity in the taxation of the corporation vis-a-vis the taxation of an individual. This is especially true when we recognize that, so far as the earning of income for tax purposes is concerned, the corporation is simply the aggregate of its owners and can best be characterized as a "conduit" through which income earned in the corporation is passed to

⁶⁴ See, e.g., Slawson, Taxing as Ordinary Income the Appreciation of Publicly Held Stock, 76 YALE L.J. 623 (1967).

⁶⁵ See J. LORIE & M. HAMILTON, supra note 36, at 113–19, for a discussion of differing points of view. Actually, the proofs for the proposition that payout policy is immaterial to valuation are more complicated than a simple assertion of an identity between a corporation and its shareholders. See id. at 119–22. The arguments do, however, present a systematic basis for the belief that those factors which are value determinants for the corporate firm, considered separately, are reflected rather fully and immediately in the economic condition of its shareholders.
the shareholders as dividends or retained earnings. Under this view, the corporation cannot be said to have tax paying ability beyond that of its shareholders.66

These perspectives on corporation-shareholder relationships must be recognized as only analogous to the question of how corporate firm income relates to the individual income of its owners. McLure's statement is a simple reminder that "corporateness" involves real people. The portfolio and capital markets theory involves projecting future returns and, at any given moment, establishing, *ex ante* their actualization, the present value of those expected returns in terms of their timing, amount, and uncertainty. In contrast, the income question asks, *ex post*, about actual changes in some quantity, which we call income, over a given period.

Nonetheless, these analogous views of the corporation-shareholder relationship tend to produce policy conclusions for the taxation of corporate income, however that term is defined. In a rough way, they provide a conceptual rationale for not taxing the corporation at all and for totally integrating the corporate income tax into the individual income tax. Specifically, an undifferentiated identification of shareholders with their corporation might support integration by an imputation of undistributed earnings to shareholders. The argument is appealing: If the corporation is a "conduit" through which dividends and retained earnings are passed to its residual owners, the shareholders, then it is a conduit in the same sense that a grantor's trust or a partnership is a conduit. And as a conduit, it should be taxed in the same manner as the trust or partnership—no tax should be imposed on the conduit-entity, but a tax should be levied on the recipients to whom the earnings belong. The argument is a simple syllogism: Earnings are taxed to the individual taxpayer who owns them. The earnings of a corporation are owned by its shareholders; therefore, the earnings of a corporation should be taxed to its shareholders.

Upon an investigation of the characteristics of firm and firm-owner income, in the economic sense, we arrive at the conclusion that corporate firm income is immediately impounded into the income picture of its individual owners, and that there is consequently no warrant for taxing the corporation. We also conclude that it is appropriate to include immediately a share of firm economic income in the shareholders' individual income calculation. However, our analysis does not support an imputation of undistributed current-period earnings, as such, to shareholders.

Many economists suggest that the proper base for income taxation of individuals is the Haig-Simons definition of income.67 This definition, pro-

66. See McLure, supra note 4, at 535.
posed by Henry Simons in 1938, has become the focal point of much of the recent discussion of personal income tax reform. The Haig-Simons definition conceives of income as the “algebraic sum of (1) the market value of all rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” 68 In other words, an individual’s income is seen as the value of what he consumes during the taxable period, plus the increase, or minus any decrease, in his net worth during that period. With respect to investments held by individuals, net worth changes are determined on a capitalization-of-future-returns basis.

While the Haig-Simons definition of income was intended to apply to the individual, 69 there is no reason why it cannot be applied to the corporation. The notions of consumption and accumulation have their natural counterparts in the corporate firm, although a firm does not consume resources in the same manner as an individual and its accumulations are offset by obligations which run to its investors. Nevertheless, the Haig-Simons definition can be adapted to fit the corporate context as follows: Corporate economic income is the algebraic sum of (1) distributions to investors, less advances from investors, and (2) the change in the value of its net worth during the income period. 70 Again, change in net worth is a function of a capitalization of the stream of returns that the firm can generate in the future.

Combining the economic formulations of firm and individual incomes, we see that, in measuring the income of the corporation, we are really measuring an aspect of the income of its investors. Each facet of the corporation’s income is immediately assimilated to the individual owner’s income. Distributions will find their way immediately into the consumption or accumulation component of the individual owner’s income, but not necessarily in the exact amount of the distribution, because changes in the net worth of an individual are also calculated, with respect to investments, by capitalizing future returns. 71 Fluctuations in the corporation’s net worth will be reflected as an end-of-period wealth change in the accumulation component of the indi-

69. Id.
70. See authorities cited in note 63 supra. For example, Sorter says: “Economic income for a firm is generally defined as the change in the value of the firm plus any dividends paid during the period.”
71. When we say that firm economic income is assimilated, or that it contributes, to the economic income of the individual firm owner, we mean that it is automatically picked up as an intermediate step in the individual owner’s economic income calculation. The details of the calculation may vary with the individual, depending on events transpiring at the individual level during the income period. For example, with respect to a firm distribution, there may be adjustments in the individual calculation. If the distribution is all spent on consumption, then it will pass through fully, in dollar amount, to the final total of the individual recipient’s economic income. However, if the individual distributee uses part of the distribution to buy a new in-
individual owner's income. If the shareholder has transacted in shares of the corporation during the income period, changes in the corporation's net worth may be allocated between the consumption and the change-of-net-worth components of his economic income (or the economic income of some other individual, in a manner similar to that described in footnote 71). Thus, investment during the income period, the new investment contributes to the capitalized-future-return net worth segment of the individual's economic income. The amount of the latter contribution may be more or less than the amount of the distribution used to buy the new investment. The foregoing should not lead to the mistaken conclusion that some amount of firm economic income might escape the income base if one looks only to the economic income of individuals, for the distributee in the foregoing illustration bought his investment from someone else, whose consumption and net worth changes will be reflected in the total economic income of all individuals.

Imagine a world of one corporate firm, X, having two shareholders, A and B, each owning one half of the entire equity (say 10 shares each) of X. At the beginning of the income period, the net worth (stockholders' equity) of X, on a capitalized-future-return basis, is $1,000. During the period, X earns $100 and distributes $50 each to A and B. At the end of the period, the capitalized-future-return net worth of X is $950. The economic firm income is $50. If A and B engage in no intra-period consumption or transactions in X stock, the firm's economic income shows up in A's and B's individual economic incomes as follows:

<table>
<thead>
<tr>
<th>Consumption</th>
<th>Change in Net Worth</th>
</tr>
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<tbody>
<tr>
<td>A</td>
<td>Cash $50</td>
</tr>
<tr>
<td></td>
<td>Stock value change</td>
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<tr>
<td></td>
<td>($25)</td>
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<td></td>
<td>$25</td>
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<tr>
<td>B</td>
<td>Cash $50</td>
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<td></td>
<td>Stock value change</td>
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<td></td>
<td>($25)</td>
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<td>$25</td>
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</tbody>
</table>

Now suppose that, during the income period, A had used his $50 distribution to buy 1 share of X stock from B. B bought candy bars with the $50 received from A; B ate all the candy bars during the period. Firm economic income is still $50, but it shows up in the economic incomes of A and B in different ways:

<table>
<thead>
<tr>
<th>Consumption</th>
<th>Change in Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Stock value change</td>
</tr>
<tr>
<td></td>
<td>(11 shares) $22.50</td>
</tr>
<tr>
<td>B</td>
<td>Cash $50.00</td>
</tr>
<tr>
<td></td>
<td>Stock value change</td>
</tr>
<tr>
<td></td>
<td>(9 shares) ($72.50)</td>
</tr>
<tr>
<td></td>
<td>($22.50)</td>
</tr>
</tbody>
</table>

A's economic income is $22.50, and B's economic income is $27.50—accounting for the entire amount of firm economic income.

From time to time, we state that, if economic income is to be the tax base, it is unnecessary to impose a tax at the corporate level, because the economic income of the firm is fully reflected in the economic income of individual firm owners. This holds strictly true where, during the income period, shareholders (1) consume all distributions, and (2) do not change their invest-
any economic income of a corporation is fully taken into account by the Haig-Simons definition of individual income. Furthermore, corporate income is included in individual income in the same period for which it is corporate income. Therefore, corporate income cannot be income distinct from, or over and above, individual economic income; nor can it be the economic income of individuals in a different taxable period. Since the economic income of the corporate entity is immediately and simultaneously the income of individuals, the economist concludes that the corporation and the shareholders represent a single taxable unit.

As regards retained earnings, two observations flow from the foregoing analysis. First, retained earnings, even current undistributed earnings, are not includable, per se, in the individual shareholder's income calculation. Undistributed earnings may, indirectly, find their way into the shareholder's income computation in the sense that they might facilitate a distribution or influence the end-of-period projections of the firm's future returns and, in the process, obliquely cause a change in the present value of those future returns. But no specific reference should be made to retained earnings, current or otherwise, as discrete amounts. Second, earnings (current or prior earnings retentions) have no independent significance as a measure of the amount of income represented by distributions to shareholders. Any distribution enters the shareholder's income calculation along with a share of any change in the capitalized-future-return net worth of the firm. Whether a distribution is "covered" by current or prior period earnings is of no significance.

Finally, distributions in any given period cannot be included in the income of shareholders without also including a portion of the changes in the capitalized-future-return value of the corporate firm's net worth. To include the amount of a distribution in a shareholder's income, without also taking into account a reduction in the net worth of the firm, would result in a tax
on something other than economic income; it would be an excise tax on the partitioning of a portion of the shareholder’s wealth from its location in the corporation to the shareholder’s other modes of ownership. Furthermore, as we have noted before, the amount of the distribution need not be separately referred to in computing the shareholder’s individual economic income. It will, in a self-executing way, work its way into the consumption or change-in-net-worth components of the Haig-Simons formulation.

In summary, the following principles emerge:

1. All aspects of the corporate firm’s economic income are, in the period during which such income is experienced, impounded into the economic income calculations of individuals.
2. It is unnecessary to tax the corporate firm separately to reach firm contributions to individual economic income; a tax base consisting of the economic income of individuals will account fully for all firm economic income.
3. Taxation of undistributed current earnings, as such, is inconsistent with the principle of taxing only economic income.
4. The amount of firm earnings, past or current, should play no independent role in the determination of income, absent distributions, and should not be used as a measure for the amount of income inherent in a distribution.
5. Including distributions in individual shareholder income, without also adjusting the shareholder’s income in light of fluctuations in the firm’s net worth (on a capitalization-of-future-returns basis), is inconsistent with the principle of taxing only economic income.

These conclusions are incompatible with the present system of corporation-shareholder taxation, particularly because the present system taxes at two levels, and at neither level does it take account of the end-of-period rise or fall of the firm’s capitalized-future-return net worth. Moreover, it uses current or accumulated earnings as a measure of the contribution of distributions to individual income. Hence, the present corporation-shareholder system does not compute the tax base pursuant to economic income principles. The economic income analysis points in the direction of integration, but not to a system that would tax the shareholder on his share of undistributed current earnings, as such, nor to one that would tax distributions to shareholders without adjustment of individual shareholder income for changes in the capitalized-future-return net worth of the corporate firm.
B. Constitutional Ramifications: Does It Matter
What Corporate Income Is and Who Owns It?

It is temptingly easy to counter the foregoing economic justification of the full integration proposal with the simple argument that nothing requires us to accept as final and immutable the manner in which the conception of economic income establishes the irrelevance of any distinction between firms and individuals. According to this latter view, the corporation-shareholder relationship can be defined for the purposes of taxation (and presumably for other purposes of national policy) in any manner which Congress deems proper. Richard B. Goode, writing in 1951, took the position that there is no reason why any country cannot choose to impose both corporate and individual income taxes, to determine how they will interrelate, and to decide what weight will be given to each, without regard to theoretical models of a comprehensive tax system. Professor Stanley Surrey has suggested that the adoption of partial integration schemes in other countries has not been motivated by the "tax theology" of corporation-shareholder unity, but rather by other national policy goals, such as more active capital markets and reduction of foreign ownership. According to some, therefore, if there are at least two tax theologies of the corporation-shareholder relationship, a legislator is not a tax sinner if he prefers one to the other. Neither theology is preordained.

But whatever the situation in other countries may be, the position that there are two or more tax theologies available to Congress is not entirely self-evident. Initially, the sixteenth amendment empowers Congress to levy a tax on "incomes, from whatever source derived." Any direct tax other than an income tax must be apportioned. Congress' freedom to tax is constrained, and it is therefore necessary to point out that the Constitution does require the adoption of a particular tax theology for the taxation of corporations and shareholders in the sense that the base of the tax must be income within the meaning of the Constitution.

We think it too cavalier and unconstructive to assume that the sixteenth amendment was not meant to convey some univocal meaning, by which the permissible unapportioned tax could be distinguished from other direct taxes. Presumably, "income" should be given some fundamental content, and should not be allowed to float freely on the shifting tides of tax theologies. It is at least reasonable to assume that the word "income" was

76. Id. at 335.
77. U.S. Const. amend. XVI.
78. U.S. Const. art. I, § 2, cl. 3; Id. art I, § 9, cl. 4.
meant to establish a tax base that is uniform in light of relevant policy, and we suggest that economic insights are as relevant as any for the purpose of defining the income base. Specifically, we have adduced the concept of economic income as a potential rationalizing element in corporation-shareholder tax systems. We next discuss the extent to which the Supreme Court’s views are consistent with the economic income principles developed under the preceding topic.

It is generally accepted that Congress, by enacting section 61 of the Internal Revenue Code and its predecessors, intended to use the full extent of its grant of constitutional authority to tax all “incomes, from whatever source derived.” Congress did not, however, adopt any particular definition of income beyond an enumeration of examples of gross income which is clearly not exhaustive. In 1920, seven years after the adoption of the sixteenth amendment, the Supreme Court rendered its first and perhaps most important decision on the issue of what constitutes taxable income when shareholders do not receive a cash or a property distribution. The case was *Eisner v. Macomber*, and it not only involved the issue of what constitutes “income” for personal income tax purposes, but also contained an important discussion of the corporation-shareholder relationship.

The facts of *Macomber* are relatively simple. Mrs. Macomber, a holder of 2200 shares of common stock of the Standard Oil Company of California, received a 50% stock dividend of common on common. The corporation reflected the issuance of this stock dividend on its books by capitalizing its surplus (i.e., by transferring an amount equal to the par value of the distributed shares from the surplus account to the capital stock account). Since the dividend shares were distributed pro rata to the holders of the common stock, the distribution did not change their proportionate holdings of common stock in any way. The Commissioner asserted that the receipt of the common stock dividend, to the extent that it represented the capitalization of post-1913 earnings, constituted income to the recipients. This position was supported by section 2(a) of the Revenue Act of 1916, which defined taxable dividends to include payments made by a corporation “out of its earnings or profits accrued since March 1, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, which stock dividend shall be considered income, to the amount of its cash value.” Mrs. Macomber maintained that a stock dividend was not income within the meaning of the sixteenth amendment and that the definition

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80. I.R.C. § 61.
81. 252 U.S. 189 (1920).
82. That is, she received an additional 1,100 shares of common stock.
of income in section 2(a) had overstepped constitutional bounds by including stock dividends, measured by earnings, as income.

In determining whether a stock dividend constitutes income, the majority began with the premise that income, in common parlance, may be defined as the "gain derived from capital, from labor, or from both combined." Interestingly, the government based its argument upon the same definition, but, according to Justice Pitney, it placed undue emphasis upon the word "gain" and ignored the words "derived from capital." In order to appreciate the impact of this difference in emphasis, it may be instructive to quote Justice Pitney's precise language:

"Derived—from—capital";—"the gain—derived—from—capital", etc. Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description.

Since the sixteenth amendment uses the phrase "incomes, from whatever source derived," Justice Pitney concluded that the common parlance meaning of income as "gain derived from" is implicit in the wording of the amendment; that income, in the constitutional sense, encompasses only that gain which is severed from capital and received or drawn by the recipient for his use and disposal.

The majority next considered whether a common on common stock dividend comes within this constitutional definition and concluded that it does not. A stock dividend, it was reasoned, severs nothing from capital; nothing from the shareholder's investment. On the contrary, it cements the earnings of a corporation into the corporate capital structure and in the end the shareholder has no more and no less than he had before. It is only when corporate assets are actually segregated from the common corporate fund and paid out to shareholders that income is "derived" from capital.

Even if the Macomber majority had not expressly rejected the view that income (in some sense) to the corporation is simultaneously and fully income (in some sense) to the shareholders, such a rejection appears, at first blush, to be implied by the Court's doctrine of realization: If a shareholder does not derive income from the capitalization of earnings and the distribution of

84. 252 U.S. at 207.
85. Id. (emphasis original).
86. Id. at 208-09.
stock dividends, he certainly does not derive income from the mere existence of undistributed corporate income. Justice Pitney, however, left nothing to the imagination. In discussing whether a stock dividend constituted income within the constitutional definition, he concluded that the result depends upon the nature of the corporation and the shareholder's relation to it:

Short of liquidation, or until dividend[s are] declared, [the stockholder] has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. . . . [A]s a stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return.87

We pause here to examine more closely the consistency of the Macomber holding with the concept of economic income developed above. Read very narrowly, Macomber holds that, absent a distribution, the earnings of a corporation may not be used, as such, to measure the amount of income experienced by shareholders. This holding is in line with our conclusion that the amount of corporate earnings should play no independent role in determining the income experienced by a shareholder. The Court was not presented with the argument that Mrs. Macomber could be taxed on her share of the income-period increase in the net worth of the corporation, computed on a capitalization-of-future-return basis. Thus, the dialectic of the Court aside, the holding can be explained in terms of economic income concepts: If a shareholder is to be taxed without a distribution, the earnings (past or current) cannot be the measure of the income. The proper measure is the stockholder's share of the rise or fall (over the relevant income period) in the capitalized-future-return net worth of the corporate firm.

Perhaps the Court sensed the impropriety of using the measure of income advanced by the government in Macomber. Unfortunately, the Court struck back with its exaggerated "severance" concept of income. Going still further, the Court suggested, in dictum, that distributions are income, presumably without adjustment of individual shareholder income for income-period changes in the corporation's capitalized-future-return net worth. This approach to distributions is clearly at odds with the economic concept of firm income, owner income, and the relationship between the two. Nevertheless, were it not for some further language in Macomber, we could perhaps pare away the Court's statements about the income significance of distributions

87. Id. at 208 (emphasis added).
and assume that the result in the case stems from the government's attempt to incorrectly measure income in the nondistribution context. But there are additional indicators in Macomber that there can be no income to shareholders, on any theory, without some sort of severance, such as a cash or property dividend or an exchange.

Macomber clearly chooses a tax theology which is based upon an extreme application of the entity theory of corporations. It is more than that, however. Justice Pitney did not, to be sure, specifically anticipate the economic definitions of firm and individual income, but he was aware of the possibility that an increase in corporate net worth (however reckoned), which increases the net worth of an individual shareholder by increasing the value of his investment, might be included in a shareholder's income tax base. Justice Pitney explicitly rejected this idea when he said that "a growth or increment of value in the investment" is not a gain "derived from" capital and hence not taxable under the sixteenth amendment.\footnote{Id. at 207 (emphasis original).}

Thus, even if the government had argued that Mrs. Macomber should be taxed on her pro rata share of income-period increases in the capitalized-future-return net worth of the corporation, the Court's opinion would probably have remained the same. It seems that the Supreme Court has not only adopted a tax theology based upon the separate legal and tax status of corporations and shareholders, but it has also rejected the implications of the economic definitions of firm and individual income. One can only conclude that the Macomber majority would have viewed as tax heresy any suggestion for the full integration of the corporate and individual income tax which would include corporate income in the income of the shareholder without a distribution or exchange.

Nonetheless, we reiterate the conclusion that, given the arguments advanced by the government in Macomber, the result of the case is in line with economic income analysis: Mrs. Macomber's income should not have been measured by the retained earnings of the firm in which she was a shareholder. The measure should have been her portion of the income-period increase in the net worth of the corporation, not on the basis of book or current asset values, but on the basis of a capitalization-of-future-returns. If there was no such increase, the Court was correct in saying that Mrs. Macomber would have been taxed on pre-income-period capital. Again, we point out that the Court's obiter statements about the income status of distributions are clearly inconsistent with economic income principles to the extent that the Court did not seem to require a recognition of the changes in net worth at the firm and shareholder levels.

It has been suggested by some tax commentators that the Macomber Court's apparent insistence upon severance as a sine qua non of income
status no longer represents the Supreme Court's tax theology. The orthodoxy of Justice Pitney's realization doctrine has been diluted by a reform movement which concedes the possibility that taxable income can arise without being severed from capital, labor, or a combination of both. The two cases most frequently cited as examples of this reformation are Helvering v. Bruun and Commissioner v. Glenshaw Glass Co.

Bruun involved the taxability to a lessor of improvements made by the lessee. The lessee had erected a new building upon the leased premises in 1929. In 1933, he defaulted on the lease and it was cancelled. Pursuant to the terms of the lease, the improvement erected by the tenant became the lessor's property. The Commissioner asserted that the value of the improvements as stipulated by the parties constituted taxable income to the lessor in 1933, the year in which the lease was forfeited. The lessor argued that a nonseverable improvement to real property had no separate and distinct value apart from the realty; therefore, the value of the improvement could not be realized as taxable gain until the disposition of the entire property.

The ruling in Bruun that the value of the improvement was taxable upon the forfeiture of the lease in 1933 does limit the role of Justice Pitney's definition of income to an expression of the distinction between a cash or property dividend (a distribution of corporate profits) and a stock dividend (which is not a distribution of corporate profits). However, the Bruun court did not abandon the realization or derivation requirement. It specifically noted that although

> economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction.

While this language expanded the category of realization-by-exchange transactions beyond those involving a sale for cash, it did not eliminate the requirement of a realization transaction. The Court merely concluded that the repossession of a newly improved demised premises constituted an exchange-type realization transaction, despite the lack of complete severance:

> It is not necessary to the recognition of taxable gain that [the lessor] should be able to sever the improvement begetting the gain

89. See note 10 supra.
90. 309 U.S. 461 (1940).
92. 309 U.S. at 469.
from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.\footnote{Id.}

Clearly, the Court was referring to a physical severance of the improvement; to read this last statement as an elimination of the realization requirement is to do violence to the language of the opinion. Even if this statement can be read to eliminate the need to "sever" gain from the original investment, it would not apply to the corporation-shareholder relationship where \textit{Bruun} apparently concedes that the realization requirement continues to apply. \textit{Bruun} says nothing about the corporation-shareholder relationship as such. Moreover, the Court's recognition that "economic gain is not always taxable as income" is a clear statement that the Court is not adopting an economic definition of income which would permit all economic gain, whether realized or not, to be included in the tax base.\footnote{"While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset." \textit{Id.}}

\textit{Glenshaw Glass} similarly disclaims adherence to the income definition in \textit{Macomber}, but, like \textit{Bruun}, it does not do away with the realization requirement. The issue in the case was the taxability of windfall income in the form of exemplary and punitive damage awards as a result of fraud and antitrust violations. The taxpayer argued for a restrictive reading of section 22(a) of the Internal Revenue Code of 1939 (the predecessor of the present section 61) which defined income to include "gains or profits . . . derived from any source whatever." The taxpayer also cited the income definition of \textit{Macomber} to support the nontaxability of windfall income. The Court found that exemplary and punitive damages were taxable and stated that, while the \textit{Macomber} definition was useful in distinguishing gain from capital, "it was not meant to provide a touchstone to all future gross income questions."\footnote{348 U.S. at 431.} The following language from \textit{Glenshaw Glass} is perhaps the most important: "Here we have instances of undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion."\footnote{\textit{Id.} (emphasis added).}

In assessing the impact of the foregoing cases, several distinctions must be noted. First, \textit{Bruun} and \textit{Glenshaw Glass} dealt with realization by exchange. Hence, their significance in the corporation-shareholder context is strongest where there is an event constituting a shifting of shareholder rights—some set of circumstances that can be called an exchange. Their import is weakest where there is no distribution and no other change in shareholder rights, not even of the minor type connected with a stock dividend. But if \textit{Bruun} and \textit{Glenshaw Glass} have meaning for the nondistribu-
tion, no-rights-shifting situation, they cut more strongly in favor of permitting an economic income system of integration (of the sort described in topic IV. A.) than a system that would measure shareholder income simply by the amount of firm earnings and tax the shareholder on his pro rata share thereof. Bruun and Glenshaw Glass emphasize the importance of dominion and control over increments to wealth. In the nondistribution situation, an economic income system includes in the individual's tax calculation only a portion of the income-period increase or decrease in the capitalized-future-return net worth of the corporation. This amount (if positive) is an increment to the wealth over which the shareholder has dominion and control, especially if the shareholder's portion of the increase in corporate net worth is measured by the income-period change in the value of the shares which he owns.

By contrast, a system that would tax a shareholder on undistributed earnings is one that attributes to the shareholder an amount by which the shareholder may not have been enriched. (If there is a corporate earnings deficit, the shareholder gets a deduction for an amount by which he may not have been made poorer.) A corporation may have income-period earnings and, though the earnings are retained, suffer a decrease in its capitalized-future-return net worth for the same period. Under these conditions, the proprietorship sector of the firm has not experienced any increase; indeed, it has become worse off over the income period. Looking at the other side of the coin, we say that the firm aspect of the shareholders' wealth has not been enhanced; it has shrunk. Moreover, a shareholder has virtually no dominion and control over a dollar value attributed to him by reference to corporate earnings, when that amount is not matched by an increase in the value of the shares that he owns.

The import of the two preceding paragraphs is really implicit in the portfolio and capital market theory debate mentioned earlier. That discussion yields the conclusion that, distributions aside, a shareholder continuously captures, through his stock ownership, not the dollar amount of current earnings of the corporation, as such, but rather changes in the present discounted value of a stream of future returns. This present discounted value is a function of the expected amounts of those returns, their timing, the rate of interest demanded for riskless securities, the premium return demanded for the risk or uncertainty connected with returns, and the characteristics (including imperfections) of the market in which the security is bought or sold.

Proponents of integration of the simple imputation-of-earnings type will undoubtedly argue that Congress is no longer bound by the Macomber view of the corporation-shareholder relation, as evidenced by its straight imputation-of-earnings treatment of certain corporations and shareholders. Perhaps the most dramatic example of this congressional departure from the
established scheme of corporation-shareholder taxation is Subpart F of the Internal Revenue Code,\textsuperscript{97} which deals with the income of controlled foreign corporations.

Subpart F was enacted in 1962\textsuperscript{98} as part of the Kennedy administration's attempt to deal with the rapidly increasing outflow of capital from the United States. More specifically, Subpart F was designed to deal with the deferral of taxes by domestic corporations operating abroad through controlled foreign subsidiaries. Under established jurisdictional principles, the income of a foreign subsidiary of a domestic parent could not be subjected to United States corporate income tax. Under the same principles, those foreign subsidiaries, by engaging in sales and service activity in a country which did not tax corporate income, could avoid the corporate tax in the country of their incorporation.\textsuperscript{99} Consequently, the income from foreign operations, when conducted through a foreign subsidiary, could be sheltered from United States corporate income tax until it was "repatriated" in the form of distributions to the domestic shareholder (usually a domestic corporation). Subpart F attacked this deferral device by attributing to certain United States shareholders their pro rata share of the earnings and profits of the controlled foreign subsidiary derived from certain activities.\textsuperscript{100} The activities which give rise to "Subpart F income" are (a) the purchase or sale of personal property manufactured outside the country of the subsidiary's incorporation, where a "related party," usually the parent corporation, is at either the selling or buying end of the transaction;\textsuperscript{101} and (b) the rendering of services abroad by the subsidiary on behalf of a related party, where the services are not rendered in the country of incorporation.\textsuperscript{102} Income which qualifies as "personal holding company income" under section 543 of the Internal Revenue Code will also be treated as Subpart F income.\textsuperscript{103}

It appears that the purpose of Subpart F, the attribution of corporate income to the shareholder, represents a congressional departure from the realization principles of \textit{Macomber}. However, the Supreme Court has not been called upon to test the constitutionality of Subpart F, and given \textit{Macomber}, its constitutionality must be regarded as open to question. It has been suggested that, in view of the possible continuing vitality of \textit{Macomber}, the constitutionality of attribution of Subpart F income to shareholders is so

\textsuperscript{97} I.R.C. §§ 951--64.
\textsuperscript{99} See discussion in B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 279 (2d ed. 1968).
\textsuperscript{100} I.R.C. § 951(a).
\textsuperscript{101} Id. § 954.
\textsuperscript{102} Id.
\textsuperscript{103} Id.
highly questionable that the provisions may be unsupportable.\textsuperscript{104} That, perhaps, is the very least that can be said. One could go farther and suggest that because Subpart F ignores the realization requirement, it is clearly unconstitutional. One writer, John W. Dowdle, Jr., has flatly concluded that Subpart F is unconstitutional on the basis of Macomber.\textsuperscript{105} In support of his contention, Mr. Dowdle cited the Supreme Court's refusal to overrule Macomber despite the specific request of the Department of Justice to do so in Glenshaw Glass.\textsuperscript{106} Mr. Dowdle correctly pointed out that, while the Court appears to have abandoned the Macomber definition of income as a touchstone to all further gross income questions, it nevertheless found that the definition serves a useful purpose in distinguishing gain from capital. Thus, as late as 1955, the Court had not changed its mind about Macomber, at least insofar as that decision applies to the corporation-shareholder relationship for tax purposes.\textsuperscript{107}

If, in fact, there are serious doubts as to the constitutionality of Subpart F, then why has no taxpayer seen fit to contest its provisions? There is no clear answer to this question, but one might draw a distinction between domestic corporations which are subject to the corporate income tax and foreign corporations which are not, even though they are controlled by United States shareholders. In the latter case, the controlled foreign corporation is being used by the United States shareholder as an avoidance device. In such situations, it is possible that Congress' plenary power to protect the revenue is sufficient to overcome constitutional objections to the tax. A similar argument was advanced by congressional proponents of section 334 of the Revenue Act of 1937,\textsuperscript{108} which provided for the inclusion of the undistributed income of foreign personal holding companies in the gross income of United States shareholders.\textsuperscript{109} Presumably, the same argument would apply to Subpart F. Moreover, the use of controlled foreign corporations to

\textsuperscript{105} Dowdle, Can Domestic Shareholders Be Taxed on Foreign Corporate Earnings Prior to Distribution?, 40 TAXES 436 (1962).
\textsuperscript{106} Id. at 445.
\textsuperscript{107} Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). See also Dowdle, supra note 105, at 445.
\textsuperscript{108} Ch. 815, § 334, 50 Stat. 820.
\textsuperscript{109} In the words of one Congressman:
The philosophy in regard to foreign personal holding companies is based upon the inherent power in the Government to protect itself from devices to avoid and evade its law. . . . We feel certain that the jurisdiction over American taxpayers and income to our citizens, together with the power to protect our revenues are ample legal support for our position.
81 CONG. REC. 9035 (1937) (remarks of Rep. Vinson). It is interesting that Congress did not adopt this approach in dealing with the undistributed income of domestic personal holding companies.
avoid the corporate income tax and to defer repatriation of foreign source income does not add to the litigation appeal of such cases.\textsuperscript{110} Whatever the situation with respect to Subpart F, it is clear that no "protection of the revenue" argument can be made with respect to domestic corporations.

Subpart F may also represent a situation where the earnings of a controlled corporation are to be treated as essentially "distributed" to the controlling corporation, because the latter has broad dominion and control over them. Of course, if \textit{Macomber} and subsequent Supreme Court cases sanction the constitutionality of Subpart F on such a dominion-ergo-distribution rationale, they might also support a straight imputation-of-earnings type integration scheme with respect to corporations that are closely controlled by individuals. From an economic income point of view, however, the amount of a distribution should not be the end of the calculation of how much income a shareholder experiences. The shareholder should also be able to recognize, as an element of individual income, his share of the firm's capitalized-future-return change of net worth during the income period. This observation isolates the inconsistency between the economic concept of income and the \textit{Macomber} dictum regarding the manner in which corporate distributions enter an individual's income picture. This point is as important as the comparisons that we have drawn between \textit{Macomber} and the economic notions of income in the nondistributional context.

But those who cite existing, unchallenged imputation-of-earnings systems of taxation as evidence that \textit{Macomber} is a dead letter have a more powerful argument than Subpart F. They can point to an instance of earnings imputation where it is well-nigh impossible to find enough control to establish a distributional equivalent. Limited partners, who are prohibited from exercising day-to-day managerial authority, and whose dominion and control over partnership earnings is no greater—perhaps even less—than that of a shareholder in a publicly held corporation, are taxed on their pro rata shares of undistributed firm earnings, except where the partnership is taxed as a corporation. Paradoxically, one of the factors that increases the risk of corporate tax treatment may be the granting of more than nominal control to limited partners.\textsuperscript{111} There is a dryly conceptual response to the assertion that this instance of earnings imputation is conclusive evidence that every vestige of \textit{Macomber} must have expired. The retort is simply this: \textit{Macomber} said that corporations are entities and partnerships are not; there-

\textsuperscript{110} Another likely reason for the dearth of litigation is that, prior to the thorough amendment of Subpart F by the Revenue Act of 1975 and the Tax Reform Act of 1976, there were so many exceptions to the application of the law that a controlled foreign subsidiary could easily find a statutory safe haven which would prevent the imputation of corporate earnings to U.S. stockholders. Needless to say, this would make it unnecessary to attack Subpart F on constitutional grounds.

\textsuperscript{111} See authorities cited in note 55 supra.
fore it is cricket to impute undistributed earnings to limited partners, while the same tax approach to corporations is constitutionally off limits. Unfortunately, the entity distinction between corporations and limited partnerships—comparing shareholders with limited partners—is arrant *petitio principii*. The entity description of corporations is a metaphor which depicts a corporation as a "person," separate and distinct from its owners, only because the business association law ground rules for operating a firm in the corporate form create a separation between the asset pool of the corporation and its shareholders *for particular purposes*. When we see a block of assets operated in a single name, with operational liability to third parties running only from that asset pool (and not from individuals), and with shareholders not handling the day-to-day conduct of affairs, we tend to call the phenomenon a "person," but the term is just a shorthand for the specific characteristics that prompted us to use it in the first place. We do not say that the phenomenon is a person in the complete sense of an individual. What is more important for present purposes, the very attributes of separation that lead us to depict "corporateness" as a sort of ectoplasmic generator of a "person," distinct from shareholders, should lead us just as easily—perhaps even more easily, because limited partners' supervisory rights are more attenuated—to predicate the same separateness between limited partners and the partnership. The situations of limited partners and shareholders of a publicly held corporation appear to be very much alike as far as "severance" and "dominion" are concerned.

Thus, there may be considerable force in the argument that the continued survival of our system of taxing limited partners means that *Macomber* has gone the way of the dodo. But a critical element in the argument is the absence of constitutional challenge to the limited partnership tax system. There may be some fairly strong practical reasons why imputation of the undistributed earnings and losses of limited partnerships has not been attacked in the Supreme Court; by and large, limited partners *want* the pass-through of partnership tax attributes. If such an attack were mounted, however, the fundamentally identical positions of shareholders and limited partners might bring the Court out swinging. The "severance" and "dominion" tests lie in solution, ready to be precipitated when the proper catalyst is supplied. It might be the ultimate irony—and yet perfectly plausible—for a limited partner to argue that he cannot be constitutionally taxed on his share of undistributed firm earnings, because of the lack of severance and dominion, while at the same time his partnership argues that it cannot be taxed as a corporation under the tests of the Commissioner's own regulations!112

112. "An organization will be treated as an association [taxable as a corporation] if the corporate characteristics are such that the organization more nearly resembles a corporation than a
In 1975, the Supreme Court decided *Ivan Allen Co. v. United States,* a case involving the issue of whether the unrealized appreciation of a corporate taxpayer’s portfolio securities could somehow justify the imposition of the penalty tax on the unreasonable accumulation of earnings. The Court held that unrealized appreciation does have an important bearing on whether the corporate taxpayer intended to accumulate earnings beyond its reasonable needs, but the Court clearly distinguished the issue of the reasonableness of accumulations from the question of the penalty tax base. In no uncertain terms, the Court repeated the prohibition against including unrealized appreciation in "income." Though the case involved unrealized appreciation at the corporate level only, and did not involve a discussion of interlevel relationships between corporation and shareholder, the categorical tone of its statements cannot be ignored. The tenor is reminiscent of the broad language of *Macomber,* suggesting that economic gain, of whatever sort, is not income unless severed by distribution or exchange. *Ivan Allen* may well be a signal that *Macomber* continues to spell trouble for either a straight imputation-of-earnings or an economic income system of including, absent a distribution, some corporate-source factor in the individual shareholder’s income base.

**C. Specifying the Implications of Macomber**

It would be unfair and inaccurate to dismiss *Macomber* as a relic of yesteryear, based simply upon an outworn and arbitrary view of the nature of the corporation. Though it may, in its broadest reading, be plainly out of line with the economic view of the corporation, the opinion nevertheless, in partnership or trust.” Treas. Reg. § 301.7701-2(a) (1976). See also authorities cited in note supra.

113. 422 U.S. 617 (1975).

114. The Court made the following statements:

What is essential is that there be "income" and "earnings and profits." This at once eliminates, from the measure of the tax itself, any unrealized appreciation in the value of the taxpayer’s portfolio securities over cost, for any such unrealized appreciation does not enter into the computation of the corporation’s "income" and "earnings and profits."

422 U.S. at 627. And again:

The taxpayer, of course, quite correctly insists that unrealized appreciation of portfolio securities does not enter into "earnings and profits," . . . As noted above, we agree. . . . The question is not whether unrealized appreciation enters into the determination of earnings and profits, which it does not . . .

422 U.S. at 632-33. The Court also cited, without any hint of criticism, a prior Second Circuit case which had indicated that an attempt to tax shareholders on undistributed unreasonable accumulations would be unconstitutional. 422 U.S. at 625 n.8. The Court described *Macomber* as a case which "emphasizes the realization of income with respect to a tax on a shareholder." 422 U.S. at 634.
its narrowest reading, states a defensible position. We tend to forget that the
Court had experienced some difficulty with the constitutionality of the in-
come tax prior to the adoption of the sixteenth amendment. The origin of
that difficulty lay in article I, section 9, clause 4 and article I, section 2,
clause 3 of the Constitution, which require that any direct tax must be ap-
portioned among the states in accordance with the census enumeration. In a
pre-sixteenth amendment case, Pollock v. Farmers' Loan & Trust Co.,\(^{115}\)
the Court had determined that a tax on the income from property was a
direct tax on the property itself and hence unconstitutional if not appor-
tioned according to the population in the several states. The adoption of the
sixteenth amendment cleared the way for the taxation of income from prop-
erty. The Court was left, however, with the difficult task of distinguishing
between income and capital, since any attempt to tax capital would violate
the constitutional provision.

Given this background, and lacking any systematic concept of economic
income, the Court hit upon the idea of "severance" as a means of disting-
guishing capital from income. The Court was willing to concede that app-
preciation in the value of property was a form of economic gain, but it could
not concede that all economic gains were income. Such gains became in-
come only when severed from the underlying capital. Justice Pitney sum-
marized the distinction: "[T]he Amendment applies to income only, and
what is called the stockholder's share in the accumulated profits of the com-
pany is capital, not income."\(^{116}\) The concept of severance became the in-
strument which enabled the Court to distinguish between income, on which
a direct tax was permissible without apportionment, and capital, on which a
direct tax was permissible only if apportioned. Therefore, the discussion of
the nature of the corporation-shareholder relationship in Macomber is sec-
ondary to Justice Pitney's statement of how severance affects the characteri-
zation of undistributed corporate profits.

It is not difficult to find fault with the Macomber opinion. The word
"derived" need not have been contorted in order to equate it with the idea
of severance. The word can mean "traced from" or "developed from" as
easily as it can mean "severed from."\(^{117}\) Had it been so defined, the idea of
severance would not have lured the Court into a constitutional corner from
which it cannot easily extricate itself.

\(^{117}\) See, e.g., WEBSTER'S NEW INTERNATIONAL DICTIONARY 705 (2d unabr. ed. 1958). The
definition of the word "derive" is "to trace the origin." Nowhere is it suggested that something
must be severed from the source or origin to be "derived." It is also interesting to note that, in
groping for a definition of income, the Court deliberately avoided economic definitions and
specifically opted for the "common speech" definition. 252 U.S. at 206-07. After citing several
common reference dictionaries, the Court determined that those sources had nothing of value to
If confronted with a nondistribution case today, the Court might concede that the appreciation in the value of corporate stock, computed on a capitalization-of-future-returns basis, is an accession to wealth and hence taxable as income to the shareholder because such appreciation is subject to his dominion and control. The Court might be influenced by the economic definition of income and could say that (1) since the appreciation in corporate stock values can be easily realized by a sale of all of the stock, and (2) since this realization can be accomplished by a mere ministerial act (calling one's broker), then the appreciation should be considered as an accession to wealth under the dominion and control of the shareholder. At the same time, the Court might adopt the views of Richard B. Goode, for example, and conclude that, in a large modern corporation, the shareholder is so removed from the seat of corporate power that it is unrealistic to think of corporate earnings as being within his dominion and control.\(^{118}\)

*Macomber* continues to cast a long shadow, however. It is difficult to escape the impact of Justice Pitney's plain statement that a stockholder's share of accumulated corporate earnings is capital, not income, and therefore not taxable under the sixteenth amendment. That difficulty is not ameliorated by taxing the appreciated value of the securities on an economic income rationale. When Justice Pitney held that not all economic gains were income, he placed a severe limitation on congressional freedom to deal freely with the income concept. In concrete terms, he may have ruled out that portion of the Haig-Simons definition of income which treats unrealized increases in net worth as income.

No matter how the Court deals with the specific definitional problem of the sixteenth amendment, it will not readily relinquish its obligation to interpret article I, section 2, clause 3, and article I, section 9, clause 4, and the sixteenth amendment. The Court will continue to search for some concept which will enable it to differentiate between capital and income.\(^{119}\)

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\(^{118}\) R. Goode, *supra* note 74, at 186-87.

\(^{119}\) Justice Pitney felt rather strongly that it was the Court's duty to protect the integrity of article I, section 9, clause 4, which calls for apportionment of direct taxes according to the population. He therefore called for a strict construction of the sixteenth amendment:

> A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

Before critiquing proposed corporation-shareholder tax systems according to their conformity with constitutional and economic income principles, we shall recapitulate our conclusions with respect to the Macomber line of authority and its compatibility with economic income concepts. We believe that Macomber is susceptible of three principal readings, two dealing with income in the nondistribution context, and a third relating to distributions. We submit them as follows:

1. **Narrow holding—no distribution.** Absent a distribution, the income of individuals may not include a pro rata share of undistributed earnings, as such. Undistributed earnings do not, *per se*, measure the amount by which a shareholder is richer, and, in a widely held corporation, the shareholder has no control over them. This holding is consonant with economic income concepts, and, if economic income is to be the tax base, this version of Macomber should not be overruled. This narrow reading might admit of a corporation-shareholder tax system that would, under nondistribution conditions, cause the capitalized-future-return net worth changes of the firm to be reflected in the income of individuals. These fluctuations represent accessions to the wealth of individuals over which they have dominion and control.

   If dominion and control become the prime tests, Macomber, as expanded, might also be read to permit an imputation of firm earnings to shareholders in a closely controlled corporation situation.\(^{120}\) This approach, which treats the corporate earnings as essentially distributed, is at odds with economic income concepts, because a share of earnings may be more or less than the amount by which the shareholder is enriched. If economic income is the desired tax base, the dominion-ergo-distribution constitutional interpretation should not be adopted.

2. **Broad holding—no distribution.** The sweeping language of the Macomber Court might preclude an economic income approach which would allow fluctuations in the firm’s capitalized-future-return net worth to be reflected in individual income. The likelihood of this constitutional result seems enhanced by the robust language of Ivan Allen. If economic income is the normatively preferred tax base, this broad interpretation of Macomber must be avoided, or, if it cannot be avoided, Macomber must be overruled *pro tanto*.

3. **Dictum regarding distributions.** Macomber may be read to legitimize the inclusion of cash or property distributions, as such, in the income of shareholder recipients, without any adjustment for

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120. See, e.g., General Revenue Revision: Hearings on H.R. 1275 Before the House Comm. on Ways & Means, 83 Cong., 1st Sess. 454 (1953) (proposal of Rep. Multer). No doubt, any such scheme would encounter administrative and practical problems unrelated to Macomber. See statement of Mr. Antoine, *id.* at 560, 562. See also the discussion of Subpart F in topic IV. B. *supra.*
income-period changes in the capitalized-future-return net worth of the distributing firm. This approach is repugnant to economic income concepts because the economic income of the firm, and hence the economic income of individuals, may be more or less than the dollar amount of the distribution.

V. INTEGRATION AND ITS INFINITE VARIETY: THE PRINCIPAL PROPOSALS

There is little chance that an integration scheme which calls for total abolition of the corporate income tax and the direct imputation of corporate earnings to shareholders can be adopted in the United States, except, perhaps, where a corporation is closely held. Such a scheme would require a major upheaval in the constitutional meaning of income, a rejection of the narrow holding of Macomber, and the abandonment of the dominion and control doctrine, which is simply not likely to happen. There are several other integration schemes, however. Each of the major ones should be examined to see how it might fit into the framework of the Macomber implications, and how it squares with economic income concepts.

One possible variation of the integration scheme which is proposed by some authorities is the present Canadian system of the “grossed-up” dividend. Under this system, the corporation continues to pay tax on its income at a relatively high rate (46% in Canada). The shareholder is then required to include in his income the entire amount of dividends received plus one-third of that aggregate amount (called the “grossed-up dividend”). The shareholder then receives a credit against his tax of approximately one-third of the actual dividend.\(^{121}\) An example will illustrate the operation of the grossed-up dividend credit. Assume that a Canadian shareholder in the 40% tax bracket receives a dividend of $300 from a Canadian corporation. His grossed-up dividend is $400 (actual dividend of $300 plus one-third). The tax at 40% on $400 is $160. A credit of 20% of the grossed-up dividend of $400 (or 80% of $100) is then subtracted from the tax of $160, so that the net tax payable by the shareholder will be $80.\(^{122}\)

While this system is only an intermediate approach to full integration, it is nevertheless grounded upon the rationale that a corporation is essentially an aggregate of its shareholders and that the corporate tax is merely an advance payment of the shareholders’ tax. An analysis of the example indicates that a portion of pretax corporate earnings is imputed to the shareholder

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122. This calculation is somewhat imprecise because it does not take into account provincial taxes, which are added after the application of the credit. The combined dominion and provincial tax is actually reduced by approximately the amount of the gross-up.
who pays tax upon it at his regular marginal rate. The taxpayer then receives a credit for a portion of the corporate tax attributable to the income distributed to him, thus alleviating the double tax burden which would otherwise apply. By contrast, in a full imputation system using the grossed-up dividend approach, the shareholder would be taxed, at his marginal rate, on the amount of corporate earnings needed to produce, after corporate-level taxes, the amount of the dividend. He would similarly receive a credit for the corporate tax on the gross amount of earnings needed to produce, after corporate-level taxes, the amount of the dividend. Depending upon the corporation's tax rate and the shareholder's individual marginal tax rate, this system of imputation would produce either a refund or an additional tax. Canada has obviously gone less than half way to the full imputation system.\textsuperscript{123}

While even the narrow holding of \textit{Macomber} stands, it is doubtful that the Canadian scheme could be adopted in the United States, except possibly for closely held corporations. The scheme still assumes the economic unity of shareholders and corporations and imputes corporate earnings, as contrasted with economic income, to the shareholder. The fact that the Canadian system imputes only some corporate income to the shareholder does not cure the basic constitutional limitation imposed by \textit{Macomber}.

Another integration scheme, the "split-rate" system, was adopted in West Germany in 1953. Under this scheme, the corporation pays a high rate of tax (51\%) on its undistributed earnings and a much lower rate (15\%) on its distributed earnings. Integration is thus achieved at the corporate level by the virtual elimination of the tax on distributed earnings.\textsuperscript{124}

The German split-rate scheme is similar to the system we employed during 1937–1939, in which integration at the corporate level was achieved by allowing a deduction for dividends paid. The Scandinavian countries of Finland and Norway use this approach. In Finland, for example, the corporation is permitted to deduct 40\% of dividends paid. In Norway, the corporation is permitted to deduct 100\% of dividends paid. In both countries, the corporation continues to pay tax at the applicable corporate rate on its undistributed income, while the shareholder pays tax at his normal marginal rate on the dividends received. No credit or imputation is required.\textsuperscript{125}

\textsuperscript{123} The Carter Commission did, in fact, propose a full imputation system using a grossed-up dividend approach. \textit{See} 4 \textit{REPORT OF THE ROYAL COMMISSION ON TAXATION} (Carter Commission Report), ch. 19, at 83 (1966). Under the system proposed by the Carter Commission, a resident shareholder would receive a credit against his personal tax on account of corporate income tax paid in respect of after-tax corporate earnings paid or imputed to him. If the credit exceeded his tax liability, he would receive a refund.

\textsuperscript{124} These provisions are discussed in \textit{BOARD OF INLAND REVENUE, 3 INCOME TAXES OUTSIDE THE UNITED KINGDOM} 58–59 (1975) (U.K.) [hereinafter cited as \textit{INLAND REVENUE}].

\textsuperscript{125} Income & Capital Tax Law, Law of Nov. 19, 1943, No. 88, as \textit{amended}, Law of June 24, 1968, Nos. 360–62 (Fin.), \textit{discussed in 3 INLAND REVENUE, supra} note 124, at 58–59; \textit{Com-
Aside from the compulsion toward distribution associated with the dividends-paid or split-rate systems, practical differences between the credit system and the split-rate or dividends-paid deduction system are insignificant. So long as the corporation maintains a proper distribution schedule under the split-rate or dividends-paid deduction regime, both systems accomplish partial integration by subjecting some portion of corporate earnings (namely, distributions) to individual ordinary income rates only. The choice between the credit system and the split-rate or dividends-paid deduction system is often made primarily on the basis of the effect of the choice on the taxation of nonresident shareholders. Where integration is accomplished by either the split-rate or the dividends-paid deduction system, the corporation pays a lower tax regardless of the place of residence, nationality, or domicile of its shareholders. Such a feature is important, since in some countries the ubiquity of foreign shareholders, mainly United States citizens, has begun to offend the country of incorporation. A credit or imputation system of integration can discriminate against foreign shareholders by simply disallowing the credit to nonresidents. On the other hand, the split-rate and the deduction systems may actually favor nonresident shareholders who are not subject to the host country's graduated income tax, or who, by treaty arrangements, are excused from a substantial amount of that country's withholding taxes on dividends. In Canada, for example, the Carter Commission regarded the idea of permitting a dividend deduction as reasonable. However, the Commission chose not to recommend corporate level integration precisely because it would enrich foreign shareholders at the expense of Canadian tax revenues.126 This objection to corporate level integration is not especially persuasive in our own situation. The United States is not, as yet, overwhelmed by foreign investors who can escape the individual tax rates by virtue of tax treaty arrangements.

Integration by way of the dividends-paid deduction at the corporate level, with only distributions being included in shareholder income, offers a workable compromise with Macomber. A deduction at the corporate level for dividends paid does no violence to the Macomber concept of the separate status of corporations and shareholders. In theory, such an approach faces up to the economic logic that follows from the adoption of a separate entity concept. It recognizes, in a partial way, that a shareholder is a provider of capital who expects payment for the use of that capital. Unlike the present

system, whereby interest on corporate indebtedness is deductible but dividends on equity capital are not, amounts paid for the use of all capital would receive more nearly equal treatment.

Throughout this article, we have sought to show that abolition of the corporate level tax can be justified by an analysis of the relationship between firm economic income and individual economic income. We have suggested that all firm economic income is fully included in the totality of individual economic income. Our focus, therefore, has been on the intimacy between the corporation and its shareholders, with the economic income concept serving as the bond between them. Here we digress to demonstrate how, even if the separate taxpayer status of a corporation must be taken as a given, economic reasoning would still yield the conclusion that the corporation should pay no tax. Our present system of taxation generally recognizes the principle that a firm taxpayer (i.e., a taxpayer engaged in production) should be allowed deductions for all economic costs except opportunity costs. Opportunity costs and pure profits are fundamentally the firm's taxable income base. An opportunity cost is the normal profit earned on endowments owned by the taxpayer. The price paid for capital not owned by the taxpayer is a cost other than an opportunity cost. If we must assume that a corporation is a taxpaying entity separate and distinct from its shareholders, it follows that all payments made for the use of capital, debt or equity, are costs other than opportunity costs, since the corporation has no endowment of its own. And the dollar cost of corporate equity is the entire operational return (distributed or not) attributable to equity. Therefore, all receipts of the corporation are offset by nonopportunity costs, and, by today's tests, there is no taxable income. The argument does not offer the more satisfyingly comprehensive view of firm and firm-owner wealth-change relationships developed earlier, but, if we are forced (say, by the Supreme Court) to accept the separate taxpayer status of corporations, the conclusion that corporations ever have normal profits, let alone pure profits, is economically puzzling. The dividends-paid deduction and the split-rate systems forthrightly, albeit only partially, alleviate the puzzlement.

Similar treatment for the cost of debt and equity capital could, of course, be achieved by disallowing a deduction for the cost of either one and not necessarily by allowing a deduction for both. Professor Alvin C. Warren, Jr., has suggested that doing away with the interest deduction is the only real alternative: A deduction for dividend payments is, in his view, simply not politically feasible and is therefore too remote a possibility to merit serious consideration.127 Suggestions for integration of the corporate and individual

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income taxes would indeed face an uphill battle, but there appears to be considerable momentum behind such a proposal. It is now being openly and seriously discussed by Congress as well as by government officials, commentators, and economists.

Since the idea of a deduction for dividends paid is clearly not subject to the strictures of Macomber, it may provide the most likely vehicle for integration in this country, particularly since it is unlikely that the Court will overrule Macomber to make way for an imputation-of-earnings scheme.

For a short period of time between 1937 and 1939, corporations were permitted to deduct dividend distributions. Although it is not entirely clear why, this system of partial integration was met with widespread opposition from corporate management. It appears that directors felt considerable pressure from shareholders to make dividend distributions in order to reduce corporate taxes and thus increase the return on shareholder investment. If successful, shareholder pressure for distribution of earnings would have decreased the amount of internal funds which were available for investment and would have fostered greater reliance on capital markets, a result management preferred to avoid. Clearly, this pressure to distribute would adversely affect the "growth" company which has traditionally financed its projects through retained earnings. It would also eliminate the practice of accumulating simply for the purpose of providing a tax advantage to shareholders, a course of conduct that results in overcapitalization and perhaps a shortage of funds for immediate application to capital formation.

The present complex of corporate and individual taxes, including the low capital gains rate, the deferral of tax on appreciation in value until the sale of the stock, and the possible escape from tax of pre-1977 gains under section 1014(a) of the Code, favor investment in the low-payout company. If this complex of advantages is offset by the higher net return on distributions, the low-payout firm may, as a result of shareholder pressure, be a thing of the

129. See paragraph four of note 36 supra.
130. Prior to the amendment of section 1014(a) by the Tax Reform Act of 1976, Pub. L. No. 94–455, 90 Stat. 1520, the basis of property acquired by bequest, devise, or inheritance from a decedent was the fair market value at the date of death. Thus, any appreciation in value from decedent's date of acquisition to decedent's date of death was never subjected to income taxation. The Tax Reform Act of 1976 provides a so-called "fresh start" provision. For purposes of determining gain, section 1023(h) now provides that, with respect to property acquired from a decedent who died after December 31, 1976, the basis shall be the higher of the actual cost to the decedent or the fair market value of the property on December 31, 1976. Pub. L. No. 91–164, § 317, 90 Stat. 1520. The step-up in basis applies only to property acquired through a decedent who owned the property on December 31, 1976, or from a trust which held the property on that date.
past, but there will be gains in economic neutrality\textsuperscript{131} and tax equity.\textsuperscript{132} Offsetting these gains are the transaction costs that must be incurred by a corporation that would, absent tax motivations, accumulate earnings for new internal operating projects. Such a firm must distribute and then engage in a costly fund-raising effort.\textsuperscript{133}

Thus far we have mentioned schemes that will achieve only partial integration. Full integration means that all corporate-source income is taxed only once to individual shareholders at their marginal bracket rates for ordinary income. The credit (gross-up), split-rate, and dividends-paid deduction formats provide only partial integration, because they achieve the integrative objective only with respect to distributed corporate-source earnings. This is so because, in all three schemes, a cash or property dividend is a necessary step in the mechanical accomplishment of integration. Full integration (reaching all corporate-source income, and not just distributions) is sought by those who see greater allocative efficiency and equity in every additional move toward the ultimate. The typical proposal for full integration calls for imputation of undistributed earnings to shareholders. This system, of course, runs most squarely afoul of Macomber, except, perhaps, in the context of a closely held corporation.

Measured by economic income criteria, none of the systems mentioned in this section passes muster. None seeks to assure that only the economic income of a firm enters the tax base. The partial integration schemes tax distributions to individuals without any adjustment for changes in the capitalized-future-return net worth of the firm,\textsuperscript{134} and the income significance of a distribution may well be gauged somehow by current or prior retained earnings.\textsuperscript{135} Moreover, the partial integration schemes tax, at the corporate level, undistributed current earnings as such, instead of looking

\textsuperscript{131} See discussion in topic III. A. supra. Neutrality would be furthered on four fronts: (1) allocation of wealth between consumption and saving, see note 29, fifth paragraph, and text accompanying note 35 supra; (2) allocation of the capital factor between corporate and noncorporate production, see text accompanying notes 31–34 supra; (3) allocation of wealth between high risk and low risk real asset projects, see note 29, sixth paragraph, supra and accompanying text; and (4) allocation of consumption deferral between financial investments that lead to immediate formation of real capital and those that do not, see note 29, third paragraph, and note 36, fourth paragraph, supra.

\textsuperscript{132} See discussion in topic III. B. supra.

\textsuperscript{133} Were it not for the repugnance of its imputation aspect to Macomber, the credit (or gross-up) system would furnish an acceptable method of achieving greater flexibility on the timing of distributions. The Carter administration appears to be leaning towards the gross-up approach. See FORBES, Aug. 1, 1977, at 21.

\textsuperscript{134} See pp. 917–18 supra.

\textsuperscript{135} Id. Some commentators have called for the abandonment of an earnings test for gauging the income significance of a distribution. See Blum, The Earnings and Profits Limitation on Dividend Income: A Reappraisal, 53 TAXES 68 (1975). The economic income analytical framework furnishes a systematic basis for reaching the same result.
only to changes in the capitalized-future-return net worth of the firm in order to account for items of income or loss, other than distributions, attributable to the firm.\textsuperscript{136}

Full integration accomplished by means of an imputation of undistributed earnings to shareholders also clashes with economic income concepts. Again, the firm contribution to the economic income base (considered separately or as an ingredient absorbed in the economic income of individuals) is the firm’s income-period distributions (less income-period injections of new capital) plus or minus its change in net worth, computed after any distributions by capitalizing future expected returns.\textsuperscript{137}

VI. CONCLUSIONS AND PROBLEM AREAS

Most tax policy commentary has concentrated on devising partially or completely integrated\textsuperscript{138} systems of corporation-shareholder taxation in order to achieve economic neutrality and equity.\textsuperscript{139} In the process, they have not concentrated on the nature, timing, and amount of firm income, or the systematic relationship of firm income to individual income. Moreover, the constitutional implications of various systems of integration have taken a back seat in the discussions. The policy analyses have assumed that the proper measure of firm income is “earnings,” a word that we have used to roughly describe accounting net income or present day taxable income.\textsuperscript{140} Tax systems contemplating an imputation of undistributed earnings, however, raise serious constitutional problems.\textsuperscript{141}

Our principal concern has been the anatomy of the tax base, particularly the possibility that the firm component of, or contribution to, the tax base should be the economic income of the firm.\textsuperscript{142} By “economic firm income” we mean income-period distributions (less new capital contributed by shareholders), plus or minus the income-period increase or decrease in the net worth of the firm, computed, after distributions, by capitalizing the firm’s future expected returns. Firm economic income could be taxed as such at the corporate level and ignored at the individual level. But, because of its systematic relationship to individual economic income, it also shows up fully in the economic income of individuals.\textsuperscript{143} Full integration can thus be

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\begin{itemize}
  \item \textsuperscript{136} See pp. 917–18 \textit{supra}.
  \item \textsuperscript{137} See topic IV. A. \textit{supra}.
  \item \textsuperscript{138} See topic V. \textit{supra}. Full integration involves taxing all corporate source income only at the marginal, ordinary-income bracket rate of the individuals who experience the income.
  \item \textsuperscript{139} See topic III. \textit{supra}.
  \item \textsuperscript{140} See p. 900 \textit{supra}.
  \item \textsuperscript{141} See topics IV. B. \textit{& C. \& V.} \textit{supra}.
  \item \textsuperscript{142} See topic IV. A. \textit{supra}.
  \item \textsuperscript{143} See note 71 \textit{supra} and accompanying text.
\end{itemize}
achieved by forgetting the tax at the corporate level and by taxing all individuals on an economic income basis. Under the narrow reading of *Macomber* regarding the nondistribution setting, the economic income approach to integration, as compared with an earnings imputation system, may be more in harmony with constitutional doctrine.

Present and proposed systems of corporation-shareholder taxation are inconsistent with economic income concepts.

Finally, it is appropriate to comment on several problem areas connected with the adoption of an economic income approach to corporation-shareholder tax systems. These are: (1) the relationship of the firm economic income aggregate to the National Income Account; (2) the question of whether the computation of firm economic income in the manner adopted in this article involves a form of double taxation; and (3) difficulties of valuation and the effects of market characteristics and imperfections.

First, because economic firm income is computed quite differently from earnings, the aggregate of firm earnings will not articulate with the National Income Account, which calculates profits more or less in accordance with accounting net income principles. Economic income is not a total stranger to the system of national accounts, however. Though they are more conceptually primitive and far less widely referred to, the Wealth Account and Accumulations Account pick up changes in net worth, presumably on a capitalized-future-return basis in the case of investments.

The reason given for not computing the National Income Account so as to show capitalized-future-return net worth changes is that the account is meant to reflect "current economic activity." But changes in capitalized-future-return net worth constitute income-period economic changes, in terms of what the marketplace expects the future will bring for investment. We come, then, to one of the normative issues in tax policy: Suppose income, as measured by the National Income Account, has been substantially offset by capitalized-future-return losses in the value of investments. Should we determine how much to withdraw from the private sector by reference to the National Income Account alone, or should we also take cognizance of capitalized-future-return value changes, which provide predictive economic information?

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144. See p. 934 *supra*.
145. See discussion in topic IV. B. & C. *supra*. A possible exception is the case where shareholders have day-to-day management control. See text accompanying note *supra*.
146. See p. 918 *supra*. Even today, A and B in the illustration of footnote 71 could complain that they should not be taxed fully on their $50 distributions. If the Supreme Court adopted an economic income approach, A and B would prevail.
148. Id. at 22-25.
Second, it may be argued that the computation of economic income has a double tax aspect about it, because it takes account of the present value of future returns at the close of period 1, and then includes a period-2 distribution as income in period 2. It might appear that the period-2 distribution was included once, anticipatorily, in the tax base of period 1, and that the amount of the distribution should not be included again in period 2. The answer lies in the fact that firm economic income for any period, including period 2, is a combination of distributions and changes in capitalized-future-return net worth. Hence, there is the possibility that the distribution in period 2 will be offset by a decrease in the end-of-period-2 net worth of the firm, reckoned (as it should be) after the distribution. The period-2 distribution was anticipatorily taxed in period 1 only if (1) there was a period 1 increase in capitalized-future-return net worth, and (2) the period-2 distribution was peculiarly responsible for such increase. But if the anticipated inclusion of the period-2 distribution in the firm’s stream of returns was peculiarly responsible for a period-1 net worth increase, then its deletion from that stream in period 2 should lead to a compensating downward shift in net worth at the end of period 2.

Third, there are the inevitable “practicality” criticisms of an economic income approach to corporation-shareholder taxation. The criticisms relate to the net worth change calculation involved in the determination of economic income. They would presumably fall in three major categories: (1) lack of evidence of capital value, (2) value effects of capital market characteristics (other than imperfections), and (3) value effects of capital market imperfections. An investigation of the magnitude of these problems is grist for another discussion, but, a priori, we see no difficulties that are drastically different from those that must be faced in various existing federal and state systems of taxation. Where there is no market for stock, it would be necessary to use the services of experts. As for the value impact of differences in market characteristics (number of shareholders, number of trades, and number of shares traded), though these characteristics have independent effects on value—so that a share whose intrinsic characteristics remain the same might have a different value depending on the sort of market in which it is traded—there is no reason to shrink from accepting the valuations provided by markets of diverse attributes. So far as the taxpayer is concerned, value is what the market, such as it is, will furnish him for his stock. There is no “other” value for him. The same goes for imperfections in the market, such as information failures about the intrinsic qualities of the firm or the number and terms of offers to buy or sell. Imperfections are with us!

We have not been strongly prescriptive in our analysis of the economic income approach to corporation-shareholder taxation. Among alternatives, however, such an approach may best conform to the limits on Congress'
power of selection. We do not believe that Congress' choice is unrestricted. The word "income" in the Constitution was meant to identify a permissible class of unapportioned taxes. It is elementary logic that a term cannot serve as a constraint on a body that has unfettered power to determine its meaning. If there is flexibility as to what "income" shall mean for corporation-shareholder taxation, it resides in the Supreme Court. Considering only the narrow holding of Macomber, the Court has not squarely rejected the economic income approach; indeed, it is possible to read the cases as exhibiting a certain sympathy to the economic income concept. The Supreme Court, and a fortiori Congress, would do well to study the implications of economic income insights regarding a firm and its owners.

150. See discussion in topic IV. B. & C. supra.