The Corporation Income Tax

An Examination of Its Role in the Federal Tax System

Tax Foundation, Inc., 50 Rockefeller Plaza
New Ycrk, N.Y. 10020

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Foreword

The new Administration and Congress in 1969 will begin a fresh examination of the Federal tax system and needs for revising it. The present study deals with the second most important part of the tax system (in terms of revenue), the corporation income tax. The examination of certain major aspects of the tax is designed to help, not only in the discussions of revision in any one year, but also over a much longer future.

The study reviews the history of the corporation tax from its initial form as an "excise" tax in 1909. The historical section covers various experiments and proposals that have been made, as well as changes that have proved more or less permanent.

The central purpose has been to analyze recent experience and research in order to suggest some priorities in tax revision. The volume of research relating directly and indirectly to the corporation income tax is so large that a review of "results" is necessarily selective and tentative.

On the question of tax incidence, a hypothesis is suggested that the burden is widely spread through changes in various forms of income, not merely through changes in dividends or in consumer prices. The most significant effect of the corporation tax appears to be on the total volume of business investment expenditures. A substantial reduction in the rate of the tax from its present all-time high (with the 1968 surcharge) would be a major revision for the long-run.

The "Introduction, Summary, and Conclusions" condense the essentials of the study for those who may not have the time to read the whole text, and provide a guide for those who wish to delve further.

George A. Bishop, Director, Federal Affairs Research, was primarily responsible for the preparation of this study.

The Tax Foundation is a private, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. Its purpose is to aid in the development of more efficient and economical government. It serves as a national information agency for individuals and organizations concerned with government fiscal problems.

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Purpose and Nature of the Study

The Revenue and Expenditure Control Act of 1968 marked the beginning of a new consideration of Federal tax reform. It directed the Administration to submit proposals for tax revision by the end of 1968. While such proposals, as it turned out, were not made public, the Treasury Department's studies and suggestions were given to the new Administration and tax-writing committees of Congress. Many additional proposals will undoubtedly be made in the new session of Congress.

Extensive tax revision takes a long time to plan, analyze, and develop in acceptable form. Detailed studies of the Federal tax system in 1955 and 1959 by Congressional committees and by private groups contributed significantly to tax changes in the early 1960's.[1]

The last substantial revisions of the Federal tax structure were in the Revenue Acts of 1962, 1964, and 1965. The 1962 act introduced an investment tax credit and made changes in the treatment of foreign income and various business expenses. The 1964 act reduced the individual income tax rates on the average by about 20 percent. It reduced the general corporation income tax rate by about 8 percent (from 52 percent to 48 percent). The 1965 act repealed a large number of miscellaneous excises.

A long-range view of Federal tax revision must include consideration of the extent of reliance on different types of taxes, their comparative burdens, and economic effects. This study examines the role of the corporation income tax and selected changes, revisions, and alternatives that have been proposed. The emphasis is on possible revisions related to the goals of greater equity in the tax system and the maintenance of a high rate of economic growth.

The study is primarily concerned with long-range issues, and only incidentally with the role of the corporation tax in "stabilization" policy, that is, short-run fiscal measures to stabilize economic activity and help maintain a high level of employment. The study does not attempt to cover the numerous issues involved in administrative and compliance problems.

The corporation income tax is a mainstay of Federal revenues. It now accounts for about one-fifth of total Federal budget receipts, as estimated for the fiscal year 1969.

Despite the large rise in social insurance taxes, the share of the corporation tax in Federal tax collections (excluding miscellaneous receipts) has remained at roughly one-quarter of the total since World War II. Excise taxes now account for only 9 percent of the total, employment taxes for 18 percent, and the individual income tax for 50 percent.

1. U.S. Congress, Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability*, papers submitted by panelists appearing before the Subcommittee on Tax Policy, 84th Cong., 1st sess., November 9, 1955; U.S. House of Representatives, Committee on Ways and Means, *Tax Revision Compendium, Compendium of Papers on Broadening the Tax Base*, submitted in connection with the panel discussions on the same subject, November 1959 (three volumes). See also Tax Foundation Research Bibliography No. 9, *Federal Tax Revision*, February, 1963.

The rate of the corporation tax is at an all-time high, if we exclude the excess profits taxes of wartime periods. The 10 percent surcharge of 1968 raised the general rate (normal tax plus surtax) from 48 percent to nearly 53 percent. If account is taken of the current speed-up in payment dates to make tax payments concurrent with liabilities, the effective rate of the tax on a cash basis is still higher.

A large unknown in dealing with the corporation tax is its incidence, or impact, on individual taxpayers. In general, the effects of this tax are so difficult to quantify that the tax rate and structure have been mainly determined by immediate needs for revenue and political considerations relating to the taxation of "business" versus taxation of individuals.

A growing volume of research has made some progress in reducing the unknowns in the impact of the tax and in delineating its effects. The present study is, in part, an interim review of this research and an evaluation of results for purposes of Federal tax revision. However, the very quantity of research work being done suggests that recent results will be modified in the future.[2]

Chapter I sketches the history of the Federal corporation income tax from its first adoption as an "excise" tax in 1909. This history is marked by numerous experiments with changes in the form, and attempts at rationalization, of the tax.

Chapter II reexamines concepts of incidence as applied particularly to the corporation income tax. It is suggested that new definitional approaches are necessary for a large revenue producing tax that has important effects on the aggregates of the economy – employment, output, investment, and the general price level.

Chapter III reviews recent research on the effects of the corporation tax on investment, saving, and economic growth. It also examines these effects in the light of the most recent data through the end of calendar 1967. The events of the past three years, which include the tax reductions of 1964, add useful evidence that sometimes modifies results of research done with data going only to the early 1960's.

Chapter IV examines certain alternative approaches to taxing corporations: the "integration" approach to income taxation which would not recognize the corporation as a separate entity for tax purposes, and the value-added tax. The integration approach has been given a new emphasis because it has been recommended by the Royal Commission on Taxation in Canada. The value-added tax has attracted more attention recently because of its adoption by the Common Market countries of Western Europe. This Chapter also reviews selected issues in the structure of the corporation income tax. These are issues prominent in discussions of current tax revision.

Summary

Incidence and Burden

Questions of tax incidence have been given a new setting in recent years when much economic analysis has used an aggregative approach to problems of national economic policy. Traditionally, the incidence of taxation was examined

2. See Tax Foundation Research Bibliography No. 28, "The Effects of the Corporation Income Tax and Its Role in the Federal Tax System."

in the context of the probable effects of a tax on the cost position of a firm, or a particular industry, given the demand for its product, and the resulting change in the output and price of its products. This approach is justifiable in dealing with a tax which is a small element in the economy, or in examining the reactions of individual firms. Because of its size, however, the Federal corporation income tax (which produces about $38 billion a year) requires other kinds of analysis. The large amount of revenue involved (and the associated government expenditures) must affect the level of business activity, the level of income in all segments of the economy, and the demand for corporate products.

Attempts have been made to take account of broader effects of the corporation income tax and to analyze its incidence in the framework of possible changes in all major segments of the economy. However, both theoretical and statistical efforts meet with great difficulties in trying to define and measure effects of changes in the corporation income tax on the assumption that "other things remain the same." Just how "other things" are to be held the same is a central problem. Statistical efforts to isolate the effect of the corporation income tax from other influences on corporate profits have yet to achieve definitive answers.

The problem of incidence has usually been posed as the extent to which the corporation tax is shifted forward into product prices, or on the other hand, reduces profits after tax. (The tax may, under some conditions, reduce returns to other factors of production.)

On the view that the corporation tax is largely reflected in product prices, it is similar to a sales tax on corporate products. The impact on low income groups, then, is heavy because their consumption expenditures are a large proportion of their incomes. Further, the tax falls rather unevenly on different types of products and services. The importance of the corporate form of business in various industries differs, as does the degree to which the tax is likely to be passed on. Public utilities, for example, can generally pass the tax forward as a normal part of costs because it is part of the rate-making process. Corporations in some industries may be subject to such competitive pressures, e.g., from imports, that little forward shifting is possible.

On the other hand, if the corporation tax falls largely on shareholders, the burden again bears little relation to the size of the shareholders' income. Many persons with low incomes, particularly among the retired population, are heavily dependent on dividends. Some shareholders with high incomes may be able to avoid part of the tax burden by influencing corporate decisions in favor of greater retained earnings. (The tax law, however, provides a penalty for undue accumulation of corporate earnings.)

On either of these views about the incidence of the corporation income tax, equity among individuals is not promoted by heavy reliance on this tax.

The present study suggests that part of the difficulty of analyzing the burdens on individuals lies in the fact that, through this tax which is not levied directly on individuals, the government has diverted a portion of national output from private uses over a long period. Consequently, it is difficult to measure the burden on individuals in relation to the incomes they *might* have received had this tax not been levied and had government expenditures been correspondingly lower, or if the same level of expenditures had been financed by a different kind of tax.

Individuals cannot be expected to assess what their incomes would be were there a substantially lower level of taxes and government expenditures. Individuals usually make their decisions on consumption and saving in the light of their incomes actually received, and with little regard for potential or accrued income, e.g., in the form of undistributed corporate profits. A certain degree of illusion concerning the size of total real income is involved. The effects of taxes may be different than if no illusion were involved and some taxes contribute more than others to this illusion.

If individuals take little or no account of income not currently received, the effect of the corporation tax will depend in part on how corporate decisions are affected by the tax. Corporations typically save a larger proportion of any addition to net income than do individuals. (Many also continue to pay dividends even when current profits are absent.) Moreover, there is a much closer tie between saving and real investment in the case of corporations than in the case of individuals. Thus, changes in the corporation income tax are likely to have a closer relation to the rate of real investment than are changes in the individual income tax. Small corporations particularly are likely to be sensitive to changes in internal sources of funds.

Changes in business capital outlays affect all personal income, first through short-run effects on the level of total payments for productive services, and second through effects on productivity and the rate of economic growth. For portions of national output that have never been distributed as income to individuals, no standard is easily available, in terms of total pre-tax income and its distribution, with which to compare after-tax results. The burden of the corporation tax on different people may be not only harder to identify but also more widely spread than is commonly assumed.

Analysis of Economic Effects

In the past 20 years, the corporation tax has not changed nearly so drastically as in the preceding 20 years. Partly for this reason, it is difficult to separate the effects of the corporation tax from effects of other changes in the economy. Nevertheless, the past two decades are more likely than any previous period to be similar to future conditions.

A review of recent research on the effects of the corporation income tax and related research on the determinants of national output and its major components, suggest the following tentative conclusions based on evidence of the period 1948-1967: (1) The level of corporate profits (before tax), particularly in the short run, is determined to a large extent by influences other than the corporation tax rate. (2) The level of dividends is usually determined by influences other than the corporation tax. (3) The impact of the corporation tax appears to be largely on corporate saving (or undistributed profits), both in short-run fluctuations and for the long term. (4) The effects of the corporation tax in changing the allocation of resources in the private sector of the economy (the "misallocation" of resources) may be less important than either the short- or long-run effects on the rate of investment.

Corporate profits before tax are the most volatile item among the major kinds of factor incomes from productive services. Dividends, however, have been relatively stable in relation to national output. Over the years 1947 to 1967, dividends averaged 2.7 percent of GNP, and apart from the Korean War period, the range of variation was from 2.5 to 2.9 percent of GNP. Over the same period, corporate profits before tax (including inventory valuation adjustment) averaged 11.0 percent of GNP, and this percentage ranged from a low of 9.2 percent in 1958 to a high of 13.2 percent in 1950.

Because of the greater stability of dividends, the corporation tax tends to increase the short-run fluctuation in undistributed profits. When corporate profits before tax fall, undistributed profits fall relatively much more; when corporate profits before tax rise, undistributed profits rise relatively much more.

This effect on internal sources of corporate funds tends to be a "destabilizing" influence through the business cycle. That is, in a recession, when business investment tends to fall, the sharp curtailment in internal sources of funds tends to accentuate the fall in investment. In a boom period, when investment and profits are rising, the relative growth of internal funds permits a larger rise in investment than might otherwise have occurred.

The high level of the corporation income tax since World War II also appears to have held down, or checked, the long-run growth of undistributed profits more than it affected dividends. For the period 1947 to 1961, undistributed profits showed no upward trend even in current dollar terms. This result was attributable in part to the rapid growth of capital consumption allowances from the low level of the immediate post-World War II years. However, since undistributed profits have been the second largest source of funds for business investment (after capital consumption allowances), the slow growth in these funds probably served to hold down the rate of business investment in relation to GNP. Gross private domestic investment averaged just under 15 percent of GNP in the years 1960 to 1964, as compared with 18 percent in 1948, 17 percent in 1955, and 16 percent in 1966. Over the whole period 1948 to 1967, undistributed profits of nonfarm, nonfinancial corporations have amounted to about 81 percent of such firms' purchases of physical assets less capital consumption allowances.

In addition to its effect on internal sources of funds, a corporate tax in the neighborhood of 50 percent is a large factor in business investment decisions. The rate of return after tax is the primary concern of investors and corporate management. A high tax rate tends to eliminate investments with low prospective returns. If we take "other things" as given for an individual firm, the rate of return before tax must be twice as high with such a tax rate to justify a given investment. Such a tax rate also tends to shift the "mix" of factor services toward those subject to lower taxes. A high corporation income tax reduces the size of capital stock most appropriate at any given level of output. Efforts to economize on capital may also serve to slow the rate of technological advance because much of technological change is embodied in new plant and equipment.

Despite the advantage given to debt financing by the high corporation income tax, the last two decades have shown little shift in corporate financial structures on the whole. The major shift appears to have been from preferred stock to long-term debt. Common stock equity has approximately maintained its share in the total financial structure of major industries and all manufacturing. The years 1966 and 1967, however, saw a large upsurge in corporate debt.

A recent estimate of the "efficiency cost" of taxes on income from capital – that is the loss in real income or output as a result of a shift in resources from heavily taxed uses to others taxed only lightly or not at all – puts the amount between $1.5 billion and $2.5 billion per year.

By way of comparison, the long-run rate of growth in corporate product has been about 6 percent, and for corporate profits over the past two decades about 5 percent per year. At the 1968 level of corporate profits, this annual growth would be about $4½ billion. A small change in the rate of growth, like compound interest, could result in a large cumulative change in the total over a period of a decade or more. Similarly, a small change in the rate of business investment in relation to total national product could make a substantial difference in the long-range rate of economic growth.

Nature and Structure of the Corporation Income Tax

In general this study suggests that the basic form of the tax, i.e., as a separate tax on the net income of corporations, has certain advantages over sweeping experiments in new forms of taxation. In large part, these advantages arise out of our long experience with this tax, rather than from its basic characteristics.

Rationale of the Corporation Tax. A heavy tax on the net income of corporations, which we have arrived at largely through the pressures of war and other emergencies, raises fundamental questions concerning its rationale. Why should such a tax be levied on the corporation, a "person" which exists only by virtue of the law? Should not all income be allocated and taxed to individuals, as has been suggested by the Royal Commission on Taxation in Canada? Should not a more uniform tax on all business whether incorporated or not, such as a value-added tax, be substituted for all or part of the corporation tax? These questions have never received very satisfactory answers, and it seems unlikely that really satisfactory answers can be found.

At the state government level, the corporation income tax has been justified in part as a kind of franchise tax – a tax levied in exchange for the benefits presumably conferred by the franchise of operating as a corporation.

It has also been argued that the government contributes in some way to all forms of production, and that this contribution provides a justification for a tax on business. The theory of government as a "partner" in economic production provides at best only limited support for the corporation income tax, in part because much economic activity is carried on outside the corporate form. Nevertheless, the arguments are made that incorporation provides substantial benefits, as well as capabilities for making and using profits without distribution to individuals, so that a separate tax is justified.

One role for the corporation income tax is to provide a means of taxing income that would not be received by individuals, even in the absence of the tax. As suggested by the debates of the 1930's over the undistributed profits tax, some way is appropriate for taxing income not distributed to individuals. Without some form of tax on corporations, it is argued, stockholders would have an easy means of avoiding the individual income tax by accumulating income through corporations. Such justifications, however, can hardly support a corporation tax rate at the current level.

Considerable attention has been paid recently to the alternative of a value-added tax, particularly because of its actual and proposed adoption by the Common Market countries of Western Europe. Apart from the particular merits of the value-added tax, it would have the advantage of being refundable on exports, while the corporation tax is not. Moreover, the widespread adoption of this tax in Europe will subject U.S. exports to larger "border taxes" representing the equivalent of the value-added tax on production in those countries.

The value-added tax has been examined by various groups and individual experts. The present study does not undertake a detailed examination of the case for such a tax. On one point, however, the study suggests that the value-added tax and the corporation tax are similar. The hypothesis put forward earlier concerning the incidence of the corporation income tax implies that the corporation income tax can logically be classified as an "indirect" tax. The GATT (General Agreement on Tariffs and Trade) rules, which permit exemption of exports from indirect taxes only (on the traditional assumption that profits taxes differ substantially in their price effects from a sales tax) can hardly be justified in the case of taxes that are levied nation-wide.

As a recent Tax Foundation publication pointed out,[3] there is a variety of possible U.S. policy steps that might be taken in response to these developments in Europe. One possible way to influence the U.S. competitive position and the flow of investment abroad is to reduce the corporation tax rate.

Another approach to the taxation of corporations, one which is aimed at a more uniform treatment of all forms of income, has had a long history in the United Kingdom. Until recently, the corporation tax there was viewed primarily as a means of collection of the individual income tax at the source. In 1965 the United Kingdom abandoned this view of the tax, and followed the United States example by adopting a separate tax on corporate profits. Yet at the same time, the Royal Commission on Taxation in Canada (also known as the Carter Commission) advocated an "integrated" income tax, designed as a comprehensive tax on all income.

The Carter Commission argued that the corporation as such has no taxpaying capacity, and that the tax on the corporation necessarily falls on individuals. Partly for administrative reasons, the Commission recommended the continuation of a tax on corporations at a flat rate of 50 percent. However, it also recommended that the tax base of the resident shareholder should include the corporation income paid or allocated to him, "grossed-up" for the corporation tax on his dividends. In other words, the shareholder would be assumed to receive a proportionate share of corporate profits before tax, for the purpose of calculating his individual income tax liability. The individual would then be allowed, as a credit against his individual income tax, the amount of the corporation tax included in his taxable income. Realized capital gains would be taxed at ordinary income tax rates.

The integration recommendations of

3. *Tax Harmonization in Europe and U.S. Business* (New York: 1968).

the Carter Commission have by no means been generally accepted in Canada. In the debates and studies of the past two decades, the idea of an integrated income tax for the United States has been repeatedly examined, in part as a means of achieving a more equitable treatment of dividends. However, it has yet to receive much support.

The possible effects of such integration would be as difficult to trace as the traditional questions of incidence of the corporation income tax. The assumption behind the integration approach is that the corporation tax falls largely, if not entirely, on the shareholder. The discussion of incidence above suggests that the burden of the corporation tax is probably widely spread. On this view, the tax in part represents a portion of national output that cannot be easily attributed, or imputed, to particular groups of individuals.

Structure of the Corporation Tax. The Federal corporation tax has seen many changes and experiments with its form and structure. The general structure of the tax today is a relatively simple one: the current statutory rates (exclusive of the 10 percent surcharge of 1968) consist of a 22 percent "normal" tax on all net income, plus a "surtax" of 26 percent on net income in excess of $25,000. This two-step structure is a result of a long evolution over the last 60 years.

The corporation tax, however, involves many complications in determining "net income," particularly in the various deductions allowed in arriving at net income. Among the difficult areas are the allowances for depreciation and depletion, capital gains and losses, surtax exemptions and consolidated returns, the special treatment of different kinds of corporations, and the treatment of income earned in other countries. This study is not intended to deal in detail with structural problems. Nevertheless, many changes have occurred in such tax provisions, some of which raise important policy problems.

The Internal Revenue Code of 1954 provided alternative methods of depreciation, which substantially liberalized these allowances, permitting faster write-offs in the early years of the life of depreciable assets. In 1962, by administrative regulation, a set of guidelines was adopted for determining "useful lives" of depreciable assets. These guidelines permitted write-offs in periods 30 to 40 percent shorter than those which had previously been in effect. The new procedures also contained a "reserve ratio test" designed to provide "an objective basis for appraising the correctness of the useful lives claimed for tax purposes." The reserve ratio test has been a subject of much controversy and its application has been largely postponed by the Treasury.

These changes have muted the lengthy controversies over tax depreciation policy that marked the previous decade.

In 1962 another important change was made in the introduction of the investment tax credit. This is a credit against tax liability amounting to seven percent of "qualified" investment in machinery and equipment (3 percent in the case of public utilities). The investment credit serves to offset, at least in part, the adverse effects of the corporation tax on investment.

As a result of the inflationary pressures in 1966, the Administration proposed, and Congress enacted, a suspension of the tax credit for the period beginning October 1, 1966 and ending January 1, 1968. The "Restoration Act" of 1967 restored the credit as of March 9, 1967—as a result of an actual and prospective decline in business investment. Suspension of the credit in 1966 was strongly criticized by many who argued that the credit was intended to be permanent and not to be used as an instrument for short-run effects on business activity.

Despite the renewal of inflationary pressures in late 1967, no suggestion has been made for another suspension of the tax credit. After the lengthy debate of 1967, the permanent character of the investment credit appears to be generally accepted, and further use of changes in the credit for purposes of economic stabilization seems unlikely.

The recent wave of mergers has raised anew problems of multiple surtax exemptions, intercorporate dividends, carry-over of losses, and tax-free exchanges of stock. Existing provisions of the law on these points have been modified significantly in the past decade. Studies of recent economic developments may suggest that further revision is necessary.

Current proposals for revisions in the corporation tax relate largely to administrative difficulties and various controversial provisions in the law. The increase in the use of industrial revenue bonds (tax-exempt bonds issued by local governments, but used indirectly to finance portions of certain commercial developments—a device to attract industry) led to the restriction of this exemption in the Revenue and Expenditure Control Act of 1968. The rapid growth of state and local bonds outstanding has led to new proposals for the tax treatment of interest on these securities, or for alternative forms of state-local financing.

Other problem areas include the status of various tax-exempt organizations and their commercial-type operations, the treatment of financial institutions, the option of small corporations to be taxed as partnerships, and the future of the "reserve-ratio" test for depreciable assets.

One area of growing significance is the tax treatment of foreign income. In the early post-World War II years, the trend of U.S. tax policy was to favor foreign investment—partly as a way of aiding recovery in war-torn countries and promoting economic growth elsewhere. In accordance with a long-standing principle, income earned in other countries by subsidiaries of U.S. companies was subjected to U.S. income tax only when "repatriated," and the company was (and is) allowed a credit against U.S. tax for taxes paid to other governments on such income. Income of foreign branches of U.S. companies, however, was currently taxable to the parent company with credit for foreign taxes.

Partly as a result of U.S. balance of payments difficulties in the early 1960's, the direction of tax policy relating to foreign income began to change. In 1961 the President recommended the removal of deferred tax treatment of earnings of U.S. subsidiaries. The Revenue Act of 1962 did not fully incorporate Administration proposals, but it did limit tax deferrals to certain categories of income, and added provisions to check the use of "tax havens" for foreign operations.

With continued difficulties in the balance of payments, it is possible that further modifications of tax treatment of foreign income will be added to the numerous controls that have been used to check the outflow of both long and short-term capital funds. The extensive regulations imposed on foreign direct investment have been a serious administrative and compliance burden, and also have led to modifications of rules governing repatriation of income for tax purposes.

Regardless of the course of the balance of payments problem, it is difficult to find agreement on basic principles of taxation of foreign income. It is not easy to pursue the objective of equal treatment of foreign and domestic business and at the same time take account of measures most countries have adopted either to promote or to check the growth of business largely owned or controlled by foreigners. The objective of simplicity is not usually compatible either with the goal of neutrality or with other policy objectives, particularly the maintenance of a stable, or "equilibrium," position in the balance of payments.[4]

In summary, no clear-cut alternatives or structural changes in the corporation income tax stand out as preferable to the existing form of this tax. Alternatively, a reduction in the rate of this tax would appear to be a more practical and significant revision than sweeping changes in the form of the tax.

CONCLUSIONS

The conclusions of the study fall into three categories. The first relates to the incidence and burden of the tax. The second concerns the chief economic effects of the tax. The third concerns the essential rationale of the tax and possible structural changes. While the conclusions are tentative and partly in the form of alternative hypotheses, they may be summed up as follows:

(1) *Incidence and Burden*

The usual approaches to the incidence of the corporation tax concentrate on the extent to which the tax is shifted forward into the prices of final products, or falls on returns to capital or other factors of production. Neither of the extreme positions, either that the tax is fully shifted forward, or that it falls exclusively on returns to *equity* capital, is strongly supported by statistical evidence.

It is suggested here that the problem of incidence cannot be formulated most appropriately in terms of what groups of individuals bear the full burden. A hypothesis is put forward that the corporation tax may be viewed in part as a means by which output is diverted to government, without the burden being fully reflected in changes in real or money incomes as seen or measured by individuals. It is suggested further that the procedures generally used in assigning or allocating pre-tax income to individuals could not be made precise even with much more adequate statistical evidence.

The diversion of resources from private uses occurs in such a way that the burden is not readily apparent to individuals. In attempting to reconstruct the way in which income would otherwise have been received by individuals, too many alternatives are possible to provide an easy answer to the question of "whose real income has been reduced by this tax."

On this view, questions of equity among individuals are less important than the effects of the corporation tax in

4. A more detailed discussion of these issues can be found in *Proceedings* of the 20th Tax Foundation National Tax Conference, "Tax Policies and the Balance of Payments Problem," December 1968.

diverting resources in a different way than would occur under other taxes, or if the corporation tax were lower and government expenditures were correspondingly lower.

The evidence on the effects of the corporation tax suggests that a major alternative private use of resources is business investment. Changes in business investment affect not only dividend income but all personal incomes, first through short-run effects on the level of total personal income, and second through effects on productivity and the rate of economic growth. The burden of the corporation tax may thus be more widely spread than is commonly assumed.

(2) *Economic Effects*

The corporation income tax in the past two decades appears to have affected mainly the aggregate size of business saving and investment. The effect on the national rate of investment may be more significant than the "efficiency effects," i.e., the relative shifting of resources toward uses not heavily dependent on equity capital in the corporate form, or in distorting effects on corporate financial structures.

The evidence suggests that short-term changes in profits before tax and dividends have been governed largely by forces other than the corporation income tax. On the other hand, undistributed corporate profits appear to have been substantially affected by this tax, both in short-run fluctuations and in the trend over the last two decades. Undistributed profits are the major source of funds for net business investment.

Despite the advantage given to debt financing by the corporation tax, the last two decades have shown little shift on the whole in corporate financial structures. Nevertheless, the tax advantages of debt financing do put pressure on corporations to increase debt-equity ratios, and debt-equity ratios have risen noticeably in the last few years. Some measure to reduce the differential tax results of debt versus equity financing may be desirable.

Quantitatively, the differential effects of the corporation tax as among different sectors of the economy would appear to be less important than the effect of the tax on the total rate of business investment.

At a rate in the neighborhood of 50 percent, this tax is a large factor in long-term business investment decisions. The rate of return after tax is the primary concern of investors and corporate management.

(3) *The Structure of the Tax*

If corporations are to continue to be an important source of tax revenue, the general form of the present tax, i.e., as a separate tax on the net income of corporations, has some advantages over alternatives that have been proposed.

Adjustments have been made to the long existence of this tax, and two decades of tax revision have mitigated or removed many objectionable features.

While problems remain with the corporation income tax, a new form of tax at the Federal level, such as the value-added tax, would have to go through a "shakedown" period, even though it may have theoretical advantages over the present corporation tax.

A different approach to the taxation of corporations is to try to "integrate" the corporation and individual income taxes so that income not paid out by corporations (undistributed corporate profits plus profits now taken by the corporation income tax) would be allocated to individuals and taxed at rates of the individual income tax. The assumption behind the integration approach is that the corporation tax falls largely, if not entirely, on the shareholder. The discussion of incidence in this study suggests that the burden of the corporation tax is widely spread. If this is the case, adoption of the integration approach might create new inequities.

This study concludes that the major priority in revision of the corporation tax is a substantial reduction in the rate. This is needed for domestic purposes of improving the tax structure and removing obstacles to economic growth. It would be helpful in mitigating current problems in the balance of payments and the international competitive position of this country. In addition, some structural changes may be necessary to reduce certain tax-favored positions or undesirable economic effects.

I.

Historical Changes in the Role of the Corporation Income Tax 1909-1968

After its first enactment as an "excise" tax in 1909, the corporation income tax during World War I became a significant revenue producer—more important than the individual income tax (Table 1).[1] Currently, its revenue importance is being challenged by social insurance taxes. Numerous changes have been made—often to be abandoned later—in the structure of the corporation tax. These past experiments show many deadends in attempts at corporate tax revision, and yet much that can be regarded as progress.

The Initial Form of the Tax

The "excise" tax of 1909 was introduced almost as an afterthought, late in the congressional session, as a means of meeting a deficit. The tax was not proposed by the Administration or by the House Committee on Ways and Means, but introduced on the floor of the House by Representative Cordell Hull and others.[2] With relatively little debate, the tax, a one percent rate on net income, was adopted as a source of additional revenue. It was called an "excise" tax because of the constitutional limitations on income taxation. An income tax enacted in 1895 had been declared unconstitutional. Although there were numerous cases involving the excise tax of 1909, the Supreme Court upheld its constitutionality.[3]

After the 16th Amendment, the first income tax act in 1913 was applied to both corporations and individuals. However, the corporation tax was viewed largely as a means of collection of the tax at the source – dividends were exempt from the "normal" tax applied to individuals. The "normal" tax of one percent applied to all taxable income, corporate and individual; the surtax levied on "upper bracket" individuals began with a taxable income of $20,000 and the rate reached a maximum of 6 percent on taxable income in excess of $500,000.

Changes in the Nature of the Tax, Rates, and Collections[4]

The corporation tax rate was raised to 2 percent in 1916, 6 percent in 1917, and reached a peak, excluding excess-profits tax, of 12 percent in 1918 (Table 3).

A special tax on munitions manufacturers was levied in 1916, at a rate of 12½ percent on net profits, following the example of the leading belligerent

1. The civil war income tax did not apply to corporations as such, although assorted other taxes were applied to various types of business. (Paul Studenski and Herman F. Krooss, *Financial History of the United States*, New York: McGraw-Hill, 1952, pp. 141-151).
2. Roy G. and Gladys C. Blakey, *The Federal Income Tax* (New York: Longmans, Green and Co., 1940), p. 26.
3. Sidney Ratner, *American Taxation* (New York: W. W. Norton and Co., 1942), p. 29.
4. A detailed history of changes in tax rates and major provisions of the law can be found in M. A. Chirelstein and others, *Taxation in the United States*, World Tax Series, Harvard Law School International Program in Taxation (Chicago 1963), pp. 108-120.