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REAPPRAISAL OF BUSINESS TAXATION

Reappraisal of Business Taxation

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The purpose of the annual symposium conducted by the Tax Institute is to focus attention on a major problem of taxation by affording an opportunity for discussion by informed participants representing different points of view. The publication of this volume carries with it, of course, no endorsement of the views—sometimes conflicting—of the various participants.

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FOREWORD

ON TWO prior occasions, in 1936 and again in 1946, the Tax Institute annual symposiums were devoted to the general subject of business taxation. Also, on a number of occasions in the past we have considered specific aspects of this topic. We felt, therefore, that this symposium should be called a "reappraisal." Recent fiscal developments and changing concepts in all fields of taxation would seem to warrant that we have this further review of business taxation.

In one sense, I suppose, it can be said that business is the ultimate source of all income. Certainly tax policy in the future, as it affects the business community, may very well determine the extent to which we can achieve the national goal of accelerating the growth of the American economy and improving our competitive position with foreign countries.

The present Administration has recognized, and in fact emphasized, the close interrelation of tax policy and economic growth. The President's tax message to Congress last April contained recommendations for a number of sweeping changes in the law, including a proposal for a tax credit to provide additional incentives for investment in plant and equipment.

The Ways and Means Committee considered these recommendations, as you know, for several months. Hearings were conducted. Testimony and comments were received from over 400 individuals and organizations. There was far from unanimity on the merits of the Administration recommendations. In late August, Chairman Mills announced that it would be impossible for the committee to complete its deliberations in the 1961 session but that the matter would be given first order of business in the next session of Congress.

Under these circumstances, certainly from a federal standpoint, the subject of business taxation seems to be particularly timely.

It is not the purpose of this organization to formulate tax policy or to advocate tax legislation. Its purpose, as you all know, is to focus attention on major tax problems and to direct to the solution of these problems the best informed opinion in all of the professions which have an interest in tax affairs.

The program for this symposium, which I think is a particularly good one, is in keeping with this fundamental purpose of the Tax Institute.

J. RANDOLPH COLEMAN, JR.
President
Tax Institute, Incorporated

New York
March, 1962

PREFACE

THERE is laid annually upon "business" a large share of the responsibility for providing all levels of government with the revenues essential to the performance of governmental functions. This responsibility includes not only a direct as well as an indirect sharing of its net product, but also the generous and substantial sharing of its facilities in the administration and collection of the revenues from business and nonbusiness sources.

Every taxing statute, substantive or administrative, at any level of government, therefore, has a real impact upon business that penetrates to an unknown extent the entire economic and social fabric.

Faced with continuing high revenue needs, with the revenue to be extracted from a maelstrom whose basic element is free enterprise marked by ever sharpening competition—operating under the continued emergence of new forms of business organization; deep seated technological developments; extended governmental regulation of business; changing legal and social concepts; rising levels of managerial and production capacities; and world-wide economic forces placing an ever higher premium on competitive talents—there is a real need for a continuing vigorous and penetrating appraisal of the tax factor in business.

The papers presented herein, coupled with those of previous symposiums, go a long way towards providing a launching pad for studies in keeping the appraisal on a timely basis coincident with the unfolding environments of the future. Each of these papers deals with matters of tremendous importance both policy- and principle-wise and constitutes a constructive and scholarly contribution to tax thought.

The participants in this symposium have spoken and written from a depth of experience and knowledge unique in tax discussions by virtue of their exceptionally rich background stemming from intimate experience in wide areas of tax history, philosophy, theory, and application.

The effort so generously and freely expended by them in time, thought, and research entitles them to the thanks of all who are interested in striving towards the discovery and application of the best use of the tax factor in our economy.

The Program Committee is proud of the product contributed by each program participant and desires to make its grateful acknowledgement for the public service that each has rendered.

Grateful acknowledgement is also made by the Program Committee of the splendid leadership provided by J. Randolph Coleman, Jr., and Mabel Walker, President and Executive Director, respectively, of the Tax Institute, Inc.

May these and all others who have contributed so vitally to this symposium enjoy a justifiable pride in their part in the enhancement of human knowledge.

THOMAS C. ATKESON
Chairman
Program Committee

Williamsburg
March, 1962

CONTENTS

PAGE

FOREWORD vii
J. Randolph Coleman, Jr., Tax Counsel, Western Electric Company

PREFACE ix
Thomas C. Atkeson, Professor of Taxation, The Marshall-Wythe School of Law, College of William and Mary

PART ONE
The Role of Business as an Object of Taxation

OPENING COMMENTS 1
C. Lowell Harriss, Professor of Economics, Columbia University

I. HOW SHALL BUSINESS BE TAXED: BASIS FOR REAPPRAISAL 3
Harold M. Groves, Professor of Economics, University of Wisconsin

II. APPROACHES TO THE TAXATION OF BUSINESS 17
Solomon Barkin, Director of Research, Textile Workers Union of America

III. TAXATION OF BUSINESS 25
Leonard E. Kust, General Tax Counsel, Westinghouse Electric Corporation

IV. THE TAXATION OF BUSINESS 33
Alfred G. Buehler, Professor of Public Finance, Wharton School of Finance and Commerce, University of Pennsylvania

V. DISCUSSION OF BUSINESS AS AN OBJECT OF TAXATION 44

PART TWO
Business Taxation as Affected by Business Form

OPENING COMMENTS 53
Stanley J. Bowers, Ohio Tax Commissioner

VI. FORMS OF BUSINESS AND FEDERAL INCOME TAXATION 55
Leonard L. Silverstein, Silverstein and Mullens

PART THREE
Some Problems Involved in State and Local Taxes on Business

OPENING COMMENTS 65
Alan M. Nedry, Assistant Counsel, National Association of Manufacturers

VII. STATES' RIGHTS AND THE SINGLE MARKET CONCEPT 67
John F. Tarrant, Tax Research Director, Connecticut State Tax Department

VIII. THE SCOPE OF STATE SALES TAXATION 76
Wylie Kilpatrick, Research Professor, University of Florida

IX. SHOULD CONFLICTS IN STATE ALLOCATION OF BUSINESS INCOME BE TOLERATED, MANEUVERED, OR RESOLVED? 86
Ira J. Palestin, New York State Tax Commissioner

X. DISCUSSION OF SOME PROBLEMS INVOLVED IN STATE AND LOCAL TAXATION OF BUSINESS 95

PART FOUR

Tax Policies in Relation to Investment and Economic Growth

OPENING COMMENTS 101
Norman B. Ture, Director of Tax Studies, National Bureau of Economic Research

XI. GAINS AND LOSSES FROM THE SALE OR EXCHANGE OF BUSINESS PROPERTY 103
William M. Horne, Jr., Director, Corporate Tax Department, Olin Mathieson Chemical Corporation

XII. DEPRECIATION, OBSOLESCENCE, AND DEPLETION 113
Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business Administration

XIII. TAX CREDITS 129
Alan L. Gornick, Tax Counsel and Director, Office of Tax Affairs, Ford Motor Company

XIV. EXPANSION PLANS AND THE ACCUMULATED EARNINGS TAX 142
Robert S. Holzman, Professor of Taxation, New York University Graduate School of Business Administration

XV. REACTIONS OF A WAYS AND MEANS COMMITTEE MEMBER 151
Jackson E. Betts, Ways and Means Committee, United States House of Representatives

XVI. DISCUSSION OF TAX POLICIES IN RELATION TO INVESTMENT AND ECONOMIC GROWTH 162

PART FIVE

Reconstitution of Business Taxes

OPENING COMMENTS 173
Harry F. Schroeder, Vice President, Bankers Trust Company

XVII. FLAT RATE CORPORATION TAX VERSUS PRESENT TAX 175
E. Gordon Keith, Professor of Economics, Wharton School of Finance and Commerce, University of Pennsylvania

XVIII. MANUFACTURERS' OR WHOLESALERS' TAX VERSUS PRESENT EXCISES ... 187
Fred S. Gilbert, Jr., Hedrick and Lane

XIX. COOPERATIVES AND MUTUAL FINANCIAL INSTITUTIONS 200
Reuben Clark, Wilmer, Cutler & Pickering

XX. BUSINESS INCOME OF EXEMPT ORGANIZATIONS 215
Norman A. Sugarman, Baker, Hostetler & Patterson

XXI. DISCUSSION OF RECONSTITUTION OF BUSINESS TAXES 232

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EDITOR'S NOTE

An address on "Business Taxation and Economic Growth" was given at a luncheon session by Dr. Harvey E. Brazer, Director, Office of Tax Analysis, United States Treasury Department. Since, however, Dr. Brazer unexpectedly spoke extemporaneously and no provision had been made for a stenographic record at that session, we are unfortunately unable to publish his address. We regret this omission.

PART ONE

THE ROLE OF BUSINESS AS AN OBJECT OF TAXATION

"Some years ago, during one of the periods of controversy about loyalty in the United States, the very distinguished Professor of Constitutional Law, Thomas Reed Powell, was asked, I am told, whether he would take an oath to support the Constitution. He is reported to have replied, 'Certainly, it supported me all my life.' I would not take an oath to support our present system of taxing business, even though, in a sense, it has supported me. In fact, I constantly criticize our present system of taxing business. Or can we call it a system?

"We now have a set of arrangements which have developed more or less haphazardly over many years. I think if at any time in the past reasonable men had tried to lay out a plan of where we would like to be in taxation in ten, twenty, or thirty years, none would conceivably have proposed, or would have outlined, the kind of arrangements we have now for taxing business.

"The public today has some choice about what kind of system it will be living with ten, twenty, or thirty years from now. It should, it seems to me, try to make the choices as intelligently and as rationally as possible.

"Although revolutionary and sweeping changes are unlikely to be made this year or next, the clearer the goal which we would like to reach, the better will be the individual changes

that can be made from time to time. The better, too, they will be as elements of a coherent, consistent, constructive program for the long run."

—C. Lowell Harriss
Professor of Economics, Columbia University, and Chairman of Symposium Session

CHAPTER I

HOW SHALL BUSINESS BE TAXED: BASIS FOR REAPPRAISAL

HAROLD M. GROVES
Professor of Economics, University of Wisconsin

INTRODUCTION

IN THE Foreword to an earlier symposium on our subject sponsored by the Tax Institute, the Executive Secretary observed:

> The subject of business taxation is in an unsettled state, theoretically as well as politically. There is no consensus among tax authorities concerning how business should be taxed, as there is, for example, in connection with personal taxation. The underlying theory of business taxation is still in dispute. Economists have not agreed whether a system of business taxation should be based on the principle of benefits received or ability to pay.
>
> There is even greater uncertainty concerning how either of these two principles could be most satisfactorily used in taxing business. . . .[1]

Much water has flowed down the Potomac since the above was written. Recalling only a few high points of business tax history, we may mention the undistributed profits tax tried and abandoned during the 1930's; two new editions of war excess profits taxes, the last one abandoned in favor of the traditional corporate net income tax but with a spectacular top rate of 52 per cent; the controversial dividends-paid credit; and accelerated depreciation. Michigan has pioneered with a value-added tax of sorts. There have been important recent studies, some of

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[1] Mabel Walker, "Foreword," *How Shall Business Be Taxed?*, New York: Tax Policy League, Inc. [now Tax Institute, Inc.], 1937, p. v.

them empirical, of the incidence of the corporate net income tax. And so on.

This increment in experience with business taxation is surely enough to warrant the choice of this subject for a Tax Institute symposium. The Executive Secretary's statement about the unsettled state of business tax theory and policy is, however, one that she could have repeated in the invitation to this conference, and one that she might have to repeat when the conference is concluded. None of this will be the fault of Miss Walker or the conference—the fault, if any, lies in the nature of tax theory and tax policy.

In developed countries, heavily committed to the net income tax, the corporation presents the tax-makers with their severest problem. Indeed it has all but wrecked the great ideal of a universal personal tax applied without discrimination and with some measure of egalitarian effects. Recent data assembled by the First National City Bank, showing comparative corporate income tax rates by countries indicate that taxes on undistributed corporate profits, abstracting from credits associated with dividends, range from 38 to 52 per cent among the principal competitors. While the figures may offer some reassurance as far as international competition is concerned, they raise serious questions concerning the inequities and other inadequacies of the corporate tax institution.

Defining a Business Tax

The 1937 symposium started with an attempt at defining a business tax and it is a fine exercise for those whose taste runs to classification. There are a few special taxes on (more or less) general business; special taxes on certain legal forms of business (notably corporations); special taxes or in lieu taxes on certain lines of business (such as banks and insurance companies); and general levies (such as the property tax) that include business taxpayers among others. Using the broadest concept of business as all economic activity we may say that all income arises from business. If the frequent assertion that all taxes

come out of income be accepted, the conclusion is inevitable that in some sense all taxes are business taxes.

The distinction between consumption taxes and business taxes, if any, is a tenuous one. How do we classify the retail sales tax? As to impact, it is paid in large part by merchants and measured by the consumers' goods they sell; some of it, however, is paid by business at all stages of production and distribution and measured by the producers' goods they buy (final purchases); and the incidence of either or both of these sectors of the tax may or may not lie with consumers. To add to the confusion we might try to distinguish between production taxes and consumption taxes, ignoring the admonition that a producer is but a consumer with a different hat on. But this difference at least is marked—a state production tax covers all production in a given territory whether or not for export; a consumption tax reaches imports and excludes exports. Thus a beer production tax in Wisconsin would tax all beer made in Milwaukee wherever sold; a consumption tax would reach beer wherever manufactured as long as it was consumed in the state.

We shall go no further with this exercise in classification. We shall assume that while boundary lines are blurred, there is enough consensus as to what constitutes business taxes so that we can talk about the subject without being convicted of pure nonsense at the outset.

The Ideology of the Corporate Net Income Tax

The role of the federal corporate net income tax continues to dominate discussion of business taxes at the federal level. Part of this discussion is ideological. Here we have a very important tax institution in search of a theory. Not too much that is strictly new can be reported, but particularly after World War II a substantial amount of analysis was devoted to the subject.

The issue was sharply posed by a committee of the National Tax Association in 1949 as follows: "If all revenue needed for

government could be raised from a moderate personal income tax and all corporate net income were distributed, would we then be in favor of a levy on corporate income, as such?" All of the many views on the rationale of taxing corporate net income were precipitated by this question. The majority thought the personal tax with graduation adequate to deal with all the faculty, benefits, and privileges associated with our economy. When the assumption concerning moderate revenue needs was relaxed, however, the weight of opinion shifted considerably. This means that some favored a corporate net income tax as a matter of priority over consumption taxes and *very severe* personal taxes.

The proponent of the benefits-received justification of business taxation can argue plausibly that government is in some sense a fifth factor of production for which business should pay as it does in the case of the others. To be sure the proponent finds himself in this dilemma: Logically, business benefit taxes should be imposed on all firms rather than only on those that make a profit, but a strong consensus supports the view that cost taxes are generally shifted forward and are in essence consumption taxes in disguise. Obliged to grasp one horn of the dilemma, the business tax proponent may now argue that the consumer *should* pay for the benefits of government incidental to the production of the goods he consumes. The fact that the benefits of government are regarded by some critics as immeasurable and indivisible can be taken in stride—rough justice is all one can expect from the tax system. Anyway we have shifted ground from a defense of a corporate net tax to one of a general business cost tax.

A few proponents of the corporate net income tax have sought to bring such a levy under the popular sanction of ability to pay. Even as applied to personal taxation the ability concept is not distinguished for its clarity and precision. Approaching the concept abstractly, the literature has usually regarded ability to pay as calling for some sort of equality of sacrifice—an equivalence of disutility. Whether collective entities can suf-

fer a psychological pain is related perhaps to whether they have souls. Corporations these days have become considerably involved in philanthropy and one finds articles in the law journals entitled "Love and the Modern Corporation." One can at least sympathize with this attempt of the corporation lawyers to capture a bit of appeal in what would seem to be a highly asexual field.

Approaching the problem more concretely, many critics would say that a tax can be supported in the name of ability to pay if it treats all incomes at the same level neutrally and reduces in some degree the inequality among different levels of income. On almost any analysis, the corporate tax is sure to come out with a low score in terms of neutrality. If the incidence of the tax is on the stockholders, it can mean only (leaving undistributed profits aside) that the corporate profit element in personal income is taxed at a higher rate than other elements—everything else being equal. In terms of distribution, the corporate tax fares much better. Assuming no shifting, much of it comes out of the pockets of rich people. This may be persuasive to some whose moral code is insensitive to neutrality among millionaires.

Taking a still more concrete approach one can argue with Richard Goode that modern corporations—especially the large and so-called "public" ones that exhibit the separation of management and ownership—typically generate a considerable residue of income to which nobody has any moral claim. This is an excess above adequate compensation for stockholders and management. It is the counterpart in the income field to irresponsible power in the area of control. Society might as well claim this considerable fund or a substantial part of it. It is a persuasive argument but it suffers from the prospect that this awesome power of corporate management might be used to pass on profits taxes along with other costs to less fortunate members of the economic community.

Still other critics, abandoning all these virtuous efforts to be rational, have argued simply that granted the present voracious

appetite for revenue, some of our taxes must be grounded in opportunism. Our consumption taxes—at least most of them—are hardly more rational in incidence, and these aggravate rather than relieve inequalities. Thus the attempt to find a rational basis for the corporate tax can end with abandonment of the attempt but with support of the corporate tax anyway. Even this approach, however, is acceptable only on certain assumptions about incidence, to which aspect we may now turn our attention.

Incidence and Effects of the Federal Corporate Net Income Tax

Festering at the root of disagreements on tax policy with regard to the corporation net income tax lies the matter of incidence of the levy. Our present system is said to impose a double burden on distributed profits, but the double burden disappears if the assumption that the incidence of corporate tax is on the stockholders is dropped. Moreover, the corporate tax may then be viewed as a heavy burden on consumers, carrying not only the usual concealment of a sales tax, but the additional one that the tax is advertised as a levy on profits. Add to this the fact that the incidence might be capricious and the face of the levy might change all the way from Dr. Jekyll to Mr. Hyde.

As has been said, corporate tax incidence has been the subject of considerable empirical study since our last symposium on this subject. Most of the studies have been historical-statistical, tracing the trend in corporate profits over the years under various and drastically different levels of the corporate levy. They show a remarkably consistent ratio of profits after tax to assets. This suggests perhaps that there is more politics and less economics in corporate business pricing than classical theory perceived. We must hasten to add that no sweeping or certain conclusions are permissible. There are other variables besides taxes in the picture, and it could be that profit ratios would

have risen to dramatic heights in recent years had not the corporate tax level also risen to prevent this. It is, however, fair to say that the new evidence has favored the skeptics of the conventional wisdom in this area.

The issue has a critical bearing on the controversial measure providing a dividend credit in 1954. A credit is logical enough under any view of incidence, but if the corporate tax is a sales tax in effect, the credit logically should be applied to reduce the corporate and not the personal tax burden. Otherwise, where there is shifting, the personal taxpayer escapes not only a double burden but any burden at all. Any credit in this area is vulnerable to attack as a concession to the rich. It might nevertheless survive if it were based on a more defensible principle.

If theoretical considerations point toward a tax on undistributed profits as the proper form for a corporate levy, considerations of development may point in the opposite direction. It is one thing, of course, to contemplate a new levy on undistributed profits in lieu of a tax on corporate income that would yield the same revenue, and another to contemplate a tax on the narrower base at the same rate that one would apply to the broader one. Suppose that we already have a tax of 50 per cent on all corporate net income. What would be the economic effect of confining the levy to undistributed profits and raising the lost revenue from other sources? Let us disregard the effects of the alternative sources. On the one hand, the absolute relief of (some) profits from taxation should support investment. On the other, the relative or differential tax favoring dividends (as it appears to the board of directors) would militate against reinvestment. It should be noted that the favor to dividends is only apparent; counting the personal tax the objective is more, not less, neutrality. But it may be the relative rather than the absolute burdens and the directors' rather than the overall view that are important for investment decisions.

The effects of the corporation tax on saving and investment are no doubt important but again nothing very definitive can

be said about them. Ostensibly the levy on corporations significantly reduces their ability to finance the purchase of new capital assets, but appraisal of effects is dependent on appraisal of incidence. Taxes recouped by raising prices, whatever else may be said about them, should have no great impact on investment. This we do know: Despite tax levels, investment as a percentage of gross national product was as high in the 1950's as during the 1920's.

There can be no doubt at all that the combination of relatively lenient taxation of capital gains and undistributed profits plus accelerated depreciation gives corporate business a powerful incentive for growth. In many cases corporate boards of directors worry as much about an outlet for available resources as about new capital supply. But growth in the economy and growth in the firm are two different phenomena. The tax system has built-in biases that favor overcapacity. The principal objection here is waste in the allocation of resources.

Accelerated Depreciation

Recent controversy about depreciation policy divides into two parts: the first concerns the sort of depreciation policy that will indicate the true income of the taxpayer; the second relates to the use of investment allowances to stimulate economic growth and/or relieve unemployment. It is perhaps fair to say, although the point is arguable, that the legislation of 1954 aimed principally at a more neutral and precise accounting of annual business income. Stress was laid upon the evidence that traditional straight-line depreciation erred in its timing against many taxpayers, taking no account of the propensity of assets—especially machinery and equipment—to lose value most rapidly in the early years. The current revisions of archaic life-expectancy tables are also of this order. Some recent proposals of the Kennedy administration, on the other hand, aim frankly at the use of depreciation policy as a stimulant. This is clearly discernible in the proposed allowance of more than 100 per

cent recovery of capital outlay—a policy long followed in the case of depletion allowances for the extractive industries.

The questions raised by these innovations are many and some of them are profound and difficult. How does one derive the facts and the formula for realistic depreciation? The illusion that accelerated depreciation would cost the Treasury nothing ultimately has been adequately demolished—in a dynamic and expanding economy the revenue never catches up with the losses. Since loss of revenue is clearly at stake, would reduced corporate tax rates serve the objectives as well or better than generous depreciation or investment allowances? Is the shortage of capital an important limiting factor in the growth of an economy alleged to be afflicted with excess capacity? Is a deliberate discrimination between the new and the old sound economics? How about the handicap to firms that have recently completed new investment programs? Granted that replacement of antiquated machinery is desirable for growth, why does free enterprise need any prodding for replacement that is economically sound? Does all of this only add to the complaint that businessmen make too many decisions on the basis of taxes? Can and will we turn the faucet off when stimulants are no longer needed? And so on.

Critics who have inveighed against unneutralities in the tax system are likely to accept some (even generous) accelerated depreciation as in accord with their bias. But investment allowances which introduce deliberate discrimination are bound to be regarded by them with skepticism. Some weight can be given perhaps to the point that businessmen are not entirely rational in replacement policy, but such innovations must carry a substantial burden of proof.

Taxation of Business Earnings Abroad

This outline of business tax problems would be seriously incomplete if it ignored entirely the knotty subject of levies on foreign business, domestically owned. Elements of the subject

include the validity of situs versus domicile or citizenship as the principle to follow in territorial finance; neutrality as to domestic and foreign investment and as to branch and subsidiary organization; the promotion of private foreign investment especially in underdeveloped economies; and the conservation of our gold reserve. Obviously this area is more than we can cover in adequate detail here even if we knew enough about it to do so well. Untaxed foreign investment could be another opportunity of the acquisitive economy to enhance wealth indefinitely outside the domestic, let alone the personal, tax system. On the other hand, available data apparently do indicate that funds remitted to this country from the cumulative foreign investment in past years exceed those currently going abroad.

Problems at the State Level

If the federal system of business taxes invites some charges of irrationality, state systems surely are worse. Take the institution of franchise taxes, for instance. The term "franchise tax" is one applied mainly to a levy on the privilege of doing business in the corporate form. Such a levy is an excise tax affording the legislature extremely wide discretionary powers, especially as applied to domestic corporations. With no defensible measure of value of the corporate privilege available, courts have permitted a wide variety of measures: gross income; net income; capital stock, authorized, issued, or according to market value; corporate excess (value of assets less that of tangible property); and several other criteria. A state may tax its domestic corporations on their franchises measuring the base by all the corporate stock (or income) of the company even though some or all of it is employed (or earned) outside the taxing state.

On another occasion the author appraised the Michigan franchise tax as follows:

> Of all the considerable array of Michigan taxes, there is probably least to be said for the business franchise tax based upon paid-up capital and surplus of corporations. It is grounded on an old and antiquated theory

that corporate privilege provides a measurable tax base. Actually there are three aspects of a business which might provide the basis of a rational tax: its property (including the intangibles); its net income; and the volume of its transactions. The franchise tax is calculated to reach none of these with any acceptable degree of precision. Book value of assets (less long-term indebtedness) is about the roughest possible approximation of property value. Add to this the fact that as administered and perhaps as necessarily administered the tax involves an excessive element of self-assessment. Moreover, much corporate property is already taxed at the local level and again taxed under the state intangibles tax. Other than the revenue it brings in, what is to be said for the franchise tax?[2]

The state taxation of interstate commerce hitherto dependent for guidelines upon courts that were ill-equipped to provide them is now on the agenda of the United States Congress. If the Congress acts with due courage and discretion, it can do much both to lay a solid plank in a sound structure of American federalism and to relieve interstate business of much uncertainty and perhaps excessive compliance costs. Decentralized decision making needs defending but having some common rules of the game prescribed by overall representation makes elemental common sense.

Should Business Be Taxed at All, and If So, How?

It is not inconceivable that a modern state could subsist on a revenue system that ignored business taxes—at least if the latter term be narrowly defined. The British system goes far in this direction, at least, in leaving industry immune. Manufacturing property has been largely "derated" for local tax, which falls mainly on houses and mercantile establishments; even the national income tax system which does tax corporate income as such at a moderate rate is mostly designed to reach personal income only.

Perhaps the main impediment in applying a concept of strictly personal taxation is undistributed profits. Even the Brit-

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[2] Harold M. Groves, "Michigan Taxes and Economic Growth," *Taxes and Economic Growth in Michigan*, Paul W. McCracken, Editor, Kalamazoo: W. E. Upjohn Institute for Employment Research, 1960, pp. 85-97.

ish have been obliged to develop various gadgetry to foreclose a wide-open invitation to use the corporation as a savings bank. The acquisitive economy is largely an incorporated way of life capable of insulating the individual from its bounties, except for capital gains, some of which are granted important tax concessions and some of which are never realized at all. The personal tax system, at least a simple one, is ill-equipped to deal with this phenomenon.

Beyond this and at the state level, corporation income taxes apply the situs principle to business earnings; without them considerable income earned in a particular state and distributed to out-of-state investors would go untaxed. At the local level, no doubt most citizens would think it unconscionable to exempt industrial property from "paying its share" for the benefits of fire and police protection, but this is hardly a matter of special business taxation.

In the area of special business taxation we encounter the old controversy concerning the wisdom of confining such taxes, if any, to corporate entities. There has always been some following for the view that business taxes, if we are to have them, should be extended to all business, however the latter may be defined. But this special effort to introduce rationality into what is mainly an irrational sector of the tax system has never had wide appeal. When we carry the business classification to include the farmer and the corner grocer, it becomes apparent that the businessman after all is, as we have said, only a wage earner, a householder, and a consumer in a different garb.

More support, no doubt, could be found for classification within the very large and diverse corporate family of institutions. Indeed we have enacted some legislation to neutralize the tax burden as between small corporations and partnerships by allowing a choice of tax status to these institutions under certain circumstances. Small business enjoys, as well, other benefits of other special tax provisions. These concessions create plenty of difficulties: boundary lines are necessarily arbitrary; some unjustified competitive inequalities may develop; cor-

porations can divide to secure advantages; complications are added to a complicated law. Nevertheless small firms do have special difficulties in securing equity capital and are especially dependent on undistributed earnings.

Finally we may record the argument concerning the applicability of progression to corporate income. The volume of corporate earnings is clearly only an index of size—certainly not of profitability. Graduation according to profitability still has some following in academic circles but it has made no progress against the traditional view that we must not attack the profit motive directly; all profits are fair if they are competitive, and if they are not competitive, we should call the antitrust division rather than the Internal Revenue Service. Moreover, proposals of this sort recall the experiences of the excess profits tax eras which many taxpayers would be happy to forget.

If and when the public and Congress fall into the mood for something new and different in business taxation, they might conceivably consider a value-added tax. Our one experience with this tax is in Michigan where the symmetry of an attractive theory has been severely compromised by arbitrary features. The tax is advertised as one the incidence of which could be made to approximate that of a flat personal income tax on all income. No doubt such a levy would encounter plenty of difficulties of its own. Its theoretical symmetry could be distorted sadly in the political process of conceding exemptions and (perhaps) classified rates. And its political attractiveness would be far below that of the corporation income tax. In defense of such a levy it could be argued with high plausibility that its incidence would be more explicit and dependable than that of the corporate net income tax.

The author has argued elsewhere[3] that our income tax system suffers from excessive marginal rates that are not effective. Ways may be found to broaden the base of the personal and the cor-

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[3] Harold M. Groves, "Revision of the Federal Income Tax," *Proceedings of the . . . National Tax Association, 1961,* Harrisburg, 1962, pp. 19-25.

porate tax, both reducing the advertised rates and increasing the yield of these levies.

Conclusion

Rigorous rationalism in the tax system is perhaps too much to expect. But rigorous rationalism in tax critics, at least the academic ones, can be demanded. These tax critics do now and should continue to find the business tax system amply provocative.

CHAPTER II

APPROACHES TO THE TAXATION OF BUSINESS

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THE REALITIES of the federal tax system have made relatively academic the issue of eliminating the corporate income tax. We cannot truly change the proportion of our federal revenue coming from this source. A battle over the shift of the burden of taxation would involve us in a major national conflict of economic interests. We have already heard the protests and witnessed the resistance resulting from relatively more modest proposals. Each special claimant determinedly fights for his position, and the mass of Americans, while inadequately represented at the hearings, can voice their sentiments in elections. Moreover, our corporate business sector has adapted itself to the impact of the tax. Our nation has lived through prosperous, highly active, full employment periods, as well as major and minor recessions, under this system of taxation. The issue remains—how to operate best within this system of taxation.

PROPRIETY OF THE CORPORATE INCOME TAX

The continued application of the corporate income tax system supports the assumption that there is much substance to the two basic presumptions argued by the proponents of this form of taxation. The first is that the government does provide services to the business society for which payments may well be requested in relation to the company's income, and second, that there is a residue of income enjoyed by business enterprises, again roughly measured by income, which results from its eco-

nomic power, strategic position, or good fortune, to which the community may well have special claims. There is an independent taxing capacity which can be and has been tapped by government. The objections to these corporate income tax payments, on the grounds that they should be more broadly assessed or that the power should be curbed by antitrust authorities, hardly get to the core of the issue. These business units have incomes and tax capacities which the community has evaluated and to which it has applied differential levies, according to rough measures of the ability to pay.

The debate on the incidence of these taxes has not been conclusive, largely because the market conditions prevailing in each of the economic areas have differed widely and have varied from time to time. We can conjecture that in the more competitive fields, the shifting of taxes is more difficult than in the oligopolistic markets where taxes are passed on more easily. The size of the transfer depends on the pricing policies followed by the original taxpayers and the latitude allowed the price-setter by competitive market factors and conditions. It is more than likely that the narrower the limits of discretion placed upon the price administrator, the less is he able to shift his tax costs. Moreover, the varying impact of the flat tax rate for all but the very low income business has different effects on corporations, depending on the rate of profit. Therefore, it must be presumed that some very substantial part of the tax burden placed on corporations is absorbed by the original business enterprises which pay these income taxes. We cannot assume that the corporation is only a conduit for the payment of taxes.

Elimination of Inequities and Abuses

The grave question before us, therefore, is not the propriety of the federal corporate income tax system. Rather, the issues are first, how to eliminate the inequities and abuses written into the law, as well as those which have developed from the ability of the taxpayers and their advisers to circumvent the obvious purpose or to capitalize on undetected loopholes; and second,

how to operate the tax system so that it contributes to the overall national purpose of achieving maximum economic stability and continued economic growth.

As for the correction of the inequities and abuses, many have written about this problem and have sought action to assure greater fairness in the application of the law. Among those proposals which appear to be most significant are the following. First, there is the currently discussed issue of the special privileges enjoyed by domestic corporations with foreign operations. These ventures had been looked upon favorably during the past few years. Now they are considered of questionable desirability, particularly as they relate to the developed countries, for they endanger our balance of payments and encourage managements to seek easier, orthodox solutions through investments abroad which provide built-in tax benefits and avoid tackling their competitive problems at home. This changing attitude illustrates the particular dilemma faced by the tax administrators and economic policy-makers, who often apply laws which are designed for specific periods, but which continue in operation long after their usefulness has been served and become converted into abuses and special privileges, and may, as in this instance, endanger the very soundness of our entire monetary system. Our tax laws should limit the period of application of special privileges and empower the administrator to reduce or even cancel them if they no longer serve national policy.

A vital area requiring correction is the much discussed tax haven for American corporations in foreign countries. These allow for tax avoidance and much manipulation. The United States Treasury provided an ample listing of these cases in its testimony last spring before the House Ways and Means Committee.

Liberal depletion allowances have also been continued long after they are appropriate. Whatever rationale there may have been for them when this nation feared a shortage of oil, it has been completely removed by the present international abun-

dance of oil resources and supplies. Continued encouragement of oil exploration in the United States appears unnecessary at this time and is a further embarrassment to our foreign economic policy.

Expense spending has been abused and has created a new dimension for untaxed executive compensation which the Treasury has sought to curb, before the sense of general outrage against special privilege inspires further cynicism and lack of respect for our tax system.

Other special areas which require immediate action are in the misuses of the privilege of establishing corporate educational and philanthropic foundations as protective covers for the control of business operations; the creation of banking resources; the domination of social, educational, and welfare institutions and activities either locally or nationally; and their use as tax havens. The loss carry-over provisions have enriched resourceful taxpayers at the expense of the Treasury and have accelerated the demise of business enterprises where owners have found it more attractive to sell out than seek to rehabilitate their ventures.

Impact of Corporate Income Tax Upon Enterprise

Still another area of close study should be an examination of the impact of the corporate income tax system upon the individual enterprise, as a business venture working consistently with the overall interests of the economy for stability and economic growth. In relation to the first of these objectives, the evidence and opinions appear to agree. The tax system has contributed to the achievement of greater economic stability. The taxes levied on the enterprise have varied their income. Moreover, the carry-back and carry-forward provisions have permitted concerns to average out their incomes. In times of business reverses the tax burden has declined and in fact, if losses were incurred, credits could be called for.

The real issues relate to the degree to which the tax system has helped economic growth. In the prior periods of high

rates of growth, the present corporate tax system has been fully operative. We may, therefore, conclude that it has been an aid and certainly not a deterrent to economic growth. Over the last twenty years, the business community has exploited recessions to seek out special privilege which has then become permanently written into the tax law.

Each was obtained in the name of aiding economic growth, but the business community was always ready to ask for another concession before the last one was fully implemented. No better illustration of this course may be found than in the continued agitation for the liberalization of depreciation allowances. The famous fight in 1940 over industry's liberalized depreciation allowances as the price for conversion to war production began this long chapter. The concessions of 1954 were followed by the agitation which prompted rejection of the special investment credit proposals offered by the Administration to this Congress.

Economic Tools to Encourage Business Enterprise

Our great need is to integrate our corporate tax system with a full program of economic programming and balance, which would encourage continued high employment and economic expansion, just as some countries with continuing high postwar employment have already done. We now employ a set of economic tools beyond those built into our economic organization to encourage business enterprise. These include grants for research or contracts for military production, which yield many opportunities for commercial exploitation. The government now underwrites many private ventures in construction and in the home building fields, which safeguard loans and which reduce costs, as in the case of high-priced land resold after purchase by the government at a loss absorbed by the government. Differentially lower interest rates are employed in various ways to assist some types of ventures. Lower tax rates are assured for operations in Latin America in order to encourage investments in these countries. Our tax system has recognized the propriety

of investment in research and allows for its deduction as a current business expense.

The special merit of these procedures is that they can be invoked only at the time of an actual business undertaking. In some instances, safeguards are written into the operation of these techniques and their supervision, which assure positive results rather than gains through subterfuge. It is unlikely that these provisions could promote such wholesale misuse as the milking of depreciation funds, as now occurs in many real estate operations.

The Administration's proposal respecting investments in new capital expenditures falls into the same category. It is not a concession applicable to all past investments and which would net a windfall to present owners of capital. It is a special incentive for investment. The great deficiencies in this approach are that it is not limited as to its period of application, and provides the administrator with little area for discretion as to its period of operation or guides for its termination. It is applicable across the board to all situations without regard to whether it is in the public interest to promote investments in specific areas. All businesses want to get in on the benefits irrespective of their activity. They fight differentiation which is becoming the focus of national economic policy.

The great challenge in our economy at the present time is to accelerate the rate of application of scientific knowledge for commercial uses. The United States government has invested billions in basic research, much of which is available to our business enterprises. The latter have not developed practical uses for this knowledge at a rate which will keep our country technically and economically ahead of other nations.

There is a great urgency in getting this process advanced. Various means must be found. The Department of Commerce is embarking on a program of popularizing the use of scientific knowledge. Perhaps we need development agencies for various industries to bridge the gaps between knowledge, development,

and commercial application. Whatever the needs are, they have to be spelled out immediately and precisely.

The government needs the fiscal and tax tools, the incentives, and the legal means for penalizing the laggards and discriminating between industries, to assure the promotion of those vital to the competitive survival and economic growth of the United States. Other countries in the Western bloc such as France, Germany, Italy, the Scandinavian countries, and England have developed a series of techniques including tax rewards and penalty devices which induce their industries to conform to their national programs for economic development.

We in the United States have hardly begun to explore our needs for new fiscal tools to aid in economic development. We have enjoyed the luxury of maintaining a Council of Economic Advisers for some fourteen years. During the last eight years, it has not been an agency for the careful guidance of the economy. Its members were government business forecasters who advised on fiscal, monetary, and political economic policy. Other Western countries have forged ahead of us and spelled out careful guideposts for development and growth. They have provided their governments with a variety of tools for achieving these results in order to maintain rates of economic growth. Their effectiveness is illustrated not only by their record, but also by the willingness of the English Conservative government to emulate them in their ways. The tax systems in these countries have been closely integrated with their programs for economic development.

The new approaches we have to study and pursue must be based in part on the recognition that the United States, as well as all other member nations of the OECD, has undertaken to increase its real national output by 50 per cent in ten years and maintain full employment. We also have an immediate responsibility to maintain a sound balance of payments. These ends cannot easily be achieved unless we provide the government with many new tools for accelerating growth and guiding

business action. The tax administrator will, therefore, have to be given more discretion and tools than he has ever before possessed to help effectuate the overall economic programs. That does not mean that the tax burden on business has to be reduced, but rather that it has to be shifted, adjusted, and varied, as may be required to effect the broader national purpose. Provisions designed for achieving short-term national purposes should be dropped when their purpose has been achieved. The tax administrator should, with the approval of the President, integrate his program with an overall federal system for stimulating economic growth and achieving stability. The personal beneficiaries of these advantages will have to share the results through higher personal income tax payments.

CHAPTER III

TAXATION OF BUSINESS

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THE TAXATION of business has in economic theory always been an anomaly. We have, nevertheless, bemused ourselves with the idea that taxing business somehow or other relieved individuals of the burden of taxation. Yet nothing could be clearer than the fact that a tax imposed on business must be borne by people—the people whose combined activities comprise the business: its customers, employees, and investors. Growing recognition of this much obscured but simple fact is enlightening current discussions of business taxation. At the same time the argument over who bears a tax on business, particularly the corporate income tax as between the shareholders or customers, is being recognized as irresolvable. The incidence of the tax is, no doubt, a changing one depending on the stage of the business cycle and, hence, the tax is one of uncertain impact.

In this state of the matter it would appear clear that the imposition of taxes on business, regardless of their nature, is really a device for collecting taxes actually imposed on individuals, but without any certainty as to what economic group of individuals bears the tax. Good sense would, therefore, seem to dictate that there should be no business taxes.

Yet, I think it must be recognized that utilizing business entities as a collection device for spreading the burden of taxa-

tion is too attractive and useful to be overlooked by a financially hard-pressed government. Aside from this hard, practical consideration, there is, in spite of the uncertain incidence of business taxes, pragmatic wisdom in avoiding a tax system consisting of only a single tax such as the individual income or expenditure tax. No tax is perfect, and a medley of taxes, if properly chosen, can help to balance the imperfections of any one tax.

The administrative convenience and relative certainty of collection of taxes imposed on business is also a compelling practical consideration which has moved legislatures to rely on business taxes. This is especially clear in the case of sales and use taxes where the tax is supposedly only nominally imposed on business as a means of collecting the tax from the purchasers.

Accepting, therefore, the pragmatic justification for business taxation, the question remains as to what should be the nature of business taxation. Should the main reliance be placed by the federal government on the income tax? In 1960, $22 billion, or 80 per cent, of the $28.3 billion of business taxes collected by the federal government (other than the alcohol, tobacco, retailers, stamp, and employment taxes) was from the corporate income tax. As compared with other nations, the United States (including the federal and state governments) relies 1.6 times as much on corporate profits taxes as do the Western European countries. Only Great Britain approaches our reliance on the corporate income tax. In view of the fact that our extraordinary reliance on the corporate income tax compels a rate of 52 per cent, which is widely deplored, it should be clear that a consideration of alternatives or supplements to the federal corporate income tax is appropriate.

Alternatives to the Corporate Income Tax

In considering such alternatives it should be kept in mind (1) that the broader the base the lower the rate can be, thereby reducing the impact of the tax on business decisions; (2) that the choice of the base may make more certain whether the tax

is shifted or absorbed and if shifted that the tax will have less impact on business decisions; and (3) that the choice of the base may determine to what extent the tax is pyramided. It should also be recognized that these considerations may be contradictory, compelling choice among them.

A tax on corporate business income is, of course, imposed on a relatively narrow base of about $45 billion, requiring in the case of the federal tax a high rate that has a substantial impact on business decisions. This impact is intensified by reason of the fact that an income tax is less susceptible of ready shifting than other business taxes. But a tax on business income is not pyramided except to the extent that it is passed on in price and incorporated in successive mark-ups.

General Business Tax

The opposite extreme of the income tax is the business receipts or turnover tax. The aggregate national base of this tax would be on the order of $900 billion and it would require a rate of only about 3 per cent to equal the revenue of $28.3 billion from the present corporate income and other business taxes which it could supplant. Since the rate would be very low and since the tax would most probably be shifted, it would have relatively little impact on business decisions. But it would clearly be pyramided through the whole production and distribution process and the extent of the pyramiding would depend on the number of business entities in the chain. This would give a competitive advantage to the industries and enterprises with the fewest number of entities in the production and distribution chain. Nevertheless, turnover taxes are quite widely and apparently successfully used by many countries, especially in Western Europe. Moreover, the problem of pyramiding is mitigated as the rate is reduced. Hence, if the corporate income tax were to be retained at, say, a 25 per cent rate and the general business receipts tax relied on to raise the remaining business tax revenues of about $17 billion, the rate would need to be no more than 2 per cent.

Value-Added Tax

There is another form of tax, the base of which lies about halfway between general business receipts and net income. This is generally referred to as the value-added tax. Professor Carl Shoup has done much to stimulate consideration of this tax and it has been adopted in a modified form by the state of Michigan as its business activities tax. The theory of this tax is that normal business accounting provides the basis for cumulatively determining national income in the aggregate, and hence if each business entity is taxed on its contribution to the national income, in other words the value it has added, the total national income will be taxed and taxed only once without duplication or direct pyramiding.

In determining the value added by a business entity one can either subtract from its business receipts purchases of goods and services from other businesses and its depreciation charges (or in the alternative, its capital expenditures) or one can add its payments made to individuals for salaries, wages, interest, and rents, and the profits of the business. Based on 1959 data the aggregate national value-added tax base would be about $300 billion, which would require a tax rate of about 9.5 per cent to equal the $28.3 billion now raised by business taxes it could replace. Thus, the value-added tax also achieves a vast broadening of the present tax base and a very substantial reduction in the rate. It would not be pyramided except as the tax is passed on in the price and incorporated in successive mark-ups.

It is much less certain, however, than in the case of the general business receipts tax, that the value-added tax would be shifted. Hence its impact on business decisions might be considerable. Moreover, to the extent that it is not shifted it could have serious economic consequences in that it would constitute a levy on capital in years when the business did not have income at least large enough to cover the unshifted portion of the tax. Here again, therefore, it might be wise to continue to rely on the corporate net income tax at about half its present rate, or 25 per cent, and to raise the remainder of the present business

tax revenues of $17 billion from the value-added tax. This would require a rate of about 6 per cent.

General Manufacturers' Excise Tax

A final alternative or supplement to the corporate income tax which I shall bring up for consideration is the general manufacturers' excise tax. Such a tax has often been advocated and almost every session of Congress has bills before it which would enact it. Canada has had such a tax for many years. In so far as the general manufacturers' excise tax would be a substitute for the present selective manufacturers' excise, it makes sense.

It is hard to see, however, how the general manufacturers' excise tax can justifiably be used as a substitute for the corporate income tax, since it would shift the present tax on trade and services to manufacturing. Even on the assumption that the tax is wholly passed on in the prices of manufactured products the terms of trade would shift against manufactured products and in favor of services with economic detriment to the manufacturing sector. If the tax is not passed on it would discriminate against investment in manufacturing. The wisdom of selecting a segment of business enterprise from which to collect the revenue or part of the revenue now coming from the corporate income tax on all business is certainly to be doubted.

The manufacturers' excise tax is not essentially different from a business receipts tax except for its coverage, and its limited coverage is its basic defect. On the other hand, being levied only at the manufacturing level it has the advantage over the general business receipts or turnover tax of avoiding direct pyramiding. But the value-added tax also has this advantage and at the same time does not suffer from the defect of applying to only one sector of business enterprise.

The advantages and disadvantages of each of the several possible business tax bases suggests that possibly a combination of all of them might be the most satisfactory. Such a solution could, however, encounter serious problems in administration and compliance, especially with respect to small business.

While I do not advocate any specific change, I would like to suggest that serious consideration should be given to reducing sharply the federal corporate income tax rate to perhaps 25 per cent and relying for the revenue lost either on a general business receipts tax of probably 2 per cent or on a value-added tax of probably 6 per cent.

Such a change would radically alter the federal business tax climate and would, no doubt, alleviate some of the most difficult problems under our corporate income tax, arising mainly from the very high rate, such as depreciation, capital gains, depletion, and foreign income.

State and Local Taxation of Business

So far as state and local taxation of business is concerned, the choice of and relative reliance on the several possible forms of business taxation is in much better balance than with respect to federal taxation of business. Of total general business tax revenues in 1960 of about $6.7 billion (other than property and miscellaneous taxes), $5.5 billion, or 80 per cent, was from sales, use, and gross receipts taxes and $1.2 billion, or 20 per cent, from the corporate income tax. Hence, if business taxation by states and local governments is to be used as a supplemental means of distributing the tax burden among individuals, there is not much to suggest for improvement so far as the choice of taxes is concerned, other than, as Professor Groves has pointed out, that there is not much to be said for a franchise tax.

There is, however, a problem encountered in state and local taxation of business which is not encountered at the federal level. This is the vexing problem of how to tax interstate business. The problem is now under investigation by a subcommittee of the House Judiciary Committee and one can hope that a solution will be forthcoming. In any event the problem is too big to explore here. In spite of the seriousness of this problem, however, I doubt that it will ever be possible to persuade the states and local governments to abandon taxation of business.

The Use of Business Taxation for Economic Growth and Stabilization

At the outset I recognized that there was a pragmatic justification for business taxation even though there might be none in economic theory. There is much discussion today, however, of the merits and the means of using business taxation as a fiscal device for stabilizing the economy and contributing to its growth. If such a use of business taxation is accepted and is effective, it could of itself justify the taxation of business as a matter of economic theory or at least as a program based on economic theory.

It is not always clear whether the various tax proposals to spur economic growth are conceived of as a use of the tax system to encourage economic growth, or as a removal of the discouragement that the tax system offers to economic growth, which could best be removed by abandoning the tax on business. It probably depends on the point of view and the convictions of the proponent. In any event, such proposals as the President's investment credit, the various proposals for liberalized depreciation, proposals for incentives to research and development, and the concessions to small business are devices to encourage economic growth, the efficacy of which depends on the existence of a business tax system. But it is not yet widely or avowedly advocated that business should be taxed in order that such devices to encourage economic growth may be used as indicated.

There is inherent, however, in the view that the corporate income tax acts as an automatic economic stabilizer the implicit argument that for this reason the taxation of business income is sound and desirable. Moreover, the existence of business taxes is prerequisite to most of the proposals for employment of fiscal machinery to moderate the business cycle. We shall, no doubt, hear much more of such proposals in the future. If such an approach to economic stabilization is accepted, this will, of course, be another justification for the need to impose business taxes.

Conclusion

Business taxation is too firmly entrenched for anyone to entertain any hope that it will be abandoned or significantly restricted. But a wiser choice and balance among the several possible bases of business taxation, particularly by the federal government, can properly be expected and should be effected.

Should business taxation become the necessary foundation for programs of economic growth and stabilization, the considerations relevant to this purpose may dictate the choice of business taxes, possibly taxes which are not extensively employed today or even familiar to us, such as taxes on undistributed profits, on capital expenditures, or on business costs. We may be facing an era in which business taxation assumes an unaccustomed role.

CHAPTER IV

THE TAXATION OF BUSINESS

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THE DIFFICULTIES encountered in formulating a rationable, equitable, and practicable approach to business taxation have been effectively appraised by Professor Groves. One wonders if any order can be brought out of the confusing situation described. Possibly by taking inventory of the theory and practice of business taxation and setting our sights on reasonable but attainable objectives we may accomplish some much needed reforms. This was my hope in 1950 when a number of us participated in a Tax Institute symposium on "Taxation and Business Concentration."

As Professor Groves and other contributors to the present symposium indicate, we are confronted with many different points of view on what business is and on why and how business should be taxed. The result is that many taxes imposed specifically on business as an object of taxation and other taxes collected from business along with other taxpayers are, to a great extent, the products of fiscal, political, economic, and social expediency.

THE NEED FOR REVENUE

We all know that the primary purpose of taxation throughout history has been the raising of revenue to support government services. The Bureau of the Census has reported that our 100,000 taxing governments collected approximately $126.6 billion in taxes and compulsory social security charges in the

fiscal year 1960. These revenues, rounded in billions, fall into these categories:

Individual income taxes	$43.2
Corporation income taxes	22.7
Property taxes	16.4
Selective sales taxes	18.2
General sales and use taxes	5.2
Customs duties	1.1
Motor vehicle licenses	1.7
Death and gift taxes	2.0
Other taxes	2.7
Social security taxes and charges	13.4
Total	$126.6

Not included in these figures were $235.3 million in net income reported for state liquor stores. These profits would be regarded by many as a tax, in effect.

Without attempting to separate the taxes on business and those collected from business, it is apparent that these two categories together constitute the great preponderance of our taxes. Individual income taxes are largely withheld at the source, property taxes fall substantially on business as well as personal property, sales taxes are either levied on business or collected by it, and social security taxes and charges are partly laid on business and partly withheld. Corporation income and franchise taxes are also assessed against business. Thus business has become a favorite target for taxation and tax collection.

What Is Business?

If business is to be an object of taxation, how shall it be defined? If we say that business, in the broad sense, is productive activity directed toward the markets for goods and services, is this a practicable and desirable definition for taxation? As we know, it is frequently not possible in taxation to draw a clear line between production and consumption or between what the economist might regard as business and nonbusiness activity.

Many difficult questions arise in defining business for taxation. If we include in business all productivity directed toward the market, should any distinctions be made with respect to the extractive industries, manufacturing, finance, trade, the professions, and other classes of business? Should a uniform business tax be imposed, or should tax rates vary with the class of business? Should uniformity and equality of taxation in each community be sought, or should distinctions be recognized for domestic and foreign concerns? Should domestic firms operating outside the community be subject to the same income taxes as such firms operating in foreign communities? These are only a few of the numerous questions arising in the development of a rational concept of business taxation.

Justice and Other Tax Principles

The principles of taxation have frequently been advanced with individual taxpayers in mind. This seems to have been largely true for Adam Smith's classic maxims of equity, certainty, convenience, and economy, which were formulated before the taxation of corporations became of great revenue importance. Justice in taxation, as related to ability to pay, benefits received, and other criteria, has been thought of as a requirement for distributing the costs of government among individuals. Where business is merely a tax collector, as for sales and purchase taxes to be added to the prices paid by purchasers, the taxes taken initially from vendors may be regarded as taxes on individual consumers. But both taxes on business and taxes collected from business are essentially impersonal in their application, and justice among individuals may be impossible to attain.

More recently, the effects of taxation on the whole community have been considered and not simply the burdens on those who are assumed to be the ultimate taxpayers. As revenue needs have multiplied, business activity has increased, and such social goals as full employment and economic growth have been emphasized, the equitable distribution of taxation has become

more and more a community problem. Much is being heard about the increased need for investment and a faster rate of economic growth, as anxious eyes are kept on Russia. Fiscal policy has turned to taxation as an instrument of influence and control over the flow of economic activity.

But economic goals may not be decisive in taxation. Political pressures are always present, and political expediency may prevail over rational economics. Then, too, as revenue needs have increased, our governments have levied a greater diversity of taxes, regardless of economic consequences. The overlapping of taxes imposed by different levels of government has also increased in the competition for additional revenues.

The interplay of economic, political, financial, and other forces has resulted in a conglomeration of federal, state, and local taxes imposed on business and collected from business. Both revenue and regulatory motives have been at work. Now we are confronted with the task of formulating regulatory as well as revenue principles of taxation and bringing order and consistency into their application.

The Unsettled Theory of Business Taxation

Considering all of the complications involved, perhaps it is little wonder that the theory of business taxation remains in an unsettled stage of development. Each theory falls down on some score, whether one refers to the numerous variations of ability to pay, costs, benefits, neutrality, equality, uniformity, or other bases of taxation. We always arrive at the point where ability, benefits, economic effects, and so on become uncertain and perhaps immeasurable. Furthermore, the different theories conflict with each other.

If one seeks escape from subjective value-judgments in devising standards of tax distribution, whether he considers only the burdens on the taxpayers or the impact of taxes on the whole community, he may find momentary refuge in an impersonal theory of business taxation. Why not tax business, or productive activity, as Professor Studenski proposed, with a value-added

tax? Saying that any tax is impersonal, however, does not prevent its falling on investors, consumers, or other individuals through shifting or tax capitalization.

A value-added tax would tend to be shifted forward to consumers in higher prices. The base of this tax would be substantially the same as that of a retail sales tax falling on the sum of the values added in production, rather than on each addition to value along the way. Why, then, resort to a roundabout process of taxing the values of production when a direct tax on retail values would tax final values? In either event, it is not production or business which bears the burden of taxation; rather it is the individuals to whom the tax is shifted.

Business Taxation and the Economy

Tax theory has increasingly emphasized the necessity for the taxation of business and individuals to be consistent with our economic and social objectives, whether taxation be employed for revenue or for regulation. Economic stability and growth are commonly cited objectives. Growth of the economy requires a consideration of the effects of taxation on manufacturing, trade, employment, investment, consumption, and other economic activity. To a considerable extent the local, state, and national economies are competitive with other economies. Industries also compete with industries and taxpayers with taxpayers.

Agreement has not been realized on the implications of such objectives as full employment, stability, and growth, and the best means for advancing these goals. Despite all of our studies, the economic effects of many of our taxes are shrouded in mystery and controversy. Taxpayers disagree with tax officials, members of both groups disagree among themselves, and tax students debate the assumed effects of various taxes. We are in doubt as to the final incidence and effects of our taxes, particularly when we relate the burdens of taxation to the effects of the government expenditures they finance.

The Sources of All Taxes

Facing such perplexing problems, perhaps our floundering around is not altogether without explanation. It may be helpful, in attempting to envision the appropriate role of business taxes and those collected from business to keep in mind a simple but fundamental fact. The sources of all tax payments, as we know, are the savings, spending, and income of the taxpayers. Ultimately, the source of taxation is income, or the output of the goods and services we produce. Property, sales, income, license, privilege, business, and individual taxes must be paid out of these sources. A problem in the tax system, therefore, is the attainment of an appropriate balance of taxes on these sources in order to assure adequacy of revenue, equity, the minimum of ill effects on the economy, and other requirements.

All Taxes Are Paid by Individuals

Another simple but fundamental fact is worth emphasis. All taxes must be paid out of the resources of individuals, however the taxes are imposed. So-called business taxes are, in effect, taxes on investors, employees, consumers, or other persons from whose funds they are extracted. Business is merely the medium through which individuals and associations of individuals conduct their productive activities, with the market as a goal.

This trite generalization seems obvious enough, but there is a common tendency to regard taxes on business as taxes on nobody and nothing. There is also the notion that to tax corporations is to tax only the wealthy. In formulating tax measures for legislative action it is common to think that both business and individuals must be taxed. Taxes cannot be cut for business unless they are also cut for individuals. The business firm is thus a mysterious entity, and taxes on its property, income, or capital seem to dissipate somehow and to burden no one.

Business is also related to profit seeking. The owners are thought to be in business, but the creditors, those who lease

their property to the firm, and the employees and others who sell their services to the firm in order to obtain income are excluded. Business taxes, from this point of view, should be confined to the owners.

Corporations are looked upon as gainers of profits and having wealth in their own right. Taxes on them do not burden anyone. Again, big business is associated with monopoly, and large corporations should pay taxes at higher rates than those of lesser size.

In all of these classifications, the attitude is taken that taxes on business either hit no one in particular or, at most, fall only on the wealthy. So it does not matter how business is taxed. The simple basic fact is overlooked that all taxes must be paid out of funds belonging to individuals and, therefore, in some way burden the individual payers, even though the burden is not visible.

Another point of view encountered when business taxes are mentioned is that these, like all other taxes, are passed on to consumers, who pay all taxes in the last analysis. Taxes on corporations thus become sales taxes, in effect, whether they are imposed on net income, capital, real estate, or other objects. Sometimes the diffusionists, who are many, suggest that no matter how taxes are imposed they finally hit the ultimate consumers through price increases.

Some of those advancing diffusion theories complain, however, that net income, capital, sales, or other taxes are too heavy or discriminatory and are burdensome to certain business firms. Evidently, exceptions are made for particular taxes and situations, and one may hear that while all taxes are diffused over consumers, a specific tax has restrictive effects and should be repealed or reduced.

The uncertainty over the incidence and effects of our business taxes is an important contributing factor to the disagreement over their appropriate role. This much is certain, however. To the extent that business taxes are passed along to purchasers, they hit them all alike at the same rate regardless

of their economic status. To the extent that these taxes fall on investors, employees, or other persons, they also tax them all at the same rate, without distinction. Many billions of dollars of taxes imposed on business and of taxes collected from business thus fall upon individuals in the most impersonal manner, regardless of ability, benefits, or economic consequences.

Why Not a System of Direct Taxes on Individuals?

Our analysis of business taxation suggests the question, why should not all taxes be imposed directly upon individuals with respect to their income, property, and spending? In this manner no problems of defining business and deciding how to tax it need be considered. Through such direct personal taxation the costs of government could be apportioned among the individual taxpayers in the desired manner and the effects of taxation would be more easily observed. Each taxpayer would know what his share of the cost of government is and could relate his tax bill to his assumed benefits from government services.

In this vein of thought, no distinction need be made as to the form of business organization, the size of the business, the retention or distribution of business income, the nature of the industry, and other variable business factors and conditions. Such aid as might seem warranted for new business, small business, investment, and other desired activity could be given through subsidies.

The tax system pictured here is, of course, an idyllic one and completely unrealistic in our presently imperfect world. Both the taxpayers and the tax officials and legislators seem to prefer a diversity of uncoordinated revenues to an orderly and balanced tax system. In the levy of our taxes, however, it is possible for us to hold in mind the taxes we would employ if we could raise our needed revenues directly with personalized imposts. The question is, what tax payments would we require of the individuals who must bear the taxes collected, whether these taxes be placed on business, collected from business, or laid on individual taxpayers?

The Problem of Federal Income Tax Reform

Having some guiding principles in mind and realizing that we are, to a considerable extent, the blind attempting to lead the blind through unknown and hazardous passages, one may ask, how should our business taxes be reformed? And how should the tax system be reformed to place the taxation of business and the taxes collected from business in their proper roles?

The questions raised here call for many value-judgments, as this discussion has indicated. For many years the reform of the federal income tax has been proposed and many conflicting opinions have been advanced. It is plain that to many persons tax reform means tax reduction. If the tax rates were not so high, the deductions and other features of the income tax would seem less important.

Two years ago the Committee on Ways and Means conducted extensive hearings on federal tax reform. Many experts presented their views in the three volumes of the *Tax Revision Compendium.* All of the witnesses wanted equitable taxes conducive to economic growth and producing adequate revenue. The prescriptions for tax reduction and reform, however, varied greatly. One can find here arguments for about any proposition he may want to advance.

In April, 1961, President Kennedy presented a number of tax revision proposals to Congress. Probably everyone would agree with the President that the tax system must be adequate for our public needs, must distribute the costs of government fairly, and must encourage the efficient use of our resources as well as economic stability and growth. But how are these ends to be promoted?

As we all know, the President's business tax proposals stirred up something of a hornets' nest in the business community. The investment incentive credit is favored by some of those who would enjoy its benefits but it is held to be discriminatory, rewarding concerns which would increase investment anyhow, and delaying other needed business tax reforms. It is further argued that the proposals for taxing foreign income, eliminating

the dividend credit and exclusion, and other tax increases would be unfavorable to investment and business activity.

Just mentioning the Administration's tax proposals has the effect of arousing arguments and counterarguments. The discussion and judgment process is typical of our way of planning and legislating taxes. Public hearings bring the issues out in the open and the various interests can present their arguments with such substantiating evidence as they can assemble. The legislative body and the informed public, after the experts have reported their findings, can then judge—intelligently and fairly, we hope—the merits of the conflicting claims and a constructive course of action can be chosen for tax reform.

Our temptation, in the face of such a complicated question as the proper role of business taxation, is to arrive at conclusions through a rationalization process which starts out, perhaps subconsciously, with the conclusions we want to reach. We are biased in favor of this or that tax measure, possibly on ethical or political grounds, and marshal data which support the conclusion we prefer.

Taxation for Regulation

Revenue measures are frequently imposed with some regulatory intent, and some are adopted with regulation, rather than revenue, in mind. It has sometimes been remarked that the purpose of taxes on business is "to give business the business," implying punishment by taxation. For economic, moral, political, or other reasons particular taxes may be selected, either as penalties or rewards. Tariffs, licenses, sumptuary imposts, graduated income taxes, and other taxes may be employed to promote certain objectives. Recently it has been proposed that the President should be granted power to raise or lower income tax rates to influence economic trends. It is the deliberate purpose of fiscal policy, indeed, to regulate economic activity by taxation and other fiscal measures.

It is not possible here to appraise the various regulatory uses of taxation. The history of regulatory taxation reveals frequent abuses for the benefit of favored groups at the expense of the

community. Often the measure chosen has been ineffective in accomplishing the desired end. The fact that taxation is a blanket, rather than a selective, measure, has commonly been ignored, and it may be chosen to promote certain objectives when only carefully selected and applied measures might be effective. If the good and the bad are to be separated for reward and punishment, someone must judge the taxpayers and mete out the particular encouragement or discouragement required. For one reason or another, tax gadgets and tax incentives have been found to have only a limited economic usefulness.

The historic and primary purpose of taxation is the raising of revenue to support socially desirable public expenditures. When regulatory purposes are introduced in the tax system, there is always the danger that revenues may be forfeited to ineffective or detrimental regulatory pressures. Should direct subsidies not be employed by governments, rather than tax discriminations, when it is desired to encourage particular activities?

We are, of course, faced with something of a dilemma in raising $125 billion a year in taxes, with many billions of dollars coming from taxes on business and taxes collected from business. All taxes have economic effects, and as taxation increases, the economic effects also increase.

Taxation for revenue and taxation for regulation should, so far as possible, be consistent with our economic and social objectives. Revenue measures should interfere with healthy economic activity as little as possible. Regulatory measures should be employed only when the objective is clearly for the benefit of the community and taxation is the most effective tool for accomplishing a desirable social objective.

These are hard requirements. They demand far more rationality in business taxation than we have thus far shown. They call for a consideration of the effects of our taxes on the individuals who finally pay them and also on the community. They also suggest the necessity for the better coordination of our federal, state, and local taxes.

CHAPTER V

DISCUSSION OF BUSINESS AS AN OBJECT OF TAXATION

CHAIRMAN C. LOWELL HARRISS, *Columbia University:* We now have some time for discussion. This can take the form either of questions posed to people who have spoken or observations by members of the audience.

I, myself, could talk endlessly on these things, and I am not going to abuse my position here, except for perhaps one point. All of the speakers have said something about the desirability of economic growth. We are all for it.

Perhaps economic growth can be usefully defined as more of what people want. Perhaps one way of getting more of what people want is to reduce tax rates and free more income for individuals to make their own decisions. At least this is not, it seems to me, unworthy of some discussion in these matters.

However, I now invite you to participate.

PROFESSOR WILLIAM VICKREY, *Columbia University:* I am unfortunate in not having been able to hear Professor Groves' paper, but I think I can add just one idea to the discussion of the corporate income tax. That is that it, together with the property tax, makes the United States the most anti-capitalistic economy in this world. If you put together the fact that both the corporate income tax and the property tax stand on the other side of the market rate of interest, we find that the gross rates of return that are necessary to induce investors to put forth money for that which is necessary to economic growth go up to 15 and 20 per cent and more in a great many cases.

I know that we have had a good deal of economic growth over the past fifteen or twenty years, and yet I would suggest that it

has not been what we could legitimately have expected. I think that it is not too out of line to say that aside from the postwar boom of reconversion the period of our slack economic growth has more or less coincided with the period when, for the first time, corporate income tax rates have reached unprecedented levels, all of which says that I should be strongly in favor of abolishing the corporate income tax. In a sense I am, but the damnable thing about it is that we just don't know how to get rid of this incubus that we have fastened on our necks. I don't know how to get rid of it.

Suppose that tomorrow we were able to abolish the corporate income tax in association with other measures that I would say it is inextricably bound up with. I would propose the following action, but have no hope of getting it adopted. This would be a package abolishing the corporate income tax, but imposing a reasonable kind of undistributed profits tax, full taxation of capital gains, closing of other loopholes, and possibly a reduction in the top individual income tax rates and imposition of a net worth tax.

All of these things, wrapped up together, might result in no net change in the progressivity of the tax system as a whole. What possibly would happen would be that we would get the opportunity for some additional investment in the long run.

But, to do this tomorrow, considering the extent to which the corporate tax has been capitalized in the values of shares and so on, would result in windfalls to individuals that would be intolerable to my sense of fairness, even with the taxation of capital gains.

What to do? We would hope that if this were done over a period of years, these windfalls would be limited to tolerable levels. One might propose that one should enact as soon as possible legislation that would say that the corporate tax is going to be reduced 5 per cent per annum over the next 10 years. Possibly in this case the windfalls wouldn't be too large because the increased investment would lower gross yields about as rapidly as the tax rates come down.

But can we do this in our system? I suspect not. We just have no way of guaranteeing that a program of this sort would ever be carried out. Even if we had a way of guaranteeing it, even if we could be sure it would be carried out, we have no way of being sure that investors would believe that it would be carried out, so that they would actually make the investments that would prevent the windfalls from taking place.

We are in a heck of a spot, and I don't know how to get out of it.

CHAIRMAN HARRISS: Thank you very much. Would any of the panelists want to comment or ask questions?

PROFESSOR THOMAS C. ATKESON, *College of William and Mary:* May I ask in connection with Professor Vickrey's comments whether he thinks the option to be taxed as a partnership offers any gradual change over time by way of extending that privilege to larger and larger corporations?

PROFESSOR VICKREY: That is a fascinating thought. I would have to think about that for a few minutes, but just offhand it looks promising, except that probably if we want to get out of this spot equitably, we have got to induce investors to step up the pace of investment so that the gross rate of return on investment will come down as the tax rates are abated.

Can we offer the investor, who is going to step up his rate of investment drastically, adequate assurance that this will actually take place? I think this is the crux. Possibly this extension of the option would be more acceptable politically. Possibly it could be made credible, but this would have to be worked out, and it would require much more study than I can give it in two minutes.

MR. L. E. KUST, *Westinghouse Electric Corporation:* May I ask a question, Professor Vickrey? Your calculation of the gross rate of return required assumes, it seems to me, that you do not believe that the corporate income tax is significantly shifted through price.

PROFESSOR VICKREY: That is exactly what I do believe. There is a great difference between a corporate tax which is paid on

the one side of the market and, say, an individual income tax which was confined to unearned income, that would be paid on the other side of the market.

An individual income tax which was substituted for the corporate income tax, a tax on unearned income, that is, would mean we would be getting at the income from property; but we would be getting it after we had gone through the capital market.

The tendency is for friction in these markets to keep interest rates somewhere in the neighborhood of 4 per cent to 6 per cent on gilt-edged securities and 5 per cent to 9 per cent on various types of equity finance. What I am arguing essentially is that what has happened is that the market rates have stayed fixed. In order to compete in the market, those who want to engage in equity financing have had to get higher rates of return. That is, they have had to shift the burden of the corporate tax to the consumer.

I have the feeling that relatively little of the corporate tax could conceivably be thought of as being a net burden on the investor today. It is a slow process; but over the years, I would say my observation would be that it is more passed on than passed back.

MR. R. H. RAWLINGS, *Bethlehem Steel Company:* Sir, I would like to address myself to Mr. Barkin. I hope that he can enlighten me in an area that has been confusing to me for a long time. I have read many pros and cons with respect to percentage depletion, and, most specifically, with respect to depletion in the oil industry.

I am not an economist. I can't really comprehend the far-reaching effects, good or bad. I think there is probably much to be said on both sides of the fence, but we have heard a great deal recently about the flow of gold in an adverse manner with respect to our national economy. In that connection—I think I understood you correctly, Mr. Barkin, and if not you can straighten me out—I believe you commented that one of the errors of special tax legislation which should probably be termi-

nated, since it has outlived its usefulness, is the depletion for the oil industry.

I think, sir, that you said further that we no longer need to encourage oil exploration in this country. That, as a shirt-sleeve reaction, seems to me to be a little bit contrary to our concern about the flow of gold.

For example, if we don't encourage oil exploration in this country it means one of two things. It means we know we have such large reserves that we have no concern about our national reserve of oil, or that there is so much in South America and Asia and other such areas that we don't need to be concerned in the United States. But if the latter point is true, it would seem to me that in order to get the oil from the other areas, we are going to be vitally concerned about our flow of funds out of the country.

As to discouraging oil production, I have read some material in connection with Venezuela—and I believe a gentleman named Perez Alfonso has been traveling world-wide trying to get around his paradox or his dilemma.

That country has increased the tax rates rather substantially on the extractive industries. Certainly that is discrimination in a direction other than we have been talking about, I suppose, but the fact has been that the oil companies—and I believe this is a proper statement—have substantially reduced their production. There are possibly other reasons, such as United States controls and so on, but they have substantially reduced the production. The economy has not been helped by the discouraging aspects to the profits of the oil community in this one country, for example. Can you help me straighten out my confusion, or is it too vast to be straightened out, sir?

MR. SOLOMON BARKIN, *Textile Workers Union of America:* I think we are getting into the dilemma that Professor Groves indicated. We have spread ourselves very thin.

The country of which you speak, I believe, is Venezuela. The gentleman of whom you speak, if my memory serves me correctly, is seeking some form of price control and trade alloca-

tion in order to maintain Venezuela's place in the market.

First, on the oil depletion problem and its relation to the flow of gold, if my understanding is correct, this concession was originally granted to encourage exploration. At the present time, if my information is correct, the world has an abundant supply or has opened up resources which are very adequate. Consequently, our immediate problem is that the world has a tremendous reserve of oil. Oil is flowing very freely from many countries. As a matter of fact, serious price wars are being conducted in Europe with Russian oil competition.

On the second question, as to the impact of such imports on our international balance of payments, the theory is that by increasing such imports we shall be creating ultimately more purchasing power in some second or third countries and thereby allow for larger exports from the United States.

The judgment can't be made about the very specific imports with which we are concerned, except, of course, where there are specific cases, such as in the case of coal, which might serve as an illustration. This commodity comes to mind as a case where the United States government instead of purchasing coal abroad specifically employs American coal for its needs in foreign countries.

But the generalization which I presume would hold is that we can't separate the oil import problems as a separate, distinctive part of our whole import problem.

To the question that Professor Vickrey raised, which I think is very intriguing—namely, how would you put Humpty-Dumpty back again if you had to start all over again—of course, many of us would, even from my side of the table, enjoy a good deal of play with some of the available alternatives, because the basic inclination would be to place major reliance on the personal income tax. But we are without that practical choice, and consequently, the problems which Professor Vickrey raises are reduced to some more practical issues.

Therefore, I call his attention to these specific issues which I raised in my paper, namely, that it is very well to say that

everybody pays taxes and some pay more than others. Consequently, the real question we have in our corporate income tax debate is whether or not it represents a tax capacity which would, under our rather imperfect economic system, remain untouched, and whether we are tapping this tax capacity adequately and fully, or roughly, in our present tax system.

I think that is the area in which I found Professor Groves' discussion hardly satisfying. It is true that in the abstract, taxes get paid by individuals, but we have created a legal fiction which may have a lot of merit, namely, that the corporation may be an individual too. Certainly many writers in the field and some of us personally have perceived that there is a tax capacity which should be touched.

What intrigues me about Professor Vickrey's introductory suggestion is that we must pay attention to all of these devices, not for the purpose of the wholesale reform of our corporate tax system, but to jog along economic performance in this country without creating windfalls.

There is a great urgency in this matter. Consequently the government needs very much advice and reflections on the value of specific kinds of tax system adjustments and tools that can be helpful.

It was for that reason, for example, that my own personal reaction was that broad management opposition to the Kennedy proposal on investment was so unfortunate, because the major debate which was posed to the American people was not whether that particular device could be made more useful but whether, having opened the door, American business could get a wholesale across-the-board revision of taxes which would be indiscriminately beneficial to various sectors of the economy.

This leads to another point that I was also making. It may very well be, and I am personally persuaded to this effect, that we have come to the point where having specific economic goals —let us say the 50 per cent increase in national income—and having concrete ideas as to what national well-being might be, I would answer Professor Harriss' question very clearly and say

the choice we have is not to give the people more of a choice in spending, but to allow the government to spend more, which happens to be my predilection.

Then, in those instances, the tax system must be geared to that policy outlook or conclusion, and our tax discrimination may, as among industries and activities, very well, therefore, have to be increased.

CHAIRMAN HARRISS: I think I can perhaps add one point. Percentage depletion is applied to foreign operations oil companies, so that imported oil, as I understand it, would qualify for depletion treatment just as domestic oil companies.

MR. RAWLINGS: It depends on the taxing system. I was thinking about whether it was a United States company or foreign company.

CHAIRMAN HARRISS: If it is a United States company, I would imagine the same would apply.

MR. RAWLINGS: If it is a foreign company, it depends on the taxing system.

MR. J. D. HARTWIG, *Hartwig and Crow:* I would like to address a question to Mr. Barkin. He used a term that tends to frighten me. He used the term "tax capacity." I am not sure I fully comprehend the limitation of the use of the term, Mr. Barkin. I wonder if you could help us by elaborating on it a little bit, and probably relating it to the proposal that has been made to the constitutional convention now in process in Michigan to tax the receipts from the sale of real estate which are in excess of the assessed value thereof, as well as receipts of trade associations, cooperatives, and labor organizations. Is this "tax capacity" you speak of merely a process whereby you look at the entity and, by some predetermined standard, say it has the capacity to pay a given amount of taxes; and if so, how do you apply this to labor unions?

MR. BARKIN: Since we have little time and since the nub of the question is the second part of it, and that is controversial, let me address myself to that section.

I would agree if a union engages in any commercial activity

for profit, it should be taxable. This is an area on which we have a good deal of information.

As to the question whether the income of a union creates tax capacity where it is exclusively for the service of that membership and the furtherance of that particular organization, my inclination is to say it does not create tax capacity.

The tax capacity I perceive as existing in a corporation is a net gain in economic returns beyond that of merely passing on taxes or costs to the consumer.

The reason why I see the corporation as having tax capacity is that in setting prices for its services in a limited competitive industry, it has an ability to create a margin of income, which is a net return, which can be taxed, and which is equal to a return which a person has for his own labors. This is net income above merely serving the process of transmitting the costs, and that appears to me to create tax capacity.

CHAIRMAN HARRISS: Thank you very much. I declare this session adjourned.

PART TWO

BUSINESS TAXATION AS AFFECTED BY BUSINESS FORM

"Because of the increasing conflict among federal, state, and local taxing authorities and their respective revenue needs; because taxation is an exaction by the governing body and not a charitable contribution by its subjects; and because Congress, state legislatures, and local governments have neglected to perform fully their assigned role, business has pursued, through foresight and ingenuity, modification and new creations of forms and modes of conducting its business operations compatible with its goals.

"There is no doubt that, as a result of the various modes of operation utilized by business, some self-created and some as the result of successful and, in some instances, unsuccessful litigation, business has effected at least a temporarily favorable tax climate.

"It is equally certain that any successful results obtained by business and its management have brought about the reaction of awakening the Congress and state and local governments, as tailors of legislation, to revisit the taxing statutes so as to not only counteract any revenue losses but to refine and maintain the morality and uniformity necessary in effective taxation.

"Actions of business and reactions of the legislative bodies at all levels of government, and vice versa, need not continue ad infinitum and perhaps, as a result of comments presented at this symposium as regards federal, state, and local income taxes

and state and local doing-business taxes, business and the legislative bodies may step forward towards effective taxation which permits effective business operation."

—STANLEY J. BOWERS
Ohio Tax Commissioner, and
President-Elect, Tax Institute, Inc.,
and Chairman of Symposium Session

CHAPTER VI

FORMS OF BUSINESS AND FEDERAL INCOME TAXATION

LEONARD L. SILVERSTEIN
Silverstein and Mullens

IT HAS long been a rusty platitude that ambitious programs of tax reform aimed at the twin objectives of more equitable distribution of the federal tax burden and simplification of the overall tax structure achieve only a little bit of the first objective, and none whatsoever of the latter. Indeed, examination of the legislative literature of the history of taxation in the United States would suggest that—in so far as the business income tax at least is concerned—revenue production has been merely a by-product, rather than the intended consequence, of a frenetic half-century of incredibly complex statutory and administrative activity.

PRESSURE OF TAX LAWS GENERATES NEW BUSINESS FORMS

It is well known that much of the complexity of the federal income tax structure is unavoidable so long as federal tax policy adheres to a graduated rate structure which strives to take into account the countless varieties of economic activities carried on in a free enterprise society. Compounding the problem has been the use of the tax laws to achieve social, political, and even military objectives. Moreover, since under the graduated structure tax rates have their greatest impact upon successful business enterprises, and upon ingenious as well as persuasive citizens, it is not at all surprising to find these parties entirely equal to the challenge presented of adapting their business and

personal activities to side-step wherever possible the full impact of the federal tax burden.

Students of this field—and today much of the public as well—are all too familiar with the forms which this specially inspired tax activity has taken. A variety of types of special legislation has resulted. Some of it produced, unfortunately, what amounts to a cat and mouse game between the taxpayer and the government. For example, since the corporate rates are less than the highest individual surtax rate, taxpayers seek to find forms of bottling up investment income in holding companies, and in unneeded but accumulated profits in business enterprises, thus necessitating the holding company and accumulated earnings tax legislation. While theoretically these provisions constitute a bar to this type of activity, in fact their requirements can be avoided to create affirmatively artificial investment and business arrangements designed principally, if not solely, to take advantage of the tax rate differentials.

The literally enormous swing between profits which are capital gains and profits which are so-called "ordinary income" has produced not only a complex legislative pattern (and an unsettled array of court decisions), but a host of business and investment transactions similarly designed solely to take advantage of capital gains categorizations.

The initially simple—and perfectly meritorious—congressional exemption of charitable institutions from income tax has been a direct source of inspiration for business enterprises to seek to engage these institutions in business activities, thus necessitating congressional reciprocity by way of the special tax on unrelated business income. Indeed, were it not for the availability of the charitable deduction for both estate and income tax purposes, it is unlikely that there ever would have developed—at least to the degree which has occurred—this vast new repository of national wealth—the private charitable foundation. Similarly, the fact that retirement programs can be instituted for the benefit of employees on a deductible—before tax—basis, has given rise to an equally impressive financial institution counter-

part—the pension and profit-sharing trust. These organizations operate directly under the Internal Revenue Code structure in a self-contained network of statutory and administrative rules. In substance, a new business activity has in large part been created by the operation of the tax laws.

In terms of transactions, the ability of a taxpayer to avoid—by deferral—all income tax on certain exchanges of property (such as stock) in corporate mergers may well have served to accelerate a national trend towards amalgamation of business enterprises. Indeed, the burden of the federal estate tax and its subsequent need for post-death liquidity has often made such pre-death tax-free arrangements a matter of urgent business necessity.

Categories of Tax-Generated Business Forms

As the foregoing review demonstrates, this cross-fertilization of tax laws, technological and business activities with human and corporate desires to pay the least and save the most, coupled with a tax administration—quite irrespective of which political party is in office—which all too often functions as a partisan advocate, has served to produce tax-oriented business and social activity unprecedented in our national history.

The special aspect of the problem to which I shall address myself today concerns the degree to which the federal income tax laws have given rise either to new forms of business enterprises or to new uses of established business forms. I refer specifically to business forms which, in general, would neither be organized nor operated in the manner in which they are legally constituted were it not for the complexities, the inadequacies, and often (in the light thereof) the artificial opportunities for operation under the federal income tax laws.

Preliminarily, it is necessary to touch briefly on the relevant tax attributes of established forms of business enterprises. A corporation and its shareholders produce the all-too-familiar double tax. A partnership (including a joint venture) and its

partners are subject only to a single tax, at individual income tax rates. The partners, moreover, can avail themselves of losses which have tax, but not necessarily economic, content. A trust and its beneficiaries are subject to a single tax, without, however, a corresponding ability of beneficiaries to avail themselves of losses.

The new breed of tax-generated business vehicles has sprung essentially from the interaction of the foregoing tax attributes with established legal forms.

These tax-generated business vehicles may be divided into four categories.

Eliminating Corporate Tax Status But Not Corporate Attributes

First are the business forms which seek to eliminate corporate level taxes but preserve local law corporate attributes.

Regulated Investment Companies. These corporations essentially hold stock and securities in other corporations. Therefore, their owners would be subject to a partial triple tax on intercorporate dividends were it not for the special rules in subchapter M of the Code. Once qualifications under these rules are met, however, the regulated investment company can avoid corporate level tax and pass on capital gains in conduit forms to its shareholders.

Real Estate Investment Trusts. These recently authorized organizations constitute an extension of the investment company approach—limited, however, to the real estate field. Under the peculiarities of the legislation (sections 856-858), the organization must itself be constituted legally as a trust which has sufficient corporate characteristics so that it is taxed as a corporation —that is, so that it would be taxed as a corporation were it not for the exception to the exception—thus demonstrating that the rule of the new breed of business-tax entity is truly an exceptional one.

Subchapter S Corporations. This form of enterprise is entirely too well known to bear extensive recitation here. For our

purposes, it may be simply stated that a corporation with one class of stock and 10 or fewer shareholders can now be created without subjecting itself to tax, thus permitting its owners to be taxed in general as proprietors or partners. They may not, however, avail themselves of losses in excess of their active investment.

"Dummy" Corporations. A corporation may be created under local law for local purposes solely. The purpose of the incorporation may be simply to hold title to property rather than to function in corporate form. Under limited circumstances, its corporate existence may be ignored for federal income tax purposes, while recognized for local law purposes.

Eliminating Corporate Tax Status and Using Partnership Deductions

The second category consists of the business forms which seek to eliminate corporate level tax but affirmatively make available all partnership or proprietorship tax deductions.

A common form of ownership of real estate now consists of a joint venture or partnership (limited or general depending upon circumstances.) Under Treasury regulations, such a syndicate may be taxed as a partnership despite the fact that ownership is widely dispersed and that management is centralized in a limited group. In practical terms, however, no legal liability exists upon the owners beyond the risk of loss of their investment.

Acquiring Corporate Tax Status But Not Corporate Attributes

The third category consists of the business forms which seek to create corporate level tax without local law corporate attributes.

Associations. This is a tax concept rather than a business form as such, and encompasses any form of incorporated enterprise or trust which possesses sufficient corporate characteristics so that double taxation is justified as if a corporation had in fact been formed. The association concept has presented a dilemma

for the government and taxpayers alike. Thus, the same tests are applicable in determining whether a professional organization constitutes an association taxable as a corporation (thereby enabling its employee owners to avail themselves of pension plan benefits), as well as in determining whether a widely-held realty syndicate is a partnership (thereby permitting its owners to avail themselves of depreciation deductions in the form of tax-free cash flow).

Professional Corporations. This is the answer of the states to the understandable disinclination of the Treasury readily to treat professional associations as corporations. The form of state legislative answer consists of a new type of professional corporation, created solely for federal tax purposes. In essence, it is a vehicle designed to limit the tax rate on professional earnings to the corporate rate and to permit these incorporated professionals to avail themselves of pension plans and profit-sharing benefits.

Subchapter R. This provision (section 1361) was enacted in 1954 ostensibly to permit qualifying proprietorships and partnerships to be taxed as if they were incorporated. It is interesting to note that because of the "complexities" of application, the Ways and Means Committee in 1957 recommended repeal of the provision, but acceded to the Senate's desires in 1958 for retention. In actual practice, the provision is of most interest to enterprises which are unincorporated under local law and which cannot qualify as associations, but which desire nevertheless to be taxed as corporations.

Organizing Corporations in Foreign Jurisdictions

The fourth category consists of the business forms which constitute corporations organized in a foreign jurisdiction by reason of special applicable tax rates.

Western Hemisphere Corporations—China Trade Act Corporations. These entities carry on business in the areas indicated and receive a percentage reduction in tax rates. While not strictly speaking a special form of business enterprise, they nev-

ertheless constitute a special business vehicle which may be formed solely for the tax benefits.

Tax Haven Corporations. These corporations are often formed in a foreign country having a nonexistent or extremely limited corporate income tax. They serve as a vehicle whereby a United States enterprise can carry on foreign business activities at a tax rate limited to the maximum tax of a foreign jurisdiction. Earnings so realized can be invested and reinvested without full imposition of the United States corporate tax.

Discriminatory Effect of Categories

These are the general categories. Observe if you will the chameleon-like quality of this new breed of tax animal. Two individuals can each be engaged in a retail grocery business in the same community. One can incorporate and thereafter elect not to be taxed as such. The other can refuse to incorporate, yet elect to be taxed as if he had. Note that under the assumed facts, the businesses carried out by each are identical, yet the choice of the legal form under which the business will in fact be conducted bears no necessary relation to business activity. Instead, the business form operates solely as a function of the federal tax circumstances of the owners. In short, the owners, after the necessary session with their tax advisers, may question whether they are in the grocery business or the tax business![1]

It seems evident that the present trend towards the development of these new forms of business-tax entities can serve only to distort further the conduct of natural business enterprise by adding a wholly new dimension of tax consideration to business planning. This dimension, moreover, is in essence simply another vehicle for adjusting tax rate impact. Unfortunately, this is achieved in an indirect and cumbersome fashion and in a manner which may be totally unrelated to the business activity

[1] Compounding the problem is the fact that artificial tax entities are never treated entirely like their genuine counterparts. Thus, the so-called pseudo corporation—the subchapter S entity—cannot function purely as a partnership or a proprietorship, but has its own special characteristics, principally corporate.

the productive capacity of which is the essential source of the revenue production.

Key to Solution of the Problem

I suggest that the heart of the problem—lack of relationship between the nature of the business activity to be taxed and the manner in which the tax is formulated—indicates the key to its solution: The income tax laws should be recast in more pertinent terms, and the test of taxability should be governed by the nature of the business activity. In framing this test, the corporate or other form in which the business activity is carried on is essentially irrelevant. I recognize that this concept cannot be implemented without taking into account, in some instances at least, the relationship to the business enterprise of its owners. This is entirely appropriate, at least in those cases where the owners of the enterprise are also its managers. Where the owners are not managers—where they are essentially investors —then taxation of these persons becomes a matter of the treatment of nonbusiness investment income.

In affirmative terms, I propose the following for consideration.

First, it should be established as a primary standard that income taxation of business enterprise should be formulated by reference to the source and nature of the business activity sought to be taxed. In this respect, the legal form in which the business is conducted should be an irrelevant, or at least a neutral, factor. In ascertaining the nature and source of business activity, due regard can be given to industrial and commercial classification which today has developed well-known distinctions. I refer, for example, to the industrial breakdown in the *Statistics of Income—Corporation Income Tax Returns*. The question of whether the earnings of the business activity once classified should be singly or doubly taxed should be resolvable through a "grossing-up" concept giving a tax credit to the owner for his prorata share of taxes paid by the business enterprise.

I must here emphasize that the classifications be made on

the broadest possible basis. A test of breakdown would be those genuine business distinctions which justify, by their business differences, separate classification for tax purposes.

Second, exploration into the nature of the business activity, to ascertain its taxable capacity, should be carried on at the level of the conference table. By this I mean that the Congress give the same consideration to economic facts as do the owners of the business itself; thus, the proprietors of a rental real estate enterprise may compute its productive capacity in terms of cash flow without regard to accounting concepts of depreciation as a function of cost recovery. In transactional situations involving disposition of a business enterprise, more tax significance can be given to known economic consequences. For example, a merger of a smaller and relatively nonliquid enterprise into a publicly listed concern gives to the surrendering shareholder stock which (unlike the nonsaleable prior securities) may constitute the equivalent of cash, because of the availability of a ready market. The tax laws should possess capacity to take this economic fact of life more realistically into account.

Third, due regard can be given—but in more direct fashion —to national policy considerations which necessarily affect the degree to which a given business activity may be called upon for revenue production as distinguished from revenue capacity. I refer here to modification of the tax laws because of special problems. For example, a national policy to stimulate oil exploration can more directly be expressed through an adjustment to the tax rate on oil activity than through the existing depletion allowance, intangible drilling, and development cost approach. Similarly, the need for adequate housing for the nation may well justify reduction in the tax rate otherwise applicable to financial institutions serving the housing market, and to rental structures similarly operated.

There are obviously countless other examples. My suggestion is that the tax structure can be enormously simplified if the nontax policy issues which today cloud tax computation

were more directly recognized and treated as an adjustment of tax rate rather than in terms of a structural modification of taxing provisions.

I fully recognize that recommendations for basic revision of a portion of the income tax laws, once pronounced, customarily and quickly take their place in the graveyard of previously expressed ideas. The ideas for changes recently expressed have been numerous, and the graveyard has many occupants. I suspect, in fact, that a few more have arrived as a result of this meeting. I cannot realistically hope for more prolonged treatment of these remarks. I urge, notwithstanding, that in the field of business taxation, far less consideration be given to legal form, and far more congressional attention be directed to the essential economic nature of the business enterprise itself —as it is carried on in today's economy.

PART THREE

SOME PROBLEMS INVOLVED IN STATE AND LOCAL TAXES ON BUSINESS

"As tax practitioners I think we have all become enmeshed in the mechanics, the philosophy, the convolutions and controversy on taxation at all levels of government. Some of the convolutions and philosophies with respect to federal taxes have been presented. We are now concerned with some of the state tax problems.

"I think you will all recall that in February, 1959, the United States Supreme Court rendered its decision in two cases which have had a substantial impact on business and on the states, and have generated an entirely new aspect and a whole series of new problems in the field of state taxation.

"These cases are, of course, now classics: *Northwestern States Portland Cement Company* and *Stockham Valves and Fittings.* In this decision the Supreme Court determined that the net income of a corporation engaged in interstate commerce could be taxed by the various states if the tax was not discriminatory, was properly apportioned to the activities within the taxing state, and there was sufficient nexus to support the tax—whatever that means.

"More recently in March, 1961, the Supreme Court modified its views in the now landmark case of *Scripto, Inc. v. Carson.* Here the Supreme Court determined that there was a sufficient degree of activity within the state of Florida to legally justify making Scripto the agent for the collection of the Florida use tax from Florida vendees.

"As a result of these two decisions there has been a considerable clamor for clarification and remedial relief from the impact of these decisions. I am sure that you are all generally familiar with the legislative history and some of the background which gave rise to Public Law 86-272, which was approved by President Eisenhower in September, 1959. This law basically did two things. Title 1 provided for a limited exemption from the imposition of the state net income taxes. Title 2 provided that the House Judiciary Committee and the Senate Finance Committee shall make further studies and inquiries into these problems and report back to the Congress on or before July 1, 1962.

"In keeping the mandate of Public Law 86-272, I think it is of interest to note that this spring, as a result of the *Scripto* decision, the Congress saw fit to enact Public Law 87-17, which broadened the scope of the initial inquiry from just being limited to net income taxes and now embraces all matters of taxation.

"The House Judiciary Committee is currently engaged in two major projects, pursuant to this law. Number one, they are preparing extensive questionnaires, one of which is to be submitted to state tax administrators, and the other to go to about five thousand selected business firms for the compilation and the formulation of statistical data that has never been effectively derived in this area. The other aspect of their activity is that they are currently conducting hearings in Washington. They expect to have about seventy witnesses from states and from affected taxpayers.

"It is not my function nor my purpose to elaborate in any depth on these problems. I just bring them to you to give perspective to our discussion today."

—ALAN M. NEDRY
Assistant Counsel, National Association of Manufacturers, and Moderator of Symposium Session

CHAPTER VII

STATES' RIGHTS AND THE SINGLE MARKET CONCEPT

JOHN F. TARRANT
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NOT MUCH MORE than a decade or so ago we in the states felt that whether you were incorporated or no, you were not doing business unless you had a place of business. We looked upon the unincorporated concern as one involving the "mama and papa" corner store and did not even bother to think of it very much as an object of taxation.

The majority of the states still so regard an unincorporated business and those that subject them to a tax do so at low rates and with liberal exemptions. We found in my state, for instance, that one would have to double our rate of tax on the gross income of unincorporated business in order to equate the burden of our net income tax rate on corporations.

Then along came subchapter S which provided that certain smaller corporations might elect to be taxed otherwise than as a corporation for federal tax purposes. The question followed whether the states would go along. Most of them did not; some because they had no unincorporated tax to pick up the revenue, others for many reasons mostly having to do with problems of administration.

The unincorporated business has no access to equity financing and this acts as a brake on capital-consuming multistate expansion. Furthermore, the high progressive personal income tax rates may force a business in its own interests to incorporate, particularly if its income puts the entrepreneur very far above

the 52 per cent threshold. In view of these facts of life, perhaps we can dismiss the unincorporated business from this discussion.

Now as to corporations: I wonder if we can get old-fashioned for a while and look at a corporation for what it really is—a group of individuals who have set aside a portion of the monetary rewards of their labor for the purpose of engaging in a venture for profit.

Division of Tax Resources

Each of these individuals is a resident of three major taxing jurisdictions: his local community, his state, and the federation of his state with the other 49—the United States. Still keeping it simple, let us apply the package theory to this troika of jurisdictions. In 1960 more than 96 per cent ($15.3 billion out of $15.9 billion) of all property taxes went to local governments. Less than 4 per cent of property taxes are collected at the state level. Therefore, it may safely be said that the property tax is the mainstay of local government.

In the same year sales and gross receipts taxes accounted for about one-half (53 per cent) of a total of over $18 billion in tax revenues in the states, being about three times the size of total aggregate state tax revenues from income taxes both corporate and individual. So perhaps we may say that sales taxes are the mainstay of state governments. Certainly while the federal government refrains from imposing a sales tax this will be true, because all of the localities in the nation combined took in only about $1.2 billion from sales taxes in 1960.

Now we come to the federal government. We find more than 73 per cent of total Internal Revenue collections (some $67.0 billion out of a total of $91.8 billion) come from income taxes, both corporate and individual. Again we are forced to the conclusion that income taxes are the mainstay of the federal government.

Assuming without deciding that the pie has to be that big, isn't this a fair division of it—property taxes for the localities,

sales taxes for the states, and income taxes for the federal government?

Real property has a fixed local situs for the property tax. Delivery of tangibles and services determines applicability for state sales tax purposes. Finally, income is generated by the efforts of the mass of people in the nation without regard to state lines—an ideal base for federal taxation.

The great thing is not to charge one fellow for the other fellow's benefits and to refrain from taxing one fellow according to the other fellow's ability to pay.

But that is precisely what we do when we grant local property tax exemptions for social and political reasons—we tax the nonexempt for the benefit of the exempt.

We do both when in state sales tax administration we run with the hares or the hounds as best suits our revenue interests. We ask the out-of-state vendor, who has had only *de minimis* benefits in the state of consumption, to collect a use tax based on the other fellow's use and we do so, I suspect, because the seller in many instances has what lawyers call the "deepest pocket," i.e., the greater ability to pay.

Finally, when two states tax a corporation's business using both the origin of sales and the destination of sales as determinants, it is taxed on its benefits in one state and its ability to pay in another.

Appeals to Congress Deplored

I deplore the suggestion of high controversy in these situations created by the *Stockham-Northwestern*[1] and the *Scripto*[2] decisions and further aggravated by Public Law 86-272 and other proposed federal legislation. I feel we have got to settle this question of state taxation as it affects the movement of goods and services across state lines in an amicable manner and with as little interference from the Congress as possible.

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[1] Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves & Fittings, Inc., 358 U. S. 450 (1959).

[2] Scripto, Inc., v. Carson, 362 U. S. 207 (1960).

What will it profit the manufacturer if the Congress enacts restricting legislation which will force the states to impose even heavier taxes on those things and those activities over which they do have sole jurisdiction? Indeed, what will it profit the states if this in turn drives the manufacturer to Puerto Rico or even to a foreign country with some of his operations?

Can we in the states—particularly the manufacturing states—strike the troglodyte pose and lose these payrolls? Whom are we trying to impress? There is no formula to which all states and all taxpayers can agree; the various tax associations with nation-wide memberships have been struggling with this problem not for years but for decades!

It is not even clear to me that Congress has the right to impose such a formula. The late Fiorello La Guardia is quoted as having said, "The devil is easy to identify. He appears when you're terribly tired and makes a very reasonable request which you know you shouldn't grant." The 86th Congress must have been very tired when it was asked to enact Public Law 272.

Alternatives to Federal Legislation

But what about the alternative to Public Law 86-272? Do we go back to the jungle? The jungle produced *Stockham Valves* and *Scripto*. But lest business forget, the same jungle also produced *Spector*[3] which was a bitter pill for the franchise tax states to have to swallow.

I think we have a Berlin type of crisis here and both sides are firing off ill-considered propaganda. Business rushed to Washington to seek federal legislation restricting the states and got it within seven months after the *Stockham* decision! Not all of us deserved those restrictions because we have voluntarily avoided *Stockham Valves* and *Scripto*. Neither did we run to Washington when *Spector* threw such a roadblock in the path of what we felt were legitimate revenue exactions for services

[3] Spector Motor Service v. O'Connor, 340 U. S. 602 (1951).

rendered the property and activities of the taxpayer in the state.

What is needed here is a little tax statesmanship on both sides. The late Justice Holmes in a federal wiretap case said something like this: "I should far prefer a few criminals to escape justice than that the sovereign should play such an ignoble role." Well, I too should far prefer a few sales to escape taxation than that the states should play such an ignoble role as is offered them by the *Stockham Valves* and *Scripto* decisions, but only if the ignobleness is deplored at both levels of government—the federal as well as the state.

I doubt that the concept of the nation as a single market is nearly so threatened by *Stockham* and *Scripto* as states' rights to exact legitimate revenues are threatened by Public Law 86-272 and similar proposed federal legislation. If there is evil in unbridled tax ferreting by the states under the authority of *Stockham* and *Scripto,* there is greater evil in the unwise restriction of states' rights by Congress.

As Justice Brandeis, another great jurist, has said: "Experience should teach us to be most on our guard to protect liberty when the Government's purposes are beneficent. The greatest danger to liberty lurks in insidious enforcement by men of zeal, well-meaning but with little understanding."

Many of us in the states have tried to be understanding in this problem and have shied away from overzealous enforcement. It is at least questionable, of course, whether *Stockham* is applicable to those states whose corporation taxes are of the franchise variety, and not income taxes such as were involved in the *Stockham Valves* and *Northwestern Cement* cases.

Reactions to Judicial Decisions

Spector made it clear to us that we could not exact a tax for the privilege of engaging in interstate commerce. But since the *Spector* decision some states have amended their laws and may want to amend them further if the occasion arises. Public Law 272 of the 86th Congress, which has been in force two years now, prohibits the states from taxing income derived from op-

erations in interstate commerce if the only operations carried on within the taxing state are solicitations of orders. The law, however, makes no distinction between privilege taxes and income taxes. So the franchise tax states are vitally interested in what the House Judiciary Committee's Special Subcommittee on State Taxation of Interstate Commerce, headed by Representative Edwin E. Willis of Louisiana, is going to do about the problem.

In any event, July 1, 1962, is the date the Willis Committee report must be made to the Congress, so it will not be very long before we shall know a great deal more about it.[4]

When the *Stockham Valves* and *Northwestern Cement* decisions broke in 1959, our legislature in Connecticut was still in session and many were urging that we change our law from a franchise type of tax to an income type of tax so as to be able to take advantage of these decisions. I was called into consultation with the then governor whose party had control of both houses in the General Assembly, and he asked for my views. I took the position that no change should be made in our law at that time and that was the final position taken by the legislature.

The next scene in the drama was that the same governor got a letter from the then president of the Connecticut Manufacturers Association asking that he lend his support to certain bills in Congress aimed at modifying the results in the *Stockham* and *Northwestern Cement* decisions. When asked for an opinion, my memo to the governor concluded thus:

> The problem here is one of keeping the equities in balance. I feel it would be unwise for Connecticut to support federal legislation that would restrain the legitimate exercise of the taxing powers of the States. I feel, equally as strongly, that the States themselves should exercise restraint to the end that this broadened power will not be abused. I am confident that when the dust settles, such will be found to be the case and the need for federal restraining legislation will have dissolved.

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[4] The study has since been extended to June 30, 1963.

Unfortunately that hope was not to be realized. The income tax states did not exercise the hoped for restraint and Public Law 272 was enacted by the 86th Congress. Meanwhile, good advice to business would seem to be: If you must stick your "nexus" out, be sure you come within the "minimum activities" rule.

Now what about *Scripto?* The same pattern was followed here. Business ran to Washington with restraining legislation. In fact, two of these bills were introduced by a Connecticut Congressman and a Connecticut Senator.[5]

Nor were the states lax in also running to Washington to oppose this legislation. The National Association of Tax Administrators lost no time in setting up at its meeting in Minneapolis in June, 1960, a committee to work up opposition.

Importance to States of Sales Tax Revenue

The efforts of this committee brought forth a plethora of figures on state revenue losses claimed to be involved in the passage of these bills. These figures have been challenged by the proponents of federal legislation and these proponents have given the committee in Washington a plethora of statements on compliance burdens which in turn have been challenged by opponents of the legislation.

According to the United States Bureau of the Census, more than $4.5 billion of merchandise is sold at retail in the United States annually through canvassing from house to house and through catalogue advertising, and this figure does not include sales by producers of the items sold nor sales made directly to industrial firms. That is something to ponder.

With Texas recently joining the club, there are now 36 sales tax states. I do not contend for one moment that all of the $4.5 billion in canvassed sales escapes state sales taxes because much of the selling will, of course, be done in the state of residence of the seller and cannot avoid the tax.

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[5] H. R. 12235 and S. 3549.

Again, much of the volume sold may include items which are not taxable in different states, i.e., food. Offsetting this, however, is the important fact that the figure does not include services which are taxable in many states nor, as stated before, sales by producers or to industrial firms.

But with all of these limitations, it is significant that 3 per cent of $4.5 billion equals $135 million. If the states are forced by federal legislation to forego even half of that amount, the situation would become serious for many of them.

This survey conducted nationally by the National Association of Tax Administrators indicates that no sales tax state claims to lose any less than one-third of its use tax collections, many of them claim the loss of one-half the use tax collections, and at least one claims H.R. 1148 and S. 381 would cause the loss of 10 per cent of total sales and use tax collections.

I am convinced that if legislation of this nature is enacted, many of those out-of-state sellers over whom a state may have jurisdiction because of their having a place of business within that state will seek the proffered tax shelter and abandon such places of business. The states would then swarm with tax-immune canvassers in competition with taxpaying local vendors. It has been estimated that such an advantage amounts to 10 per cent where the out-of-state vendor is able to escape corporation income taxes, sales/use taxes, and indeed, local property taxes.

Fortunately there is good indication that this type of legislation will not be enacted. The nation cannot afford to have the states' taxing authority thus bargained away.

Tax Statesmanship Essential

But some solution to this problem must be and can be found. I said at the outset that tax "statesmanship" will be required. Statesmanship must take the form of mutual cooperation and understanding on the part of tax administrators and taxpayers. I submit that this is not a mere visionary objective and that it is attainable.

To me "tax ferrets," "border patrols," "ports of entry," "tax

informers," "crackdowns," "penalties," etc., have always been dirty words in tax administration.

The most amazing thing to any foreigner studying our tax systems in this country is the degree to which we achieve honest self-assessment.

I leave with you the plea, then, that we—tax administrators as well as taxpayers—do all in our power to strengthen and uphold that principle. Neither side can afford to do less.

CHAPTER VIII

THE SCOPE OF STATE SALES TAXATION

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THIS sophisticated audience would be wearied by a repetition of the bromides or conventional views regarding state sales taxation. Any contribution I can offer will consist in presenting a series of footnotes to the conventional wisdom; not necessarily to challenge past study, but to probe tax form or structure, nomenclature, and practices to reveal where we are in state sales taxation.

An initial footnote is to ask the question as to why sales taxes are on a program of business taxation. With an overriding concern with economic growth, a viable balance must be struck between capital investment and consumer demand to sustain and encourage business expansion. I shall leave to others the ambitious task of deciding on the line of balance between these factors that interact with improved technology and automation and the health and education of the people to advance or retard economic growth. I shall content myself with the more modest task of indicating the degree of diversification resulting from sales taxation that affects the desired balance. Excessive sales taxes, such as state cigarette taxes at 7¢ and 8¢ per package, may so concentrate taxes in one category as to undertax other categories. The very absence or small size of sales taxes may concentrate taxes at high levels on income and property.

The form of the sales tax permits little manipulation to adjust for capital formation or consumer demand. Perhaps an exception consists of excises on sick industries. Examples are

the repeal of the federal tax on freight, and the hesitancy of cities to tax admissions which would adversely affect moving pictures. Net income taxes provide a keener cutting edge not merely in adjusting rates but also in allowances for depreciation, capital gains, carry-back and carry-forward provisions, and the pending Kennedy plans for accelerated depreciation for technological obsolescence and an additional deduction for capital investment. Nonetheless, sales taxes are generated by pressures to diversify tax sources so that excessive reliance upon one or a few sources is avoided or minimized. Among these pressures are the loads of property and income taxes, the extent to which states assume responsibility for financing local governments, and the level of educational costs.

Sales and gross receipts taxes of all American governments, amounting to $24.5 million in 1960, equaled 18.6 per cent of total general revenue—nudging out the corporate income tax as the second largest revenue producer. State and local sales taxes, though under one-half of the three-level total, equaled 27.2 per cent of state and local general revenue—a proportion over three times larger than both corporate and individual income taxes and second only to property taxation. Between 1950 and 1960, the proportion of state and local general revenue decreased slightly from all sales taxes and from property and corporate income taxes, and rose slightly for the individual income tax and all other revenue. Despite variations among minor sources and among states, the surprising footnote is that the great upsurge in revenue did not disturb the overall balance in state and local revenue. This is not to say that the present distribution among sources is justified.

States Classified by Sales and Income Taxes

To get a closer view of tax concentration or diffusion than is permitted by global figures, the states are classified in Table 1 as to whether, in fiscal 1961, they levied (1) a broad-based individual income tax but not a general sales tax, (2) a general sales tax but not an individual income tax, (3) both a general

sales and an individual income tax, and (4) neither a general sales nor an individual income tax. Only the four states of

TABLE 1

STATE TAX COLLECTIONS BY STATES CLASSIFIED ACCORDING TO USE OF INDIVIDUAL INCOME AND GENERAL SALES TAXES: 1961

Type of Tax	All States	Individual Income Tax States	General Sales Tax States	Income and Sales Tax States	States Without Income and Sales Taxes
	Per Cent of Total Taxes				
Individual income	12.4	33.9	.1	12.7	.1
Corporate income	6.7	11.2	3.4	7.7	2.0
Sales and gross receipts	57.8	32.8	73.9	59.5	52.8
General sales	23.7	—	38.5	29.8	—
Selective sales	34.1	32.8	35.4	29.7	52.8
All other	23.1	22.1	22.6	20.1	47.1
Total	100.0	100.0	100.0	100.0	100.0
	Per Capita Taxes				
Individual income	$ 13.13	$ 38.61	$ .11	$ 14.60	$ .10
Corporate income	7.06	12.74	3.44	8.89	1.49
Sales and gross receipts	61.31	37.30	75.06	68.35	39.58
General sales	25.16	—	39.11	34.20	—
Selective sales	36.15	37.30	35.95	34.15	39.58
All other	24.53	25.17	22.86	22.99	33.83
Total	106.03	113.82	101.47	114.83	75.00
	Taxes Per $1,000 of Personal Income				
Individual income	$ 5.92	$ 15.72	$ .05	$ 7.21	$ .04
Corporate income	3.18	5.19	1.51	4.39	.68
Sales and gross receipts	27.63	15.19	33.04	33.76	18.00
General sales	11.34	—	17.21	16.89	—
Selective sales	16.29	15.19	15.83	16.87	18.00
All other	11.05	10.24	10.07	11.35	15.38
Total	47.78	46.34	44.67	56.71	34.10

Source: United States Bureau of the Census, *State Tax Collections in 1961.*

Nebraska, New Hampshire, New Jersey, and Texas were in the fourth class in fiscal 1961, though in fiscal 1962 New Jersey will have a commuters' income tax and Texas a sales tax. New Hampshire is included in this class because her income tax is limited to dividends and interest, the same reason for which Tennessee is classified as a sales tax state. Though states with individual income taxes usually have corporate income taxes,

several states with the corporate tax lack the individual tax. Findings from the four-fold grouping are as follows:

1. Selective sales taxes, such as motor fuel taxes, were more important in the aggregate as was to be expected, since they were imposed by all 50 states, whereas general sales taxes were imposed by only 35 states in 1961. In the states which impose general sales taxes, however, they are more productive than the selective sales taxes.

2. As measured by the percentage of total taxes, the two income taxes accounted for a proportion over twice as large in the income tax states (45.1 per cent) as in the income and general sales tax states (20.4 per cent). By the same measure, sales and gross receipts taxes, consisting solely of selective sales taxes, were small in the income tax group (32.8 per cent); they were much larger in states levying both income and general sales taxes (59.5 per cent); and they were still larger in the general sales tax states (73.9 per cent).

3. The two income tax yields, as shown by per capita amounts, were over twice as large in the income tax states ($51.35) as in the income and general sales tax states ($23.49). By the same test, sales and gross receipts taxes were much the lowest in the income tax states, much larger in the income and general sales tax states, and still larger in the general sales tax states.

4. Income tax states without a general sales tax included a number of high ability states—Delaware, Massachusetts, Minnesota, New York, Oregon, and Wisconsin. States taxing general sales but not individual income tended, with a few exceptions, to be above average in personal income per capita, including Connecticut, Illinois, Indiana, Michigan, Ohio, Pennsylvania, and Rhode Island. States taxing both individual income and general sales tended to be average, or often below average, in personal income levels, including most of the southern states. A notable exception was California. Tax diversification was to be expected of this group as was tax concentration of the previous groups.

5. Use of state and local sales taxation as a substitute for local property taxation results in diversification relevant to the taxation of business property. States with individual income taxes but no general sales tax were likely to be high in property taxation. States without either tax were high in property taxation. Witness New Jersey especially, as well as Nebraska and New Hampshire. Having high property taxes by southern standards, Texas is a late recruit for general sales taxation.

Form of General Sales Taxation

Tax form is most specifically related to business taxation in sales to industrial and farm users. The conventional wisdom, to which I subscribe, objects to the inclusion of such sales in the

general sales tax base because it conflicts with a single-stage tax by involving two stages or two taxes—one for the industrial consumer and one for the ultimate consumer. How does the record square with standard views? Some double taxation is debarred by the conventional rule restricting taxation to sales of tangible personal property not for resale. Physical ingredients entering into processed goods are exempt in most states. Beyond these rules, the practice is contradictory and unsatisfactory. Industrial machinery and equipment is exempt in seven states, if directly used in processing, though this class is accorded lower rates or tax limits in several more states. Industrial supplies are exempt in only a minority of states. Farm equipment, supplies, and products are treated inconsistently. Put another way, the urge for larger tax collections too often results in a two-stage tax.

The same urge is expressed in the unlike treatment of the "big three" already subject to state and federal excises. Exemption of motor fuel from the general sales tax is prompted more by highway needs than by equity. Inclusion of alcoholic beverages and tobacco seems based on Mark Twain's remark that excessive use of anything is bad, but excessive use of liquor and tobacco is barely sufficient. American tax practice has so widely expressed Mr. Clemens' aphorism that I do not so much question sumptuary taxation as to ask why general sales taxation of liquor and tobacco is necessary when the excises can be readily adjusted to provide "barely sufficient" revenue.

The clichés invoked concerning the controversial exemption of food need be barely mentioned. One is that an across-the-board sales tax, including food sales, is sharply regressive; another is that the American tax system as a whole is progressive; and still another is that the food exemption renders the sales tax proportional as among different size classes of family income. Even when food is exempt, the sales tax differs from the first proportional bracket of the federal income tax in which a limited progressiveness results from personal exemptions and deductions.

The footnote here concerns the revenue loss from the food exemption. To provide a guideline, information for 1960 was assembled from 17 states, 10 taxing food and 7 exempting food for off-premise consumption. On-premise consumption in eating places, which is taxable under all general sales taxes, accounted for a very small proportion of total sales taxes but for an important part of food consumed. Typical percentages were a high of 22.6 per cent in Michigan and a low of 16.1 per cent in South Carolina. Another reason for the overstatement of sales taxes from food is the frequent classification of sales by food establishments, including nonfood sales. Bonafide food sales for off-premise consumption, expressed as a percentage of total general sales tax revenue in the 17 states, ranged from 15.0 per cent to 23.2 per cent. The median was 20.1 per cent.

The range excludes Pennsylvania in which off-premise food, if taxable, would have been 28.5 per cent of sales tax collections. Pennsylvania has the narrowest base of any sales tax state, making the cited percentage abnormal. This points to another conclusion—the size of the percentage loss from off-premise food depends also upon the extent of other exemptions. If North Carolina had taxed off-premise food in 1960, $24 million more taxes would have been collected, or 21.4 per cent of total sales taxes. If all exemptions had been removed, except motor fuel, food for off-premise consumption would have been 14.9 per cent of the total. In the long run, the revenue potential of a sales tax is larger with a proportional tax, flexibly permitting higher rates, than with a regressive tax for which only low rates are tolerable.

The theoretical basis for taxation of many services is widely accepted as part of the single-stage taxation of consumer expenditure. Commodities and many services are either parallel forms or often interwoven forms whose separation for commodity taxation is either difficult or undesirable. For example, repair work, such as motor vehicle repairs, forms a unified transaction in which both the service and the goods should be taxable. Consumer expenditure for services is growing rapidly,

goods expenditure more slowly. Between 1950 and 1960, American expenditure rose 46 per cent for durable goods, 53 per cent for nondurable goods, and 104 per cent for service expenditure.

Notwithstanding the theoretical consensus of the desirability of the taxation of selected services, a footnote must be appended that the record is disappointing. Perhaps public utility sales, especially electricity, gas, and local communication, constitute at once the largest service class subject to the general sales tax and the class whose inclusion is least desirable. Utility services are partly taxed federally, often are subject to separate state excises, and are taxed locally at rates varying from nominal to 15 and 25 per cent of gross sales, including the overpricing of rates by not a few city owned utilities to produce surpluses for general funds. Transient lodgings provide a respectable revenue to Florida and other tourist centers, and an unrespectably small revenue in other areas. Admissions afford only minor yields.

In brief, the retail sales tax states skirt the edge of service taxation by levies on a few classes least capable of defending themselves. Illinois in 1961 enacted a service occupation tax as a companion measure to the sales (retailers' occupation) tax. The new act was not designed to tax services but more effectively to tax tangible personal property sold in conjunction with services. States having broad-based gross receipts taxes, in which a beginning at least has been made to tax services, provide a better clue than the retail tax states. The tabulation below sets forth the rates and collections from service taxation for 1960 in six of the seven gross receipts tax states, excluding Indiana. Even in this group, the yields were minor because of the rela-

TABLE 2

State	Rate	Revenue (*In thousands*)	State	Rate	Revenue (*In thousands*)
Arizona	1%-2%	$1,584	New Mexico	2%	$3,577
Hawaii	3.5%	6,827	Washington	1%	8,520
Mississippi	1%-2%	3,857	West Virginia	.65%-1.05%	2,409

tively small population of the states, the limited number of services taxed, and the low rates, except in Hawaii.

Taxation of sales to governments, though obviously legal when state and local governments are the buyers, runs into the question of tax form when the federal government is the buyer. A simplified version of the legal rule is that if the sales tax is imposed in the form of a levy on the sale, the legal incidence being upon the buyer, sales to the federal government are debarred from taxation. If the tax is in the form of a privilege tax on the retail occupation, the legal incidence being upon the seller, taxes on sales to the federal government can be sustained.

Illinois successfully collected such a tax until sales to state and local governments were exempted, and the courts invalidated the tax as discriminatory. The baseball score is "one hit, one man caught off base, no runs." Though the door is still open to nondiscriminatory taxation of sales to the federal government, under the privilege form, the reluctance to tax sales to state and local governments has prevented the states from entering the door. The privilege form of sales tax also makes possible taxation of national and state banks because the legal incidence is on the seller, even though the economic incidence is passed on to the consumer bank. More baseball runs are being scored here.

Semantics or Substance?

A final footnote raises the questions whether nomenclature is misleading because of the lack of consistent patterns of state sales taxes. The Washington State Tax Commission compared the Census-reported retail sales of 1958 with sales taxable under state retail rates. In the gross receipts tax states, only the retail sector was included. The comparison reflected both retail exemptions and the taxation of services at the retail rate. Taxable sales as a per cent of Census-reported sales exhibited the extraordinary range of 55.1 per cent in Pennsylvania to 141.9 per cent in Louisiana. In 9 of 31 surveyed states, taxable

sales were under 90 per cent of Census sales, while in 10 states they were over 110 per cent of Census sales. The closer approach between the two in the remaining 12 states did not mean a pure retail sales tax. Taxation of public utility services could offset some retail exemption, while the two-stage taxation of capital goods could offset other retail exemptions.

Modification of the retail tax is fortunately not a one-way street of erosion. Ten states in 1961 broadened their sales tax base. Without evaluating individual changes, North Carolina notably plugged many holes in her retail base, introduced a low rate on capital goods, and extended the sales tax base to include service sales by laundry and dry cleaning establishments.

Ever since the sales tax was a gleam in the eyes of a few lobbyists and university professors, the debate over turnover taxation and tax pyramiding has been persistent. In the 7 gross receipts tax states, the retail rate is the highest, usually much the highest, of any of the categories, except for the very low rate of Indiana. In the other 6 states in 1960, the retail sales accounted for 63 to 81 per cent of the total collections of the gross receipts tax in 4 states. Only in Hawaii and West Virginia did retail sales collections drop to about 45 per cent of the total, resulting in sizable turnover taxation. Wholesale rates are very light except in New Mexico; extractive rates are light aside from West Virginia; and service rates are high only in Hawaii. The unique Indiana gross income tax minimizes tax pyramiding by exceptionally low retail and wholesale rates and a uniform rate of 1.5 per cent for other categories, especially for wages and property incomes that are not part of sales taxation.

Perhaps not sufficient is known for a definitive answer as to whether turnover taxation is nominal or genuinely oppressive in pyramiding. Perhaps not enough is known regarding so-called retail sales taxes that depart from the retail concept. In addition to the indispensable Census reports of tax collections and the legal compendiums, do we not need a special study—or better yet, recurrent surveys—of the occupational classes of sales

taxes comparable among the states; measures of revenue losses from exemptions or gains from additions to the tax base; the seriousness of tax pyramiding; the impact of extra high rates from selective sales taxes, especially when levied by two or three governmental levels; and the role of all sales and gross receipts taxes in promoting or retarding capital formation and consumer demand. Without further probing, we are likely to indulge in semantics rather than grapple with substance.

CHAPTER IX

SHOULD CONFLICTS IN STATE ALLOCATION OF BUSINESS INCOME BE TOLERATED, MANEUVERED, OR RESOLVED?

IRA J. PALESTIN
New York State Tax Commissioner

HEARINGS on the nettlesome question of state taxation of business enterprise engaged in interstate commerce were begun by the House Judiciary Committee's Special Subcomittee on December 4, 1961. Their inquiry was instituted to ascertain the conflicts of law and their consequences between state jurisdictions taxing interstate enterprise.

POWER OF STATE TO LEVY CORPORATE INCOME TAX

The power of a state to lay a direct income tax on a corporation exclusively engaged in interstate commerce was upheld in 1959 by the decision of the United States Supreme Court in the *Northwestern-Stockham* case.[1] Prior to that time, of course, state taxation addressed to intrastate business activity had long been acknowledged as a proper levy of franchise or business privilege taxation. Reacting quickly to the definitive statement by the majority in the *Northwestern-Stockham* case that a state may lay its tax on a corporation doing an exclusively interstate business, provided a nexus of activity exists between the corporation and the local taxing sovereignty and provided further that there is a fair apportionment from total income to the

[1] 358 U.S. 450.

local taxing jurisdiction, Congress in 1959 enacted S. 2524 into Public Law 86-272.

The hearings just opened by the House Judiciary Committee's Subcommittee are intended to adduce the facts upon which recommendations required by this act will presumably be made for possible federal legislation in the matter of state and local taxation of business engaged in interstate commerce. Meanwhile, under the act, the mere soliciting of orders for tangible personal property that are filled by shipments outside the state falls short of the nexus required for local taxation of a foreign corporation whose only business is interstate.

S. 2524 was accompanied by a report of the Senate Finance Committee. The report stated:

> No two States [taxing business income] have exactly the same formula for apportioning the amount of income attributable to local activities within the State. The committee understands that the formulas currently in use are complex, that even within the formulas the meaning of the basic words are inexact; and that for example, many of the . . . income tax States used a different definition to cover the term "sale."[2]

Mr. Justice Frankfurter, dissenting in the *Northwestern-Stockham* case, had been even more pessimistic. Speaking of the "thousands of relatively small or moderate size corporations doing exclusively interstate business spread over several States," he said:

> To subject these corporations to a separate income tax in each of these States means that they will have to keep books, make returns, store records, and engage legal counsel, all to meet the divers and variegated tax laws of forty-nine States, with their different times for filing returns, different tax structures, different modes for determining 'net income' and different, often conflicting, formulas of apportionment.[3]

It is presumptuous for a speaker to discuss the "facts," now that the legislative inquiry has been opened. But so much has been written and said on the subject since, if not before, the handing down of the *Northwestern-Stockham* decision that my few words may be permitted to enter the flood stream.

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[2] S. Rep. No. 658, 86th Cong., 1st Sess. (1959).
[3] 358 U.S. 450, 474.

Thirty-six states and the District of Columbia impose corporate taxes on or measured by net income. Each uses proceeds of sales of tangible personal property as a factor in arriving at business net income allocable to the taxing state. Most use the Massachusetts three-factor apportionment formula. Its factors, equally weighted in the classical application of the Massachusetts formula, consist of property, payroll, and sales or gross receipts.

Conflicts Arise in Sales Factor

There are no disparities in the use of the property and payroll factors which could not easily yield to uniform adoption by all states taxing corporate income. It is in the sales factor where most of the conflicts in apportionment law exist—conflicts which arise not from accidental inclination but as a result of regional jockeying for what is deemed a good taxing position.

Whether sales are to be allocated to the taxing states on an origin, or seller's, basis—as would benefit a manufacturing state; on a destination, or buyer's, basis—as would benefit a "market" or "consumer" state; or merely on the basis of the place where the sales contract is negotiated, could depend largely on the local legislature's view of its state's economy. Obviously, an "import" state will derive relatively little from a formula that relies for its property and, particularly, its sales factor on its own domestic industry.

Forty per cent of the states apportioning business income use a sales factor determined by the destination point of the merchandise shipped. Almost an equal number use the place of sales negotiation as the determinant. Three locate sales on a shipment origin basis. Three use a combination of several factors within sales activity. Two, possibly three, use a 50 per cent origin-50 per cent destination basis in measuring the sales factor.

Before further remarking on the differences in state allocation sales factors and their economic motivation, recognition should be given of a "position" which, as Charles Conlon told the

symposium of this Institute in 1960,[4] has been taken favoring total elimination of any sales factor in a local apportionment formula. This may have had reference to Professor Harriss' proposition that only property and payroll—i.e., capital and labor—create wealth and income, or that the selling effort necessary to create income is adequately accounted for by ". . . the remuneration of the human and material resources that perform the selling function."[5]

I wonder whether this economist's observation exactly fits the problem of income taxation. We are concerned with a corporate income tax. Capital and labor produce wealth—probably "income" in some economic sense—but not realized dollar income. You cannot pay the states in kind, and realization means marketing operations. Without a market, a most valuable inventory of manufactures or even of fungible precious stones, although fruits of commerce, has not reached that gross income stage upon which operating net profit or loss is computable.

Method of Computing Sales Factor

"Market" is an all-inclusive term. It embraces negotiation; offer and acceptance; appropriation of merchandise to the buyer's order; shipment by the seller; delivery to the buyer; the buyer's post-delivery right of inspection; the buyer's ultimate acceptance of delivery. Perhaps "remuneration of the human and material resources that perform the selling function" is broader than only wages and the carrying charges and return apportionable to capital. In any event, the states determining allocation of business income by apportionment formula accord a separate gauge to the conversion of inventory into money.

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[4] Charles F. Conlon, "Problems in Uniform Apportionment of State Income Taxes," *Management's Stake in Tax Administration,* Princeton: Tax Institute, Inc., 1961, p. 201.

[5] See C. Lowell Harriss, "Interstate Apportionment of Business Income," *American Economic Review,* XLIX (June, 1959), 400. See also Paul Studenski, "The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint," *Virginia Law Review,* XLVI (1960), 1132.

If every marketing step should enter the sales factor with its own separate weighting, a formula computation would pile up to frustrate any tax administrator's office.

The various marketing stages divide easily into three categories. Offer and acceptance relate to location of the sales office or place of solicitation, i.e., to negotiation. Appropriation to the order and shipment relate to the point of origin. Delivery, post-delivery inspection, and acceptance relate to point of destination. It is these broad categories in which the sales factors used by various states fall.

Among those that relate their sales factor to place of negotiation, many use sales office location as the test, but they divide on its definition. The predominant view considers the sales office to be that out of which the salesman works, even though it might be in a different state from the scene of his personal solicitation. A few jurisdictions define place of negotiation as the actual point of solicitation, regardless of sales office location. "Place of negotiation," therefore, is a protean concept that baffles the uniform lawmaker. In contrast, place of shipment, i.e., origin, and place of delivery, i.e., destination, provide fixed points as to which little interpretive controversy can be had.

Just as the local legislature's view of the economy of its own state will determine the choice of the sales factor in apportioning income of an interstate corporation, so economic motivation molds corporate attitudes on allocation formulas. A destination supporter would be a corporation whose gross sales, fragmented outside its manufacturing state, would limit the tax due to the manufacturing or sales origin state. Such a corporation could minimize tax imposts in more lenient market states.

Corporations whose manufacturing sites are dispersed over several states might or might not favor the sales origin basis for a particular state. That could depend on the degree of concentration of their factories within one or more taxing states. They would prefer not piling up property, payroll, *and* sales factors in the same state. Thus they might favor an origin sales basis

for a heavily industrial state in which they have located none of their own plants, but to which they ship large volumes of parts or finished products.

No reliable statement can be made concerning the apportionment predilections of corporate taxpayers generally. The thought has occasionally occurred that the same taxpayer may favor a different sales factor for various states according to the location pattern of its factories and markets. The inquiry of the House Judiciary Committee's Subcommittee undoubtedly will develop the extent of conflict in definitions of taxable base, apportionment formulas, tax burden, and compliance costs.

Struggle for Uniformity in State Laws

In July, 1957, before the suggestion was made in Public Law 86-272 of uniformity of state laws under congressional mandate, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved a model Uniform Division of Income for Tax Purposes Act (UDITPA). Later that year this act was approved by the House of Delegates of the American Bar Association. Briefly, it incorporates the Massachusetts three-factor apportionment formula, with sales of tangible personal property included in the numerator if delivery of the property across state lines is received in the taxing state, i.e., sales are allocated on the destination basis. Presumably, a basic requirement of taxability under UDITPA would be the prevailing local law of nexus, or jurisdiction to tax. The act provides that if the purchaser is not taxable in the state of destination, the sale is allocable to the shipping state on an origin basis. Thus far, two states, Alaska and Arkansas, have adopted this proposed uniform law.

The dispute between the adherents of the origin and destination basis for sales has been compromised in New Jersey. That state in 1958 adopted a corporation tax based on net income. It used the familiar three apportionment factors, with sales allocable 50 per cent to the origin state and 50 per cent to the destination state. This year my own state, New York, amended

its sales factor to like effect. Before that we had been a sales origin state.

It may be that the 50 per cent origin-50 per cent destination sales factor is a practical compromise limiting the revenue loss which heavy industrial states would sustain if they should completely abandon sales origin for destination. But it is also recognition that marketing, which results in income realization, cannot be confined to a single item of an entire process. New York and New Jersey in effect are now using four parts of a formula—(1) location of property; (2) location of payroll; (3) location of goods appropriated to the order; (4) location of delivery point—with a one-third weighting for each of the first two and one-sixth weighting for the remaining two; this, even as they preserve equal weights for the three familiar categories of property, payroll, and receipts.

If the hearings now in progress confirm the misgivings voiced in the *Northwestern-Stockham* dissenting opinion of Mr. Justice Frankfurter and by the majority in the Senate Finance Committee, the necessity for resolution of the many-sided conflict is indicated. Such a uniformity is in the best tradition of a vigorously functioning federal system composed of sovereign states wise enough to harmonize their individual views to serve a national community.

The adoption by all our states and dependencies of a Uniform Negotiable Instruments Law and a Uniform Warehouse Receipts Law, the adoption by the overwhelming majority of our states of the Uniform Sales Act, and a long list of other uniform acts governing commercial practice are solid recognition that the states can merge their differences to provide a common national business community. The Uniform Negotiable Instruments Law was approved by the NCCUSL in 1896. It was enacted in New York in 1897. Final enactment in 1917 by California and Maine made unanimous its application in all our states and territories. The Uniform Sales Act was approved by the NCCUSL in 1906. It was adopted in New York in 1911. It is now in force in 36 states and the District of Columbia, last

having been enacted in the state of Colorado in 1942.

Patently, it takes a long time for uniformity to emerge out of law conflicts. Its quest is never easy. We should further recognize that resolution of conflicts arising from economic need, as in the case of state taxation, may prove more difficult than composing differences that have developed in philosophical or juristic concept under the common law.

No state tax administrator freely would prefer a compulsory uniformity to one achieved by voluntary cooperation. Can congressional intervention be a stimulant rather than a bludgeon? In this connection the statement of Professor Harold M. Groves given at the hearings before the Senate Select Committee on Small Business held shortly after the *Northwestern-Stockham* decision is pertinent. He said:

> . . . what we need here is interstate cooperation with congressional intercession, as I call it, or congressional prodding.
>
> . . . I think the States should be given an opportunity, through conference, compromise, and contract, to put their own house in order in this area.
>
> . . . the intercession, I would hope, might come from a Federal agency . . . which would prod the States, and the agency in turn would be prodded by Congress. . . .[6]

I will leave the discussion at this point, particularly in view of the pendency of a responsible investigation into all aspects of this problem.

Before concluding, let me say that uniformity is a desirable predicate upon which laws taxing business income should be shaped. Every state, of course, is free in its choice of an available subject of taxation. Uniformity of *existing* law does not require its automatic extension elsewhere. As for the state of New York, its position was well presented by my colleague, the Honorable Joseph H. Murphy, Commissioner of Taxation and Finance, in a statement presented to the Select Committee on Small Business of the United States Senate on June 19, 1959.

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[6] *State Taxation on Interstate Commerce—1959,* Hearing Before the Select Committee on Small Business of the Senate, 86th Cong., 1st Sess., Washington: Government Printing Office, 1959, Part 1, p. 67.

He there gave his view of New York's aspiration for a good business climate. Our state imposes a corporate privilege tax based, in good part, upon net income. New York is an adherent of the three-factor Massachusetts apportionment formula. It will not supplement its existing privilege tax with a direct income tax laid on foreign corporations engaged in interstate commerce.

Instead our state has now given its endorsement to an apportionment sales factor compromised between the state of shipment origin and the state of destination. Will this compromise, which rests on a firm economic base, light the way out of the present difficulty?

CHAPTER X

DISCUSSION OF SOME PROBLEMS INVOLVED IN STATE AND LOCAL TAXATION OF BUSINESS

CHAIRMAN ALAN M. NEDRY, *Assistant Counsel, National Association of Manufacturers:* Now comes your turn. Do you have any questions or comments?

DR. HENRY FRANK, *Fairleigh Dickinson University:* Mr. Chairman, if there are no questions, could we prevail on Dr. Kilpatrick to fish that other paper out of his suitcase and summarize it?

DR. WILEY KILPATRICK, *Bureau of Economic and Business Research, University of Florida:* I would prefer to have a few questions first. Of course, I can talk through the dinner, I assure you, but the hall will be empty long before that time.

DR. FRANK: May I comment on certain services that are sometimes subject to general retail sales taxes? Some states and cities have meals and lodgings taxes separate and apart from the general retail sales tax—Massachusetts, Vermont, Alabama, and New York City are cases in point. If the sales tax of a state or city is extended to a service already subject to a special tax, it is not likely that much additional revenue would be picked up.

DR. KILPATRICK: All general sales tax states include in their tax base meals served on the premises (a tax on commodities), and most of these states tax transient lodgings (a tax on services). Apart from the general sales tax, however, I recall only Vermont and Texas that have levied a state excise on hotel services, and Texas in 1961 adopted a general sales tax. Taxation of these two classes normally takes the form of city excises

in a few states lacking a state general sales tax. The record reveals an irregular city adoption of separate excises and usually small tax yields.

Separate city excises on small tax bases result in fragmentation of taxation. Once we begin splintering the general sales tax into small city excises, we lose the possibility of substantial revenue and introduce distortions in which one segment of business bears a load and another segment bears little or no load of a similar nature.

We must differentiate between undesirable fragmentation and desirable diversification. An acceptable, if not ideal, type of diversification is secured by states which make a conscious effort to relate together, in a balanced tax structure, the taxes on net income, property, general sales, and selective excises justified by benefit, regulatory, or sumptuary purposes.

In relation to the general sales tax, as an instrument flexibly to be used, the broad, proportional base strikes me as much better, as much more advantageous, than picking out high rates for special classes. For instance, New York City recently repealed the 5 per cent tax on theatrical admissions. It was a sick industry. The federal tax on freight was eliminated, and the tax on passenger service is likely to be eliminated.

The cities hesitate to tax admissions because of the reaction upon the moving picture industry. Except for a sick industry, the sales tax has been too rough an instrument to be consciously manipulated as a means of either encouraging consumption or encouraging capital formation. The presence or absence of general and selective sales taxes and the levels of their rates, however, significantly affect consumption and capital formation.

A proportional base and elastic rate for the general sales tax form a better instrument than fragmentized and diverse taxes and rates. Selective excises, with the exception of public utilities, are often meager revenue raisers at the local level; and at both the state and local levels, they may distort the distribution of the tax load by discrimination among commodities and services.

DR. FRANK: Sir, I have another question. You are decrying the fact that services are hardly tapped under the sales tax. Could you suggest, other than transient rentals and food served in restaurants for on-premises consumption, some other services which might be good for sales taxation?

DR. KILPATRICK: Here is a list that is typical of a limited type of service taxation. The state of Washington now taxes amusements, architects, attorneys, barber shops and beauty parlors, collection, advertising and other agencies, dentists, engineers, general contractors, hotel rooms, tourist courts, real estate and insurance agents, stock brokers and loan companies, storage warehousing. This limited tax, at a rate of 1 per cent, yielded $8.5 million in 1960.

This is one of the more respectable showings by any state. At a 3 per cent rate, Washington could have collected over $25 million. A proposal was made in the 1959 legislature to subject personal services to a 4 per cent rate, but the professional groups organized so effective a lobby at Olympia that the proposal was roundly defeated.

Washington's limited array notably omits repair services, which are the most logical candidates, particularly automobile repairs.

Of course, you can without too much difficulty, as the general sales tax states do, require the garage to itemize the service, or the labor, and the parts separately when you take your car in for servicing.

What I am saying is that when your car is serviced, or a smash-up has occurred, or a new job needs to be done, you have in effect one economic transaction. Why require the repair shop to separate on the bill the labor or the service and the parts when, from an economic standpoint, the job is a single, unified transaction? North Carolina recently tapped laundries and dry cleaners, and some states have tapped printing and photography. I could extend the list, but these types are indicative.

DR. LLOYD SLATER, *New York State Department of Taxation and Finance:* I am research coordinator for a special tax structure study committee established by Governor Rockefeller in New York State. In listening to the discussions this morning, at noon, and again this afternoon, I am led to contemplate somewhat the possible advantages that might be achieved by some reshuffling of the different tax sources that are used by the federal government and those that are more traditionally, as has been pointed out, mainstays of the states and local governments. Therefore, I would like to pose a question, something like this: If it should become politically feasible—which you might question—would there possibly be some advantages in having the federal government take over most, if not all, of the taxing of business as such, except for the property tax, and of relinquishing at the same time to the state and local governments a larger proportion of the individual income tax base? I am assuming—though again you can comment on this, if you think it is not true—that the interstate activities and income of individuals create fewer allocations problems than the interstate activities and income of business.

I don't direct that question at anyone in particular, although possibly John Tarrant would be the logical one to comment on it. I would appreciate any other comments.

MR. JOHN F. TARRANT, *Tax Research Director, Connecticut State Tax Department:* I would be happy to comment on it, Lloyd, and my comment is a very practical one. Your suggestion is probably just put up as a trial balloon, because I am sure that you don't put it forward as an abstract theory. If your suggestion were acted upon, once your system was put in effect, the overriding political influences in the state would bring it right back to where it was.

CHAIRMAN NEDRY: Are there any more questions or comments?

PROFESSOR THOMAS C. ATKESON, *College of William and Mary:* This morning we heard a reference from an economic standpoint that the income tax is passed on in the nature of

the nature of a sales tax, which we generally think of in other terms. My question goes to this. We have at the federal level the test for deductibility of a sales tax as a tax that is specifically imposed on the purchaser by the state legislature. You have a number of instances in which the state legislature did not specifically draft the statute in such a way as to make the tax imposed upon the buyer, and as a consequence it was not deductible from the federal income tax.

What I want to know is: In the economic thinking that goes behind the building up of a tax system in a state, to what extent does the legislature give effect to the interrelationship of the state tax and the federal tax from the standpoint of the deductibility of one tax against the other?

DR. KILPATRICK: I don't think too much consideration has been given to that question in sales taxation. We have—and I think perhaps I slurred over this point too briefly—two types of legal form. First, the privilege tax is legally based on the privilege of selling. The tax is on the vendor, the seller. We have, secondly, the tax that legally is based upon the purchaser, namely upon the consumer. If my memory is correct, the states are about evenly divided. Perhaps the taxes legally based on the consumer are in the slight majority.

Of course, from an economic standpoint, the privilege tax is in effect passed on to the consumer. When I mentioned, for example, sales to the federal government, I was assuming a privilege form of taxation. You cannot tax under the consumer type of tax any sale to the federal government; but if you tax the vendor, as Illinois successfully did for a while until it made a mistake in excepting sales to state and local governments, the tax legally is for the privilege of selling. In economic incidence, the tax is likely to be passed on to the federal government.

The same question arises in taxation of state and national banks, which must be treated alike. If you have a privilege type of tax, you can tax people selling to banks, the vendors. If you have the consumer type of tax, you can't tax the national banks, and therefore the state banks automatically are exempted.

PART FOUR

TAX POLICIES IN RELATION TO INVESTMENT AND ECONOMIC GROWTH

"Private investment is generally conceived to be an important component of economic growth, not merely because it serves to expand the amount of productive capacity, but also because it is a major vehicle for conveying advances in the industrial arts and sciences into the actual processes of production.

"I think most of us are familiar with the very interesting research that has been carried on in recent years, which tends to emphasize the importance of technical progress rather than mere expansion in the quantity of resources as major components of growth.

"There are, of course, a great many difficult questions which concern the processes of economic growth, the contributions of private investment thereto, and the nature of business investment decisions, questions which must be resolved if we are to know what kind of tax policies can and should be used to influence investment.

"The gaps in our present knowledge, therefore, pertain both to the fundamental processes by which an economy expands and to the way in which the tax structure impinges on growth-generating activity. The latter relationship must often seem particularly mysterious because of the great number and complexity of regulations which apply in the taxation of business income and which may affect both the capacity and the willingness of businesses and individuals to save and invest, as well as the composition of their investment.

"Some of the more salient features of the present system of business income taxation and proposals for revision thereof are those to be discussed in this session this morning."

—NORMAN B. TURE
Director of Tax Studies, National Bureau of Economic Research, and Chairman of Symposium Session

CHAPTER XI

GAINS AND LOSSES FROM THE SALE OR EXCHANGE OF BUSINESS PROPERTY

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IDEALLY, business decisions on disposal of property should be made without regard to tax consequences.

Unfortunately, this is not the case under the present tax laws. Nor does it appear any more likely to be achieved under proposals now under consideration by Congress.

ADMINISTRATION PROPOSALS RELATING TO INVESTMENT

Take, for example, the 8 per cent credit which is proposed for new investment in certain types of depreciable property. This proposal is the principal feature of the Revenue Bill of 1961, a bill which the Ways and Means Committee did not report out in the 1961 session of Congress. Instead, the Committee late in the session released the text of the bill for study by the public. At the time of its release, the chairman announced the Committee would take up the bill early in the 1962 session.[1]

To prevent abuse, the tax credit proposal includes a recapture provision. This would cause the taxpayer to retroactively lose the credit if the property was disposed of or leased within six years of the time it was first placed in service.[2] This recapture provision could "lock-in" the property for six years. While it is true that the recapture provision would apply only if the

[1] See House Committee on Ways and Means, Press Release, August 23, 1961.
[2] Committee Print (Discussion Draft) of Revenue Bill of 1961, H.R.—, 87th Cong., 1st Sess. §2.

Internal Revenue Service determined that allowance of the credit would confer a benefit inconsistent with the tax credit provision,[3] this "safeguard" could prove illusory. Revenue agents could be expected to apply the recapture provisions whenever a disposition occurred within the six-year period, putting the burden on the taxpayer to establish that the disposition was required in its business. This does not imply any criticism of the Internal Revenue Service. Procedures of this type might be deemed necessary to prevent tax avoidance. On the other hand, most taxpayers would seek to avoid disputes by holding the property for the required six years.

Enactment of legislation modeled on the Revenue Bill of 1961 could substantially influence business decisions on disposition of property in still another way. I refer to the provisions of the bill which relate to gain from certain dispositions of depreciable personal property.[4]

Under these provisions, any gain recognized on the disposition of most kinds of depreciable personal property would be taxed at ordinary income rates to the extent of any depreciation deductions previously allowed.[5]

Standing alone, these provisions certainly do not appear to stimulate new investment nor to promote economic growth. On the contrary, they will discourage a taxpayer from disposing of equipment that is obsolete or unnecessary in the taxpayer's business but which may have utility to others.

It has been estimated that the average age of all machinery

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[3] The Discussion Draft provides that the Secretary or his delegate is to determine whether the disposition or lease within the six-year period is to result in loss of the credit.

[4] Discussion Draft, § 7.

[5] Section 7 of the Discussion Draft would add a new § 1245 to the Internal Revenue Code. This new section would, with certain exceptions, apply ordinary income treatment to the excess over adjusted basis of either (1) the recomputed basis of the property or (2) the amount realized from a sale, exchange, or involuntary conversion (or the fair market value in the case of other dispositions), whichever is the lesser. Recomputed basis would be determined by adding back to adjusted basis the amounts previously allowed as deductions for depreciation and amortization. These provisions would apply to all depreciable personal property, other than livestock.

and equipment in the United States is over 9 years.[6] In the past few years, the stock of equipment over 10 years old has been rapidly rising. By contrast, the average age of equipment has been declining in the more rapidly expanding economies of Western Europe.

The President and Treasury spokesmen have been urging enactment of the investment credit as a means of stimulating replacement of our growing stock of obsolete and inefficient equipment.[7] Paradoxically, the Treasury at the same time is supporting the proposal to tax gain on the disposition of equipment at ordinary income rates. This proposal appears to work as a *disincentive*—a deterrent to equipment replacements. Furthermore, this proposal is not required as a "package" with the investment tax credit. As we have already seen, the tax credit has its own recapture provision.

Arguments for Taxing Gain from Disposition of Personal Property

What, then, are the reasons for this new proposal on taxing gain from the disposition of depreciable personal property?

In proposing this change, Secretary of the Treasury Dillon stated that the gain sought to be taxed as ordinary income "reflects prior depreciation allowances in excess of the decline in actual value of the asset."[8]

During the prior Administration, the Treasury made a similar proposal to the Ways and Means Committee. At hearings on this proposal in March, 1960, the then Under Secretary of

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[6] Machinery and Allied Products Institute, "Changes in the Age Composition of the Stock of Business Capital Goods," *Capital Goods Review*, No. 40 (December, 1959).

[7] See *e.g.*, the President's Tax Message to the Congress, April 20, 1961; Address of Secretary of the Treasury Douglas Dillon to The Business Council, Hot Springs, Virginia, October 20, 1961; Address of Under Secretary of the Treasury Henry Fowler to the American Retail Federation, New York City, October 12, 1961.

[8] Detailed Explanation of the President's Recommendations Contained in his Message on Taxation, as submitted by Secretary Dillon at Hearings Before the House Committee on Ways and Means, May 3, 1961, p. 34.

the Treasury testified that capital gain treatment on the sale of depreciable assets was a "troublesome barrier to sound administration of depreciation allowances."[9]

Since the Congress will undoubtedly consider this proposal in the 1962 session, it is timely to examine the arguments advanced in support of its enactment.

First, let us examine the contention that ordinary income treatment is needed because prior depreciation allowances are excessive. Are present depreciation allowances, in fact, excessive? Many commentators, including some of our distinguished panelists, have testified on the need for depreciation reform.[10] The view has been expressed that United States depreciation policies are the worst of any industrialized nation of the free world.[11]

The prior Administration took cognizance of the need for depreciation reform with enactment in 1954 of accelerated *methods* of depreciation.[12] It also undertook a revision of Bulletin F, the guide to average useful lives. This study, however, was based on historical experience. The project was dropped when it became apparent that it would not result in any substantial reduction in average lives.[13] Instead, the Treasury in 1960 instituted a survey of the depreciation practices of indus-

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[9] Hearings Before the House Committee on Ways and Means on H.R. 10491 and H.R. 10492, Bills to Provide for the Treatment of Gain from the Sale or Exchange of Tangible Personal Property Used in Trade or Business, 86th Cong., 2nd Sess., March 2-3, 1960, pp. 4, 7.

[10] See *e.g.*, Statement of Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business Administration, at Hearings Before House Committee on Ways and Means on the President's 1961 Tax Recommendations, 87th Cong., 1st Sess., May 12-19, 1961, Vol. 2, p. 951.

[11] See *e.g.*, Study by the American Economic Foundation, August, 1961. See also Statement of Joel Barlow on behalf of the Chamber of Commerce of the United States, Hearings, *supra* note 9, p. 34.

[12] Reference is to adoption of the declining balance method and sum-of-the-year-digits method in the Internal Revenue Code of 1954 (§ 167 [b]). See H. Rep. No. 1337, 83rd Cong., 2nd Sess., pp. 22-25; S. Rep. No. 1622, 83rd Cong., 2nd Sess., pp. 25-29.

[13] See testimony of Under Secretary Fred C. Scribner before House Committee on Ways and Means, Hearings, *supra* note 9, pp. 4, 6, 7.

try, together with a questionnaire as to the type of depreciation reform that industry preferred.[14]

The present Administration has also stressed the need for depreciation reform and similar measures to stimulate economic growth. It has already taken action to reduce depreciable lives, by an average of 40 per cent, in the case of one industry—the textile industry.[15] Administration spokesmen have indicated that similar reductions will be made for other industries where a case can be made for the reduction.[16]

In light of the emphasis on depreciation reform, one may properly inquire whether present depreciation allowances are, *in fact,* excessive.

Let us examine the second argument for the proposal to impose ordinary income treatment on the gain from disposition of depreciable personalty. According to this argument, the strict enforcement attitude of the Internal Revenue Service towards depreciation allowances could be significantly relaxed if ordinary income treatment applied to dispositions.

It should be noted that the Treasury advanced this argument in hearings held in March, 1960, prior to the Supreme Court's landmark decisions on depreciation in June, 1960. These decisions were the *Hertz,*[17] *Massey,*[18] and *Evans*[19] cases.

You are all undoubtedly familiar with these decisions. For this reason I will not go into the facts in these cases but will only restate the principles enunciated by the Supreme Court. The Court upheld the Treasury Regulations, as promulgated in 1956, defining "useful life" to mean not the physical life of

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[14] Letter of Under Secretary Scribner, July 5, 1960, to 2,700 corporations; also letter of Administrator, Small Business Administration, August 8, 1960, to small business firms surveyed as to their depreciation practices and opinions.

[15] White House Press Release, October 11, 1961.

[16] Announcement by Secretary Dillon that special engineering studies would be made of six major industries: aircraft and parts manufacturers; automobile manufacturers; electrical machinery and equipment manufacturers; metal-working machinery and machine tools; railroads; and steel mills. Treasury Department Release dated December 6, 1961.

[17] Hertz Corp. v. United States, 364 U.S. 122 (1960).

[18] Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).

[19] Evans v. Commissioner, 364 U.S. 92 (1960).

the property but the customary holding period of the property in the hands of the taxpayer. This is broadly referred to as the economic life of the property. Similarly, salvage is to be determined as the amount estimated to be realized by the taxpayer on disposition of the property at the end of its economic life.

As a result of these Supreme Court decisions, the practices of which the Treasury complained in the 1960 hearings were substantially blocked.[20]

If we eliminate these practices from consideration, it seems less apparent that capital gain treatment under present law is a "barrier to sound administration of depreciation allowances." Certainly, taxpayers who testified in the 1960 hearings were not convinced that revenue agents would relax their attitudes on depreciation allowances if the ordinary income treatment proposal were enacted.[21]

Is Capital Gain Treatment an Unwarranted Benefit?

If there are, then, legitimate questions on the arguments which have been advanced in support of the proposal, are there other reasons for its enactment which have not been fully considered?

For example, is the capital gain treatment of existing law an unwarranted tax benefit? If the taxpayer is entitled to an ordinary loss deduction where depreciable property is sold at a loss, why should he receive a capital gain when its disposition results in a gain?

In the first place, it is important to note that the taxpayer frequently is *not* entitled to an ordinary loss deduction when the disposition results in a loss. Gains and losses of this type must be aggregated or netted.[22] A taxpayer may receive only

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[20] In this connection, the effect of application of the *Cohn* case (Cohn v. United States, 259 F.2d 371 [6th Cir. 1958]) should also be considered. In this case a depreciation deduction was denied by redetermination of salvage value where it became known that proceeds to be realized from disposition of the property were substantially in excess of the previously estimated salvage.

[21] See Hearings, *supra* note 9, pp. 30, 46. See also Donald J. Yellon, "Depreciation Developments in Congress and the Courts," *Taxes*, XXXVIII (December, 1960), 952.

[22] I.R.C. 1954, § 1231 (a).

a 25 per cent tax benefit from substantial disposition losses.

It has been observed that the gain on disposition of depreciable property is frequently the result of factors other than excessive depreciation. For example, the gain may be attributable to inflation, to increased costs of replacement, to change in location, or other special factors which make the property more desirable.

In the case of capital assets, such as stocks and securities, any gains due to inflationary factors are taxable at capital gains rates. In the case of nondepreciable property, such as land, gain attributable to inflation or to special factors affecting value is also taxable at capital gains rates. Take the case of land which greatly appreciates in value because of a more desirable location as a result of a population expansion. When this appreciation is realized on a sale, the gain is taxed at capital gains rates.

In the case of depreciable personalty, such as machinery and equipment, the factors of inflation and choice location are less likely to lead to a market value in excess of depreciated cost than in the case of real estate. In many instances, however, these special considerations can, and will, result in a gain on the disposition of such property. Increased replacement costs will sometimes result in the old property having a higher market value than its depreciated original cost would indicate. Is it logical to tax at ordinary income rates these types of gain resulting from inflation and other special factors in the case of depreciable personalty but not in the case of real property or nondepreciable capital assets?

An example which points up the problem is the treatment of patents under the proposal. A patent is, of course, subject to depreciation over its remaining life. Since the patent is depreciated at a straight-line rate over this remaining life, it seems difficult to believe that the depreciation on the patent would be excessive. If the patent is sold for an amount in excess of its depreciated cost, the gain is undoubtedly attributable to special factors affecting value. Yet this gain would, under the

proposal, be taxed at ordinary income rates to the extent of the depreciation previously taken on the patent.

"Real Estate Shelters"

When the Treasury made the present proposal to the Ways and Means Committee, its recommendations included depreciable real property as well as depreciable personal property.[23] In his testimony, Secretary Dillon referred to the fact that withdrawal of capital gain treatment would eliminate much of the tax advantage presently obtaining in so-called "depreciation shelters."[24] In these so-called shelters, the aggregate allowances for depreciation and for mortgage interest on a building owned by a real estate syndicate will frequently exceed the rental income from the building in the early years. During this period, distributions of "income" are tax-exempt in the hands of the investor. When the depreciation and interest allowances fall below the rental income, the building is sold and a capital gains tax paid on any gain realized on the disposition. Secretary Dillon referred to the fact that this gain is attributable to the depreciation allowances. Whether, in fact, the gain is attributable to the depreciation allowances or whether it is attributable to inflation in real estate values is, of course, the question. The Ways and Means Committee apparently determined that the latter was the significant factor and deleted application of the proposal to real property.[25]

Apparently the Treasury Department has not given up on the question of extending the ordinary income treatment to gains from the disposition of real property. A recent speech of a principal Treasury spokesman indicated that the Treasury

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[23] See Detailed Explanation of the President's Recommendations Contained in his Message on Taxation, *supra* note 8, p. 34.

[24] Statement on President's Tax Message submitted by Secretary Dillon at Hearings Before the House Committee on Ways and Means, May 3, 1961, p. 40.

[25] See House Committee on Ways and Means Press Release, July 14, 1961 (Item II).

would continue to press for some solution of so-called "real estate shelters."[26]

If Congress should reconsider its decision not to extend the proposal to real property, there would be several alternative possibilities for segregating out the gain which is attributable to inflation or other special factors. Some of these alternatives might be equally applicable to gain on the disposition of depreciable personal property.

For example, a price index might be applied to eliminate from ordinary income tax treatment any gain due to inflationary factors. The gain due to these factors would remain taxable at capital gains rates.

Another alternative would be to make the ordinary income treatment only a presumption. The taxpayer would then be permitted to show that price level increases or other increases of property values were the cause of the gain. If the taxpayer could rebut the presumption, the gain would be taxable at capital gains rates rather than at ordinary income rates.

Another alternative would deal with the depreciation shelter. Under this proposal, so-called "true depreciation" on the property would be regarded as the annual depreciation which is not in excess of debt amortization for that year. Any gain on disposition of the property would then be treated as ordinary income to the extent of the difference between the depreciation previously allowed and the so-called "true depreciation."

Careful Study of Proposal Needed

In closing, I wish to again call your attention to the fact that two administrations have endorsed the ordinary income proposal dealing with gain on the disposition of depreciable personal property. The Ways and Means Committee has also tentatively endorsed the proposal in principle.[27]

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[26] See remarks of Assistant Secretary Stanley S. Surrey before Annual Meeting of American Institute of Certified Public Accountants, November 1, 1961.

[27] See Press Release, *supra* note 25.

Before this complicated provision is added to the Internal Revenue Code, I urge all of you, as educators, practitioners, and businessmen, to give it your careful study. You may wish to ask these questions: Is the proposal needed to prevent tax avoidance? What effect will it have on economic growth? Is it logical, fair, and equitable? When you have reached conclusions on these questions, I would urge you to make your views known to the Treasury and to the Congress.

CHAPTER XII

DEPRECIATION, OBSOLESCENCE, AND DEPLETION

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A REAPPRAISAL of the tax treatment of depreciable and wasting capital assets is especially timely now. In spite of the absence of new tax legislation, the widespread acceptance of the need for reform in the tax treatment of investments in capital equipment has made 1961 a notable year in the development of our tax system. The proposal for an investment credit as the only item of tax relief dramatized the importance of the subject. Whatever we may think of the method proposed, the fact of the proposal was much more significant than the substance. The proposal itself has made reform in the tax treatment of depreciable assets politically acceptable and hence feasible. The more recent action in authorizing much shorter lives for machinery and equipment in the textile industry is a welcome precedent for additional revisions of authorized depreciation rates for other industries in 1962.

Extensive revisions of authorized lives for depreciation during the next several months will be a culmination of the Treasury investigations undertaken several years ago. If achieved, this will make 1962 important in tax reform, again even in the absence of tax legislation. There is, in addition, the prospect for legislative consideration of the modified proposal for an investment credit and, in view of prospective authorization for faster

* Grateful acknowledgement is given for time made available, under the research program of the Harvard Graduate School of Business Administration, for inquiries into matters of tax policy.

depreciation, a real need for repeal of the section of the law giving capital gain treatment to profits on the sale of depreciated property to the extent that they arise from any overdepreciation. A review of the issues involved in these various aspects of the tax treatment of capital assets is appropriate.

Arguments for Depreciation Changes

The need for more realistic and liberal depreciation to encourage capital investment has been well stated so many times in recent years that there is no need to do more than summarize the principal arguments. Faster depreciation permits a faster recovery of a capital investment in depreciable property. Faster recovery of capital may be regarded as, in a sense, reducing the net cost of an investment or increasing the rate of return on an original investment from any anticipated cash income flow. From either of these points of view, the result is to shift the margin in favor of investment. This is only one way in which faster depreciation will facilitate new investment.

Faster depreciation also helps in the financing of capital investment through the more rapid cash throw-off from depreciation. For any given unit price and physical volume of business, faster depreciation will give lower taxable income and lower taxes in the early years of life of a property. There will thus be a larger amount of disposable funds arising from any given level of operations. These larger funds are in turn available, among other things, for new investment or for more rapid reduction of debt previously incurred to finance the investment. The reduction of debt, by restoring debt capacity, permits earlier new borrowing to finance investment as an alternative to a direct use of internal funds. Also, the possibility of faster debt repayment may open new sources of financing, such as term loans which would not be available otherwise.

Two other ways in which faster depreciation may encourage capital investment are more subtle and have received less attention in the general discussions; they both have psychological rather than financial significance, but are nonetheless important.

Favorable effects on attitudes towards investment may be more important than a faster flow of funds in some instances. Virtually all capital investments involve risk and uncertainty, both of which discourage a commitment of available funds. The longer one has to look into the future to foresee a recovery of a capital investment, the greater are the uncertainties and the greater the discouragement to the investment. Since one can typically foresee the near future with more confidence than the more distant future, a prospect for more rapid recovery of an investment can be a positive factor in its favor quite apart from the prospective rate of return. The importance of the period for recovery of a capital outlay is indicated by the preference for faster recoveries instead of higher returns in the investment decisions in some companies.

The second way in which faster depreciation may improve the attitude towards capital investment is not altogether logical, but may still be significant. The fact that existing machinery and equipment has been fully depreciated may make a management more disposed to replace it, or to review the possible advantages of replacement. Logically, the fact of full or substantially full depreciation should have no place in a decision on replacement under prevailing theories of capital investment. But unsophisticated presumptions still have a place in the real world. A rule of thumb that useful life may be expected to equal the life assumed for depreciation and that replacement is due, or at least due to be considered, when property has been fully depreciated probably still has considerable acceptance in business practice. To the extent that it does, faster depreciation may induce new investment.

All of the foregoing arguments for faster depreciation were considered when the declining balance method was proposed and adopted in 1954. They are equally relevant for decisions to be made in 1962 concerning the authorization of shorter lives for depreciation. Some, but by no means all, are also relevant to the proposed investment credit.

There has been, thus far, a tacit assumption that additional

capital investment is desirable; the analysis has been directed to the effects of faster depreciation on investment. On the more fundamental proposition concerning the importance of investment itself, this paper cannot even review the arguments. The importance of capital, along with enterprise and management, has been emphasized in studies of economic growth and development. The rate of investment has even been taken to indicate potential growth. With capital recognized as vital to the less developed countries, it has again come to be recognized as important and respectable in the more developed countries. Those who are particularly concerned with our own rate of growth in comparison with those in some other countries stress our rate of savings as a measure of non-inflationary investment potential, thereby indirectly stressing the importance of investment.

Investment has increasingly been recognized as a basis for greater efficiency and productivity, and not simply as a basis for greater capacity with constant productivity. It was only a few years ago that many critics of depreciation reform cited excess capacity as though it were a conclusive argument against additional investment. This superficial objection has dropped by the wayside somewhere in the recent past and cost-saving investments are widely accepted as possible and desirable.

The new concern about the balance of payments gives added significance to investments which reduce costs. A restoration of prices which are competitive internationally is greatly in the national interest. More efficient capital equipment is essential to permit high-wage labor in this country to compete with labor in other countries where wages are lower and where machinery is frequently more modern than it is here. Our advantage of being among the first countries to have large-scale and highly-mechanized production may turn out to be a disadvantage if we do not replace old machinery rapidly enough to keep it as efficient as the new equipment in the countries of Western Europe and Japan where rapid expansion of total capacity assures a relatively modern average plant.

Criteria for New Rates

In the minds of most businessmen, faster depreciation is the most straightforward and effective method of depreciation reform. The implications of faster depreciation are clear and understandable. The change fits into familiar patterns of business thought and decisions of the sort previously described. The extent to which authorized lives should be shortened depends on the facts and circumstances in particular industries. Very fast depreciation, such as a five-year life for all machinery and equipment, would be so unrealistic that it could be justified only as a major tax incentive for new investment. There is no present evidence that any such incentives are needed or that their effect on the budget could be accepted. What seems to be called for is an authorization of service lives which is somewhat, but not greatly, on the short side of probable useful lives in a highly dynamic economy where technological improvements are expected to be substantial.

The historical record of the past generation should not be regarded as very significant in setting service lives for the future. Depression, war, and inflation have, each in its own way, acted to prolong the use of existing capital equipment. The absence of any one of these adverse forces would shorten future useful lives. More rapid technical improvements can also be expected to come from the increasing expenditures on research. International competition, made more intense by inflationary wage increases here, will increase the concern about costs and make business more receptive to cost-saving innovations. These are among the reasons that future allowances should not be tied down by the past.

The data collected by the Treasury in 1960 on the depreciation rates actually used should be a major factor in setting new rates. There will doubtless be great disparities in the rates used by different companies within an industry. It would seem undesirable to lengthen the lives used by an appreciable segment of an industry. Rather the rates used by the more dynamic companies, which have justified faster depreciation than that in-

dicated in Bulletin F, should be used as a base for setting new authorizations. The rates envisaged here might give little increase to some companies and for a very few there might even be a decrease in depreciation allowances. But rates would be generally and uniformly available. The benefits of the revision might be greatest for those smaller companies which have tended to adopt or accept without argument the depreciation rates given in Bulletin F.

Hopefully, new rates may be given on rather broad categories of property. This would be a great simplification, which is an important advantage by itself. The Canadian practice which has less than twenty categories of depreciable property, of which not more than four or five are relevant to any one company, seems desirable. With as much room for errors of estimate as there is in even an elaborate depreciation projection, an attempt at undue refinement hardly seems worth while. A relatively few categories of depreciable property are also given in England and many other European countries with apparent satisfaction to both tax officials and taxpayers.

Relevance of Capital Gains Provisions

With faster depreciation, it will become really essential to tax as ordinary income profits on the sale of depreciated property, arising from any overdepreciation. Faster depreciation and modification of section 1231 should go together. The Congress properly resisted the proposed change in section 1231 until the nature of depreciation reform was made clear; the Treasury might equally resist the adoption of depreciation reform until it is assured that any too rapid depreciation will not permit an unintended and unjustified tax advantage from playing the tax rates against each other. So long as the gain from what turns out to be excessive depreciation is taxed only at the capital gain rate, it would seem necessary as a matter of fairness and to protect the revenue to be strict in permitting deductions which reduce income taxable at the regular rates. Faster depreciation is itself an advantage because of present value considerations, but

somewhat too rapid depreciation does not appear to be an abuse so long as any gains arising because of it are taxed at the same rate as that applicable to the income which was decreased by the previous deductions. The modification of capital gains treatment should apply to all property including real estate.

Though the present tax treatment of gains seems inequitable, the full taxation as ordinary income of gains up to original purchase price might discourage replacement of capital equipment because of the cash burden of an immediate tax payment. This point may be significant. The discouragement could be avoided by allowing the gain to be applied as a reduction in the tax basis of newly acquired depreciable property. This has been done in some other countries with apparent good results. The tax consequences of the gain are thus postponed and appear as reduced depreciation allowances in later years. It seems both fair and economically desirable to permit a reduction of a basis as an alternative to immediate taxation of the gain arising from excess depreciation. If it is permitted, however, the reduction in basis should be limited to property with substantially similar useful service lives. In one European country where there are no restrictions, gains on sales of short-lived machinery are typically applied to the basis of new buildings, a practice which gives an unreasonable postponement of the tax impact.

The shift from existing to faster depreciation presents real transition problems with respect to future depreciation on existing partially-depreciated properties. As a minimum, the lives authorized for new properties should be a maximum for the remaining life of existing properties. Good arguments can be made for still greater reductions in the remaining lives of existing properties. In view of the revenue impact, however, the minimum adjustment would appear to be sufficient; it would at least not penalize prior purchases of depreciable property, and that should be enough.

Capital Gains on Sales of Depreciated Real Estate

Reference was made previously to capital gains on sales of

depreciated real estate. Real estate investment and speculation is conspicuously founded on tax considerations and special tax maneuvers, as is immediately apparent to anyone who even glances at the articles and books on the subject. The topic is too broad to cover here, and quite frankly, I have not explored the elaborate routes taken in real estate transactions enough to be confident of any tentative conclusions, but a few possibilities may at least be mentioned. In addition to the taxation as ordinary income of profits on sales of overdepreciated real estate, up to original purchase price, one might consider denying declining balance depreciation to real estate. In many respects the sinking-fund concept of depreciation seems more appropriate to a one-building real estate company. One might also limit depreciation on any tax basis arising from debt to the amortization of the principal of debt. These are drastic changes, but the present situation is also a drastic one, as is indicated by such fantastic concepts and phrases as "the tax-free depreciation income" which arises in real estate promotions.

Present tax laws unquestionably encourage construction, though sometimes it seems the construction is undertaken to have buildings to finance, to depreciate, and to sell rather than to occupy. The question is whether the tax shenanigans can be justified by the additional construction. It seems clear that they cannot be justified, especially when they are so devious; if there were to be a tax subsidy for construction it should at least be forthright and measurable.

Division of Responsibility Between Congress and the Treasury

The division of responsibility between the Congress and the Executive, represented by the Treasury, in establishing depreciation allowances is a delicate one. Basically, the responsibility is in the Congress which establishes the law which the Treasury administers. Depreciation deductions have typically been authorized in broad terms; certainly specific rates have never been given in the law, except for the special amortization for emer-

gency facilities. The work load involved in fixing and periodically reviewing individual rates would appear to preclude congressional determination; the time required would be an undue burden on the Ways and Means and Finance committees. The law does not justify manipulation of depreciation rates by the Executive, however, and changes in allowed rates should not be made on a short-term basis or as a counter-cyclical gadget.

A major revision of rates, such as may now be in process of development, might best be undertaken in consultation with the appropriate congressional committees and in some way receive legislative sanction through a committee report on accompanying legislation. Or new legislation might specifically direct the use of a few broad categories of property for depreciation, with a general directive on the basis for determination of specific rates and reference in the committee report to at least some of the rates which, in consultations between the Treasury and the Congress, are determined to be consistent with the policy directive at the time. Such a procedure would preclude arbitrary manipulations of rates in later years and at the same time avoid placing an undue burden, and constant pressure for individual rate adjustments, on the Congress. Though the division of jurisdiction here is difficult, it would be most unfortunate if jurisdictional difficulties led to any appreciable delays in the revision of depreciation allowances. The subject is important and action is urgent. It would be almost inexcusable if action were not completed during the 1962 session of the Congress.

Relation of Depreciation to Book Accounting

The possibility of limiting tax depreciation to depreciation taken on the books is an intriguing one. It was considered in 1954 as a condition for use of declining balance depreciation, but was rejected at that time because, among other things, of the undue rigidities created by the requirement that LIFO inventory accounting could be used only if no other method were used for any purposes. In retrospect, it appears that it may have been a mistake not to limit tax depreciation to book deprecia-

tion. The complexities and, in my opinion, the confusion introduced into corporate reports by so-called reserves for future taxes seem worse than the rigidities which might have come from a limitation on tax depreciation.

According to one point of view in the accounting profession, a tax adjustment account should be established to reflect all differences between tax and book accounts, including presumably such items as research expenditures, liabilities for pensions and deferred compensation, and liabilities under guarantees as well as differences in methods and useful life estimates for depreciation. It is to be hoped that this degree of complexity will not be introduced into our accounting records. The theoretical perfection towards which it strives would not be worth the trouble and, in fact and in theory, the reserves for future taxes would appear to be misleading because they would become significant only as a company declined towards eventual liquidation. For a growing company, or even a mature company, the reserve would appear to be more in the nature of a surplus reserve and it should be treated as such.

There are some expenses where a difference between tax and book accounting may be expected and even appropriate. This is conspicuously the case regarding research expenses in a newly established company which does not have enough income to absorb expenditures for research outlays. A requirement that the deduction be permitted for tax purposes only if it is taken for book purposes would to some extent negate the desired result of the authorization for current deduction for tax purposes. If the view favoring a general adjustment reserve for taxes prevails, differences arising from estimates of useful lives for depreciation will be only one of the significant elements and these differences would not be solely responsible for the new accounting complexity. If the adjustment account were to be required only for differences in depreciation then it would seem desirable on pragmatic grounds to restrict tax depreciation to book depreciation and thereby forestall the appearance of these confusing reserve accounts on published statements.

Such a limitation would have an important incidental result of helping to limit the present tax abuse by which some utility companies pay partially tax-exempt dividends because of an absence of "earnings and profits" under the tax concept when their tax depreciation exceeds the depreciation taken or allowed under state regulatory commissions. But this problem might better be dealt with directly; it does need correction.

A final point in favor of a limitation of tax depreciation to book depreciation arises from the fact that the higher book depreciation which would thereby be established would mean that what would otherwise be larger disposable profits, available for many uses, would instead become internal funds arising from depreciation, and these funds are especially likely to be directed into new capital investment. Thus it is argued that a failure to require book depreciation to be at least as large as tax depreciation would mean that an opportunity would be lost to shift internal funds into a category most conducive to capital outlays. This argument is important. Against it is the proposition that larger book depreciation might be reflected in unit costs and, hence, decisions on pricing. The extent of this inflationary effect is uncertain.

An Investment Credit

The relative merits of an investment credit and faster depreciation have been discussed at length in recent months. It is not likely that anything new can be added, or that the arguments can even be summarized briefly. The principal advantage of the investment credit, it is asserted, is that it will produce the maximum impact for a given revenue loss. The effect of an investment credit is to reduce the net cost of the capital equipment to which it applies. The cost reduction is immediate; there are no lingering or delayed effects through modifications of subsequent depreciation allowances. With a lower cost of equipment, any given income stream would represent a higher rate of return and hence shift the margin in favor of investment.

The investment credit gives the same dollar benefit for an investment regardless of applicable tax rate; this means that the advantage is greater for the lower-bracket corporations or proprietorships than would be the case under faster depreciation or additional deductions, such as the British investment allowance. Also, it was argued that since an investment credit could not be taken on a company's own books, except as a reduction in tax, there would supposedly be no reason for new discrepancies between tax and book records. There would seem to be a good argument, however, for taking it directly as a reduction in cost of depreciable assets rather than as a reduction in current tax, thereby spreading the effect over the life of the property but without any use of a reserve for future taxes.[1]

Against these advantages is the objection in principle to any deduction in excess of actual cost. This is a major objection; if we depart from cost, a precedent will be established for all sorts of differential tax subsidies and penalties for industries which are in particular favor or disfavor. The original proposal was unreasonably complex, with carry-overs and adjustments which would have left some taxpayers uncertain as to what if any credits they might receive from current outlays.

Also, the investment credit does not fit into the pattern of business analysis and decisions. This is a major objection. The impact of the credit may be apparent to a group in a seminar discussing scientific capital budgeting, but most decisions are not made in a seminar or by former members of seminars. Either faster depreciation, or even a first-year write-off of a large part of cost, has meaning because it fits into familiar patterns of thought. The investment credit does not. (The very interesting recent analysis by George Terborgh that an 8 per cent investment credit would be equivalent to a 40 per cent first-year initial depreciation allowance under some reasonable assumptions dramatizes the significance of the traditional thought. I suspect that the psychological impact of an extra 40 per cent

[1] Comments subsequent to the presentation of this paper suggest that there will be proposals for allocating the tax effect through a reserve.

first-year depreciation would be much greater than the impact of the 8 per cent credit on most businessmen.)

The investment credit also fails to have some of the important incidental effects of faster depreciation, such as the fact of full depreciation in shorter periods, faster cash throw-off to justify shorter-term financing, and larger internal funds arising through depreciation and presumably available for new investment.

In view of these many objections, an investment credit, even one at a flat rate, seems a very poor substitute for faster depreciation. It is questionable whether anything beyond realistic depreciation is justified or needed. Any credit which goes beyond a deduction for actual costs is so bad in principle that it should be adopted only if the need is urgent and no alternatives are available. The case has certainly not been made yet; hopefully, no action will be taken on the present draft legislation.

If it is concluded that something is needed in addition to more realistic rates of depreciation, a better alternative to an investment credit is fortunately readily available. The simplest and most useful change would be to broaden the section of the present law which gives a deduction of 20 per cent of the first $10,000 of annual investment in depreciable tangible personal property with lives of six years or more. This provision was developed by the Ways and Means Committee and the Treasury in 1958 to assist small business. At the time, it was recognized that the $10,000 ceiling might later be removed, with or without a change in the 20 per cent factor, to reduce tax barriers to general business investment in machinery and equipment. This special first-year allowance reduces the tax basis of depreciable property; regular depreciation, including ordinary first-year depreciation, is allowed on the reduced basis, but the total deductions cannot exceed total cost.

An extension of this existing provision of the law would have almost all the advantages of the investment credit. It would have additional advantages of its own by conforming to accepted business concepts and by increasing the funds arising through

depreciation rather than generally disposable net income. It would avoid the disadvantage of giving deductions (or credits) in excess of costs.

But whatever is done should be done promptly lest uncertainty lead to postponement of investment. (It should be a matter of surprise that, in view of the Administration's reiterated emphasis on the importance of the proposed investment credit, it showed no concern about possible postponements of investment when the matter was laid over for another year. One can only infer that the proposal was not really very significant or that there was a singular lack of appreciation of the realities of investment decisions.)

Depletion

The title suggested for this paper included the word "depletion." Reference to this subject will be very brief, both absolutely and in relation to the discussion of depreciation. Like so many other economists, I have found the traditional equity arguments in favor of percentage depletion unconvincing if not actually specious. The fact that an oil or mineral deposit is unique, physically exhaustible, and irreplaceable does not seem to be a good reason why its value, rather than its cost, should be recovered tax-free. There are many other types of unique, exhaustible, and irreplaceable property in which value exceeds cost, including copyrights, patents, successful styles or designs, for which no one has even proposed a tax-free recovery of value. But one's annoyance with reiterations of equity arguments which one finds unacceptable should not obscure possible economic arguments which may justify some form of special tax treatment for the extractive industries.

On practical grounds, the case for percentage depletion on foreign production is good. The principal foreign countries where oil is produced appear to establish taxes which at a minimum equal the amounts creditable against the United States income tax. Any increase in our taxes through a reduction of depletion allowances thus would not be likely to bring in

additional revenue to our Treasury; it would rather be an invitation for higher foreign taxes, perhaps even on a discriminatory basis, on our companies producing abroad. Such taxes would, in turn, place United States companies at a disadvantage in competition with foreign companies.

As regards domestic production the significant fact now is that oil and many solid minerals are relatively expensive in comparison with foreign sources. The products have a world market and a world market price. Transportation costs are not prohibitive and great distances do not offset basic differentials in production costs. These economic realities mean that domestic production may not be competitive. A domestic industry in being may be necessary for defense purposes, however, and differential tax treatment may be as good a way as any to assure its continuation.

Many statements have been made about the possible consequences of a reduction in percentage depletion allowances. Unfortunately they have too often been contradictory, sometimes apparently even unconsciously so. Would a reduction in the depletion allowance mean that we would have too little oil or too much oil (but from foreign sources)? Would it lead to much higher prices of refined products, or lower prices (but again because of a flood of low-cost foreign sources)? Would profits be unduly low or would they be restored by higher prices? Any of the foregoing seem to be possible results, but they certainly cannot all occur simultaneously. As an economist, I want to know which of these results is more likely to occur before I can have much confidence in a judgment as to the desirability of changing the percentage depletion allowance.

Two additional economic aspects of a modification of depletion are the possible effects on integration within the industry, as independent operators sell for capital gains to new owners who use cost depletion based on the present value of a proven oil or mining property, and the possible impact on federal and state excise tax receipts from gasoline. If prices were to be appreciably higher, there might, depending on the elas-

ticity of demand, be an appreciable reduction in taxes for highway construction. These questions and uncertainties can only be posed today; their resolution requires a good deal more analysis than seems to have been given to the subject thus far.

CHAPTER XIII

TAX CREDITS

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THERE ARE, of course, various significant types of tax credits involved in our tax structure. The propriety, and the adequacy, of each of them raises its own problems. Certain of these provisions, such as the dividends-received credit, do have a limited beneficial effect on inducing risk-taking in permanent equity investments. For the most part, however, the existing credits are designed to minimize double taxation, or to remove inequities of treatment as between different types of receipts, rather than to provide any positive spur to economic growth.

If taxation is to be deliberately adapted toward encouraging economic growth, and if our rate of annual growth is to be substantially increased, it is obvious that a very huge increase in business investments will be required. Moreover, the risks of large capital investment are so familiar that it is almost superfluous to give examples. Perhaps only one will suffice. The automobile industry, I believe, is typical of many other industries in the large amounts of capital at risk. The degree of risk, preplanning, and necessary advance commitments, however, are greater than those of most industries. In a typical new model program, for example, approximately 40 per cent of the additional expenditures for tooling, engineering, styling, and manufacturing facilities are definitely committed at least a year before the first new car comes off the assembly line. Mistakes are costly. In fact, a number of consecutive mistakes can

seal the doom of even a strong, well-established company. In the relatively few years since the beginning of the automobile industry, some 1,500 automobile and truck manufacturers, producing more than 3,000 different makes of automobiles, have either failed, merged, or ceased manufacturing.

With such typical capital risks, and with high tax rates foreseeable in the indefinite future, the tax laws must be heavily weighted in favor of, rather than against, capital risks if our tax structure is to play any part in bringing about a substantial increase in growth. One type of investment which tends to yield more than average long-run returns relates to expenditures for research and development. Possible types of tax credits or additional incentives for outlays on basic research, which benefit the public at large as well as the company paying the expenses, have received legislative attention in various foreign countries and might merit further attention here. The problem, however, is to encourage the channeling of savings into business investments which tend to increase employment and produce future income. Therefore, major attention has been focused on the area of investments in machinery and other fixed assets. At the present moment, when one mentions tax credits, businessmen tend to think of the much publicized and controversial "investment incentive credit" proposed by the Administration in last April's tax message. In view of the fact that the proposal will be under consideration again next year, it is appropriate to examine it with some care.

Proposed Investment Credit

Under the original proposal submitted by the Administration, an investor would be given a credit against his tax bill equal to 15 per cent of certain eligible investment expenditures on new plants or equipment (with a useful life of six years or more) in excess of his depreciation allowances. In addition, he would be given a credit of 6 per cent on investment between 50 per cent and 100 per cent of depreciation. No credit would apply to the first 50 per cent, except that as a minimum credit

he would be allowed 10 per cent of the first $5,000 of investment regardless of its relation to depreciation. Such credits would be separate from, and in addition to, depreciation of the eligible new investment at cost.

After hearings on the proposal, and after consultation with the Ways and Means Committee, the Administration agreed to drop such graduated credits in favor of a flat rate credit of 8 per cent applicable to new productive machinery and equipment (excluding buildings and structures) with a prospective life of six years or more. A limited credit would also be allowed for purchases of up to $50,000 of used property. Like its predecessor, however, the modified proposal was part of a tax package, and when the package itself was deferred to the next session of Congress, it went over also. The revised proposal, therefore, will be under consideration by Congress again next year.

The proposed investment credit was advanced in the belief that it would substantially encourage the placing of additional investment in plant and equipment. No one will deny that the objective is an important one. It is questionable, however, whether the proposed credit is the best initial step to attain the desired result. I am reasonably confident that most businessmen would share this opinion. Most, I believe, would consider that the first step should be to overhaul our basic depreciation system.

An investment credit, in whatever exact form proposed, is not to be construed or treated as a substitute for depreciation reform. Careful review of what the credit would and would not accomplish is rather revealing. The Administration, in specifying the applicable tests for an acceptable tax measure, requested "a more equitable tax structure and a simpler tax law." Although the proposed 8 per cent investment credit would be simpler than the previously proposed 6 per cent and 15 per cent graduated credits, geared to depreciation allowances, it would still be far from simple in many cases. Moreover, it would be of questionable equity in practice.

First of all, the credit is preferential. It would help only a

limited segment of industry, while tending to exclude a much larger part. The credit would favor business which can obtain ample financing to provide funds for expansion or modernization. Smaller business is often unable to obtain financing as readily, although smaller business is considerably more in need of such cash with which to expand. Thus, it would appear that the greatest relief would be available to taxpayers with the least critical need for funds.

More importantly, the investment credit would constitute a special provision conferring preferential treatment upon certain taxpayers more or less fortuitously. Taxpayers who might have postponed making investments in prior periods, but who happened to invest after such a credit became applicable, would enjoy the benefits of a credit windfall. This would be true even though the commitment for the investment might have been made previously, and though the investment would have been made even in the absence of such a credit. Taxpayers who are able to make considerable large investments in the immediate future would also be in a position to benefit from the investment credit, solely because of their greater flexibility of operation and their possible ability to finance and carry out large capital investment programs quickly.

From a businessman's standpoint, a prime objection to the tax credit (in addition to strong opposition to certain other parts of the tax proposals) is the element of possible impermanence. A broad thread of uncertainty runs through the whole fabric of the credit proposal. The very fact that the investment credit would allow a recovery of more than 100 per cent of original cost, and would thus not be tied to any approximation of true economic depreciation, would make it unusually vulnerable to future change. It is noteworthy that the British investment allowance of 1954 has been characterized by numerous rate fluctuations, terminations, reinstatements, and other changes which no doubt reduce its effectiveness as a reliable stimulus.

Industry, in committing itself to long-range expansion pro-

grams, would desire to be able to rely on a continuance of the credit. Machines must be designed, built, installed, tested, and finally placed in production. Most capital investment programs require from 18 to 24 months to devise and carry out their objectives. The Administration emphasized, however, that the proposed credit would be subject to continual review and modification from time to time, so as to adapt it to the needs of the changing economy. Should the credit be repealed at the midpoint of a long and costly program, the taxpayer engaged in such a program would find upon completion that the anticipated tax credit would not be forthcoming. This would be unsettling, to say the least, without considering the serious effect the absence of such a credit could have on the marginal financial utility of such equipment in the taxpayer's manufacturing operations.

Therefore, the proposed investment credit, if adopted, should be guaranteed to some extent both in rate and tenure. A five-year duration period would appear to be a minimum. This is not without precedent. The emergency facilities certified for use in World War II, and later in the Korean War, carried with them a statutory guarantee of a five-year write-off period. It is very unlikely that the same results would have been achieved if taxpayers had not been given the guarantee of a five-year write-off, but had instead been warned that Congress would place the continuation of the credit on trial each year.

Where long-range programs are involved, the taxpayers should also be able to rely upon a particular *rate* of credit. This is especially true in the case of marginal programs. If the taxpayer's financial analysis indicated the program to be barely feasible under a 10 per cent credit, the allowance of some lesser credit at the actual date of completion, some years hence, would shift the program into the area of financial unacceptability. He might meanwhile have committed himself beyond the point of no return. On the other hand, taxpayers entering into a program on the assumption of an 8 per cent credit would enjoy an unwarranted extra benefit should the overall credit have meanwhile been increased to 10 per cent. These possible revi-

sions in the rate of credit could have a sharper impact upon the relative competitive position of taxpayers than would a uniform change in rates or other general provisions.

The proposed credit contained a provision that disposal or diversion, within six years, of assets for which a credit had been granted, would cause the credits already taken to be added back to taxable income. This recapture provision would add to the factor of uncertainty. All other things being equal, assets scheduled for retirement might well be kept in use until economically unsound, merely to retain the advantages of the tax credit. A lag factor would tend to become built into the holding period of assets, depending primarily on the length of the recapture period for tax purposes. This tendency would defeat, or at least slow down, what should be a program of continuing replacement and modernization.

The hope has been expressed that the credit would tend to even out fluctuations in the business cycle and to stabilize the economy. When business conditions are favorable, however, the tendency would be to enter into additional investment commitments. In fact, statistics would readily show that gross investments fluctuate closely with the gross national product, and that peaks of investment would tend to occur at the tops of the business cycle. If a boom period is followed by a contraction period, however, investment could fall off sharply and contribute to a steeper decline than would otherwise be the case. Moreover, the uncertainties as to the duration and future rate of the credit would discourage taxpayers from entering into long-range commitments. Instead, taxpayers would tend to adopt short-term, and possibly less satisfactory, expansion programs which could be completed within the forseeable period of eligibility for the credit. This would be true despite a possible, but always uncertain, carry-over of unused tax credits. Such a possible emphasis upon short-range expenditures might well accentuate extreme fluctuations in the business cycle, rather than moderate them.

I think, therefore, that we must be realistic in reviewing the incentive credit. Although credits of this type might have con-

siderable merit in the eyes of their sponsors when originally enacted, today's "incentive" can easily become tomorrow's "loophole." The credit as proposed is concededly a form of subsidy. Although it is hard to conceive of a wholly neutral tax law, I think one can say that business generally wants to operate on a sound basis in a healthy economic climate. Under such conditions, one would expect, as has been the case, that business generally would feel that a preferential and unpredictable subsidy of this sort has a doubtful place in our tax structure.

Bracket System

In the general area of fixed asset problems, there has been considerable recent discussion of some form of bracket system. Under this system maximum and minimum rates would be established for various groups of assets, but a major problem would arise in establishing groups which would be appropriate to all taxpayers. The inevitable tendency might well be to establish more or less "catchall" groups. Such categories would tend to favor the holders of assets with relatively long useful lives as compared to holders of other assets with much shorter lives but falling within the same general group. The bracket system, unless very carefully developed, could thus tend to create serious inequities among taxpayers.

Typical of the many basic questions which would be involved in adapting the bracket method for general use are the following:

1. Would the new method apply to all existing assets, or to new acquisitions only? (If the latter situation prevailed, a long transition period could result, measured by the time it would take to retire the assets ineligible for use in tax bracket categories.)
2. Would the specified rates be applicable for use with accelerated methods of depreciation?
3. Would the classes, together with applicable minimum and maximum depreciation rates, be established by statute or by regulation? (The designation of suitable categories and rates would require extensive studies by tax experts and engineers, to recognize substantial differences which may exist between various industries.)

In connection with the preceding point 3, a problem would

arise in the area of relating such brackets to asset accounts now maintained by taxpayers. One of the difficulties encountered in the Treasury Department depreciation survey of a year ago was in devising categories of fixed assets that would be applicable to most industries submitting the requested information. I dare say that even within the broad category of machinery and equipment, for example, there is a range of life for different types of machinery extending all the way from 5 years or less to 25 years or more. Assuming that a bracket life of 10 years were established, a holder of assets having an actual average 5-year life would be placed within the 10-year bracket, and would be confronted with the burden of proof to overcome the presumption that the claimed 5-year life was too short. At the other end of the scale, the user of 25-year assets might find that all his problems as to support of useful lives had vanished.

Also, if the adoption of the bracket system were not predicated on the corresponding adoption of such brackets for book purposes, each taxpayer could be faced with the maintenance of bracket categories for tax purposes and continuance of the present method of accounting for assets on the books. This would involve the maintenance of two complete sets of records, which would not only create undue accounting problems but would enhance the chance for error.

A natural question that arises at this point is, if business is not receptive to the investment credit, what solution would achieve the desired growth in our economy? I would say that the program in this area should embrace depreciation reform in two steps. The first would involve administrative changes in the application and administration of the present tax provisions. Secondly, legislative changes, less preferential in nature but probably more permanent than the investment credit, should be considered.

Possible Administrative Changes

There is a definite need, which has become recognized by the Treasury Department and taxpayers alike, to provide a more

appropriate recovery of capital now invested in depreciable assets and property. One objective, which should apply without distinction to large and small taxpayers, is that more realistic useful lives should be used for tax depreciation than are now generally allowed. Many companies' tax depreciation is less than the book depreciation used in connection with stockholder reports, financial statements, pricing policies, and the determination of return on capital invested. It is necessary that proper economic lives be used for financial accounting purposes since so many business investments and everyday decisions are based on book depreciation policies. Normally, such lives for book purposes would soundly reflect both past technological obsolescence and anticipated future obsolescence. Rapid economic and production changes, to provide an improved product for consumers, must also be considered. To the extent that tax depreciation lags behind book depreciation, taxes are overpaid, becoming an additional and burdensome cost to be borne. Recognition of more realistic lives for tax depreciation purposes would tend to close, or at least to narrow, this gap.

If business is forced to maintain antiquated depreciation schedules, in the long run old industries will be seriously affected because assets are not replaced as often as required to keep pace with technical improvements here and abroad. The textile industry, in which the recently announced depreciation rate reform was long overdue, is a case in point. Similar examples of other industries no doubt exist in this country, and similar reform should be assured such industries.

The whole field of depreciation examination philosophy should be critically reviewed. There is a tendency for agents to be overmeticulous in failing to recognize obsolescence and other business risk elements. Many businessmen complain that the tendency of agents to use hindsight on allowable depreciable lives acts as a real deterrent in proceeding with business investment decisions. Such an overly conservative attitude on the part of the examiners acts as a practical obstacle to investment, since no businessman particularly welcomes a long-drawn-out depre-

ciation controversy. There is a general feeling that examiners should more readily accept taxpayers' business judgments and practices concerning claimed depreciation rates, especially where tax depreciation is already less than the depreciation recorded on the taxpayers' books. More than 60 per cent of the firms responding to the Treasury's recent depreciation survey attributed the inadequacy of existing allowances to excessively long useful lives for tax purposes. Depreciation experts often differ among themselves as to the length of time depreciated assets may reasonably be expected to be useful to the taxpayer in his trade or business. The Service should recognize this as a natural occurrence, and should not merely attempt to resolve all doubts as to useful lives in the government's favor. The latter stringent policy, over a period of years, undoubtedly lessens taxpayers' risk-taking, and acts as a real brake to growth.

Possible Legislative Alternatives

The administrative changes which I have mentioned would go far to eliminate much of the present dissatisfaction with the application of the present depreciation provisions of the Internal Revenue Code and would, in my opinion, encourage productive capital investment.

It would appear that the simplest means of accomplishing a further acceleration of depreciation would be an increased write-off in the first year of an asset's use. Such write-off should be on the order of magnitude of 30 per cent to 40 per cent of cost. A provision of this type could be very easily accomplished within the framework of the present law; Congress would need merely to extend the principle of section 179 by removing the $10,000 cost limitation presently in effect, and simplifying its operation. This route would have the added advantage that the initial allowance would be charged against basis, thus permitting no more than 100 per cent recovery of cost, compared with an effective recovery of 116.7 per cent of cost for taxpayers subject to a 52 per cent tax rate under an 8 per cent investment credit system.

The initial write-off would be relatively simple in application, if it were allowed on an unrestricted basis for all assets acquired in a given year. This requirement is necessary to facilitate the maintenance of proper depreciation records, as otherwise some assets would qualify for the initial allowance while others would not. Restricted eligibility would tend to create confusion, with the chance for errors increasing with the size of the company and with the number of years such restrictions remained in effect. However, should the initial allowance be made effective for all assets acquired after a given cutoff date, there would be no insoluble problem of identification other than the year of acquisition. Since such information is maintained in any event, chance for error and confusion would be minimized.

Another approach to the problem would be the adoption of some method of depreciation which gives recognition to changes in price levels. These possibilities have been explored at length in previous meetings of this group and, therefore, I have not attempted to discuss them at this time. I do not mean to infer that there is not a substantial case for such reform. Such methods, however, would inevitably complicate and discriminate, since they deal only with one segment of a company's assets. Moreover, it would appear that some of the goals sought through price level adjustments could be attained through the adoption of depreciation legislation granting an increased initial write-off.

Conclusion

A great deal of time has already been spent in oral and written discussion as to what the investment credit might or might not do. I believe it is safe to say, however, that most businessmen are of the opinion that the credit should not constitute the first order of business in achieving much-needed depreciation reform. It is not surprising that the credit has not received the support of business, since it constitutes a subsidy which would be erratic in operation and would be unlikely, by reason

of its very nature, to be accepted as a permanent part of our tax structure.

Instead, concerted attention should be given to developing suitable administrative changes within the framework of the present Internal Revenue Code and Regulations. Such changes should give greater recognition not only to the important technological progress which has been made in recent years, but to future advancements which are foreseeable at an accelerating rate. The Treasury Department has recently found this technique of administrative relief not only feasible but acceptable in the use of shorter lives which are now permitted to the textile industry. The extension of this shorter-life plan to other industries certainly cannot now be denied as impossible to accomplish. Such measures should be looked upon not as relief to be granted only to industries which are depressed because of foreign competition, but rather as a matter of right to which each industry is entitled based upon a realistic review of depreciation rates and lives, with recognition being given to the special factors of obsolescence and the rapidly changing currents which may prevail in that industry.

The second prong of basic depreciation reform should be some form of legislation which would serve as an incentive to invest in productive facilities. Such reform should be approached on a long-term basis, and, accordingly, should not be based upon subsidies, providing depreciation over 100 per cent of cost, which might soon be withdrawn from the tax structure. In connection with any such possible legislation, it is believed that the most feasible and practical approach would be an initial write-off, on the order of 30 per cent to 40 per cent. A 40 per cent write-off, according to a study prepared by the Machinery & Allied Products Institute, is equivalent to the 8 per cent credit in average, or overall terms, in the case of companies subject to the full corporate tax rate. The desired economic stimulus to expansion and modernization could easily be achieved by such an extension of deductions in the initial year of acquisition, to-

gether with less archaic lives over which assets are to be depreciated.

Meanwhile, in the whole field of depreciation reform, we must always recognize the real difference which now exists between activity and accomplishment. It is to be hoped that all of the study and discussion, which for years has revolved around the most desirable form of depreciation allowances, will soon develop into the concentrated phase of action and real accomplishment.

CHAPTER XIV

EXPANSION PLANS AND THE ACCUMULATED EARNINGS TAX

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THE CONCEPT of expansion often involves change, especially in this day of unprecedented technological development and opportunity. But the tax laws, instead of offering incentives to encourage expansion, have the opposite effect under many circumstances. Specifically, the tax on accumulated earnings may make it quite expensive for a successful corporation to finance its entry into a new or different field of endeavor with the funds accumulated from past successes.

USE OF ACCUMULATED EARNINGS FOR NEW VENTURES

The tax on accumulated earnings actually is a tax upon *hoarding*.[1] A corporation may sustain additional tax up to 38½ per cent if its earnings are allowed to accumulate beyond the reasonable needs of the business in order to save shareholder surtaxes.[2] The key to the problem is that phrase "beyond the reasonable needs of the business." By court interpretation, earnings may not be retained with impunity except for the needs of the business as presently constituted. But it may not be to the best interest of the corporation or of the economy to have the

[1] Robert S. Holzman, *The Tax on Accumulated Earnings*, New York: The Ronald Press Company, 1956, p. 9.

[2] I.R.C. 1954, § 531.

business restricted to the products, services, or activities of yesterday. Perhaps much more could be done with the corporation's potential if the corporate organization, experience, and know-how were applied to new or additional endeavors. Whatever made the corporation successful enough to acquire earnings in the first instance might equally well be applied to another venture.

At least as far back as the time of Adam Smith, it was sound economic thinking to believe that capital automatically flowed to those areas where it could be most profitably employed. But in 1776 there was no man-made law which said that retained earnings (which already have been taxed once) could not be transferred into a more necessary and therefore more profitable field, except at the peril of a tax upon this retention.

Economists generally agree that one of the healthiest forms of expansion is created by the ploughing back of earnings into an enterprise for further development. Surplus funds might be obtained for expansion or development by means of increased capitalization or other outside sources. The courts have agreed, however, that for the purpose of the accumulated earnings tax, "there is nothing reprehensible in achieving the same result by ploughing back earnings. Moreover, the election to adopt the latter practice does not demand that Section [531] be applied if the purpose is not to avoid surtax on shareholders."[3] But the ploughing back must be into the corporate enterprise itself and not into other fields.[4] That is not what the Regulations say. "The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake."[5] The decisions do not support the Regulation.

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[3] *Wean Engineering Co.*, T. C. Memo., Docket Nos. 107584 and 109876, entered July 24, 1943.

[4] *Southland Industries, Inc.*, T. C. Memo., Docket No. 3387, entered October 31, 1946.

[5] U. S. Treas. Reg. § 1.537-3 (a).

Thus, a corporation faced with declining profits in its field of automobile engine rebuilding was subjected to tax on accumulations for the purpose of entering the new field of television film production.[6] A radio broadcasting company was not sanctioned in retaining surplus for the purchase of a department store. "[E]xpected investment in a merchandising enterprise has no bearing on the needs of the broadcasting business in which petitioner was engaged."[7] A corporation in the business of cold storage and warehousing was taxed upon earnings retained to purchase residential lots and the construction of homes thereon.[8] An automobile dealer could not retain earnings in order to invest in an income-producing warehouse.[9]

In the only decision where there was specific citation of the favorable subsection of the Regulations quoted above, the taxpayer lost. A bar concessionaire (a tenant) was not justified in accumulating profits to buy land next to the landlord's property, in order to prevent neighboring occupancy by competitors. Said the court: "The petitioner had no intention, at least none appears, of using this land to carry on a separate business. Cf. . . . section 1,537-3. . ."[10]

In what seems to be a conflict with that favorable subsection of the Regulations is another subsection. The Regulations give certain examples of unreasonable accumulation of earnings, one of which is "Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation. . . ."[11] Expansion of a business (which may be in products or services as well as in size) might meet the language of this disqualification. For example, one of the major manufacturers of airplanes, confronted with government contract cancellation,

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[6] *Automotive Rebuilding Co.*, T. C. Memo., 1958-197, filed November 28, 1958.

[7] *Southland Industries, Inc., supra* note 4.

[8] *J. M. Perry & Co. v. Commissioner*, 120 F.2d 123 (9th Cir. 1941).

[9] *Kerr-Cochran, Inc.*, 30 T. C. 69 (1958).

[10] *Raymond I. Smith, Inc.*, 33 T. C. 141 (1959), *aff'd*, — F.2d — (9th Cir. 1961).

[11] U. S. Treas. Reg. § 1.537-2 (c) (4).

recently shifted its emphasis to cement. Is investment in cement properties related to the business of airplane construction?

Study of the cases indicates that corporations collectively have been served illy by many taxpayers who went to court on the issue of retention of earnings in order to enter new fields. Many of the litigated cases were flawed by such perennial accumulated earnings tax weaknesses as stockholder loans, failure to effectuate plans, or vagueness. But these are the cases which supply the precedents. What we cannot get away from is the language which the courts have published for the edification of revenue agents and others.

Thus, in one case it was stated by the court: "We think the reference in the statute to the 'needs of the business' must refer to the regular business of the taxpayer . . . in which it is then engaged (as contrasted with some other unrelated business not then carried on by it . . .)."[12] Another court declared: "The statute, we think, contemplates immediate need, need associated with business in hand. . . ."[13] In a recent case, the court said disapprovingly: "There was lack of relationship between petitioners' established course of business and their plans for expansion."[14]

The very language of these cases is difficult to buck if a taxpayer's expansion is to be in a field other than that in which it was engaged in the year of the accumulation. Earnings may be retained with impunity only for the needs of the business. By judicial gloss, this means the needs of the *present* business. A corporation that would diversify its activities must look for new financing as opposed to ploughed back earnings, for retained earnings would be regarded as being beyond the reasonable needs of the business which had accumulated them.

The ploughing back of earnings means that a corporation may raise itself by its own bootstraps. Profits are used to finance

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[12] *Automotive Rebuilding Co., supra* note 6.

[13] *McCutchin Drilling Company v. Commissioner,* 143 F.2d 480 (5th Cir. 1944).

[14] *American Metal Products Corp. v. Commissioner,* — F.2d — (8th Cir. 1961).

growth. But there can be no substitution. Earnings, to be retained properly, apparently must be for the exclusive benefit of the business which accumulated them. There is no room for flexibility. It was fruitlessly argued in one case that a corporation had added a second business to the original one, which was becoming less important. The court pointed out that purchases and debts of the new enterprise in no way benefited the original business.[15] An analogy may be seen with the tax treatment of loss carry-overs. The Internal Revenue Service was not willing to let a corporation which changed the nature of its business utilize the losses sustained in one type of endeavor against the profits earned in a new undertaking, until the courts intervened.[16] But in the basic cases involving loss carry-overs, at least the courts recognized that if the same corporation is involved, profits from one type of business may be bracketed with losses of another type of business. The only requirements are that there must be a continuity of ownership and a sound business reason for the acquisition.

In cases involving the tax on accumulated earnings, the meeting of these two requirements has not been a factor at all. In fact, the only analogy that can be cited is the treatment of gambling losses. Often the Internal Revenue Service takes the position that gambling losses only may be used to offset gains from that same type of gambling. But it is rather preposterous to liken unto the gambler the successful businessman who decides, after consideration of all the hazards, to expand into a new field. Certainly the one gamble he should not have to take is the Internal Revenue Service's interpretation of "the reasonable needs of the business."

In connection with tax-exempt organizations, there has developed the concept of unrelated business income.[17] The tax shelter of these exempt organizations does not extend to unre-

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[15] *Jacob Sincoff, Inc. v. Commissioner,* 209 F.2d 569 (2d Cir. 1953).

[16] *Alprosa Watch Corp.,* 11 T. C. 240 (1948).

[17] I.R.C. 1954, § 512 (a).

lated business income. There is an analogy in the tax on accumulated earnings. The shelter of retention for the reasonable needs of the business does not extend to investments, which, in the language of one decision, "had no relation to its storage business."[18] Investments in income-producing properties likewise were regarded as "unrelated investments" in the case of a distributor.[19]

Where entry into a different type of business is part of a policy of expansion, the corporation has made its choice voluntarily. If the corporation is not prepared to use new funds or to grapple with unfavorable accumulated earnings tax decisions, the expansion need not be undertaken at all. This element of choice is utterly lacking where a corporation has to go into a new field because the old one looks hopeless. But here the courts have been just as determined that retention of earnings must be for the purpose of the *existing* business. Thus, a corporation that had lost its franchise retained earnings in order to enter upon a new field. The health of the chief executive was poor, perhaps the reason for the loss of the franchise or the result of it, and hence the court had doubts as to the reality of the ultimate entry into the new field. It was not sanctioned.[20]

Other Obstacles to Retention

There are other obstacles to be hurdled by a corporation which retains earnings in order to enter a new business. It was held in one case that retention was improper where costs of the new facility and its commercial feasibility were as yet unknown quantities.[21] No specific amount, the court felt, could be labelled a reasonable figure for acquisition of facilities on which there was yet no price tag. But often that is the actual situation in a business unfamiliar to the taxpayer. Similarly, it may not be

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[18] *J. M. Perry & Co., supra* note 8.

[19] *Kerr-Cochran, Inc., supra* note 9.

[20] *Egan, Inc. v. Commissioner,* 236 F.2d 343 (8th Cir. 1956).

[21] *KOMA, Inc. v. Commissioner,* 189 F.2d 391 (10th Cir. 1951).

possible to project for an unfamiliar undertaking "estimates on which petitioners might reasonably have relied as a reason for accumulating earnings in the scale and manner in which they accumulated them."[22] Retained earnings of another corporation were not sanctioned because there was no proof that the taxpayer was going to depart from its long established course of business.[23] Or what was wanted actually may not have been obtainable at the time.[24] The courts have been very lenient in imposing the accumulated earnings tax upon new corporations, which lack the educative advantages of experience as well as the most modest of earned surpluses.[25] But now we are dealing with corporations which may not argue that they are new, even though many parts (if not most) of their business may be.

Purported change in an established pattern of doing business has not elicited very sympathetic reaction in the courts. Their honors seem to mistrust the reality of accumulations for the purpose of effecting change, questioning why, if this proposed change had reality, it had not been effected in the past. Thus, where a corporation retained earnings in order to acquire a factory, the disapproving court noted that there had been no such acquisitions in the past 14 years.[26] Accumulations to provide additions to a plant were not recognized in another case, on the grounds that the corporation had leased its premises in the past and "It is reasonable to assume, in the absence of evidence to the contrary, that it would continue to follow the same practice."[27] It is difficult to see how a corporation may legitimately retain earnings in order to expand into a different field, where these cases state in so many words that if something has not been

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[22] *American Metal Products Corp.*, 34 T.C. 89 (1960), *aff'd*, — F.2d — (8th Cir. 1961).

[23] *E. L. Bride v. Commissioner*, 224 F.2d 39 (8th Cir. 1955).

[24] *Southland Industries, Inc., supra* note 4.

[25] *Hemphill Schools, Inc. v. Commissioner*, 137 F.2d 961 (9th Cir. 1943).

[26] *Wellman Operating Corp.*, 33 T.C. 162 (1959).

[27] *American Metal Products Corp., supra* note 22.

done in a particular way in the past, there is no reason to give it reality at this time.

Desired expansion into another field was not accepted as reason for retention, even though negotiations already were under way, where, by the end of the taxable year, it had not been possible to come to terms with the prospective seller.[28] Yet the coming to terms with parties in fields with which the taxpayer is as yet unfamiliar may be expected to require more time than negotiations in the old line of endeavor.

Certainly business must expand if our country is to grow. As was said in one accumulated earnings tax case: "A capitalistic economy requires some freedom of action on the part of those engaged in it and the needs of a growing business of necessity must be determined by those engaged in its direction."[29] Even more to the point is this sentence from another accumulated earnings tax case: "To remain static in this field would be to invite customers to discontinue their custom."[30]

But the only favorable decisions in the area of earnings retention for expansion are limited to the taxpayer's own business. A corporation could enlarge activities in its own field.[31] A tool company could add precision tools to its regular line.[32] Change to a new color process was justifiable in the case of a photofinisher.[33] A manufacturer of office furniture was allowed to accumulate earnings in order to introduce a new line of steel chairs.[34] A manufacturer could branch into retail outlets.[35] The buying up of a concession was valid.[36] Addition of new plants

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[28] *I. A. Dress Co. v. Commissioner,* 273 F.2d 543 (2d Cir. 1960).

[29] *F. E. Watkins Motor Co.,* 31 T.C. 288 (1958).

[30] *Fotocrafters, Inc.,* T.C. Memo. 1960-254, filed November 29, 1960.

[31] *Solar Oil Corp. v. Ferguson,* D.C., Kan., Dec. 3, 1959.

[32] *Newman Machine Co.,* 26 T.C. 1030 (1956).

[33] *Fotocrafters, Inc., supra* note 30.

[34] *Metal Office Furniture Co.,* T.C. Memo., Docket Nos. 107369 and 238, entered October 28, 1952.

[35] *Defiance Lumber Co.,* T.C. Memo., Docket No. 34067, entered July 8, 1953.

[36] *Lion Clothing Co.,* 8 T.C. 1181 (1947).

to be closer to important customers was approved.[37] A corporation could make provisions to extend its existing specialty into foreign lands.[38]

But all cases of this type involve retention of earnings for expansion (horizontal or vertical) of an existing business. If a corporation's executives have the courage, imagination, money, and pioneering spirit to enter upon a *different* business, and surplus is accumulated for this purpose, they must be reconciled to having to resist an accumulated earnings tax with some of that same courage, imagination, money, and pioneering spirit.

[37] *J. E. Baker Co.*, B.T.A. Memo., Docket No. 87758, entered June 6, 1939.
[38] *Thomas W. Briggs*, T.C. Memo. 1956-86, filed April 16, 1956.

CHAPTER XV

REACTIONS OF A WAYS AND MEANS COMMITTEE MEMBER

JACKSON E. BETTS
Ways and Means Committee, United States House of Representatives

THERE ARE some things about Congress and Congressmen that I think you ought to know. One of my friends in Washington got a letter from some mayor out in the Midwest who asked him to secure a speaker for a Fourth of July celebration. He said to this friend in Washington, "If you can get me a Cabinet officer, that would be fine. If you can't get a Cabinet officer, get a Senator. If you can't get a Senator, get a Congressman, but don't get anybody lower than a Congressman." The friend said, "Well, for your information, there is no one in Washington lower than a Congressman."

You also ought to know that in Congress we worship at the shrine of seniority. That means you become important as people ahead of you die, or are not re-elected, or are assigned to some other committee. To be important in Congress you have to have seniority.

Moreover, you should know that it is also important to belong to the majority party. So, for your information, I am fourth from the bottom on the minority side of the Ways and Means Committee. That is what you have here tonight to talk to you about taxes.

It is a pleasure to be here. I am really flattered to be asked to appear before this distinguished group. Of course, I am delighted to see so many people from Ohio and particularly to see that one of our Buckeyes has been elected head of this great

organization. Stanley, I want to tell you on behalf of all your Buckeye friends, that back in Ohio we are really proud of you and the part you are playing in this organization.

I have looked over your program and the speakers that have appeared and with the exception of this episode that is coming up, I want to commend you for the work you have done and the speakers you have had here. It is a tremendous thing to give your time to something as important as taxes.

I never realized the importance of taxes until I got on the Ways and Means Committee. Life used to be serene and calm over in the Banking and Currency Committee. We met a couple of times a week and heard somebody from the Federal Reserve talk about banking, and somebody from the Comptroller's office; but being on the Ways and Means Committee is really a job. We really have to work.

This organization has made a great contribution in helping to give assistance to those of us who sit up on the committee rostrum and try to analyze tax problems, because from this organization there have come many erudite and profound statements about tremendously important tax problems.

The first thing that I want to say is that I am not a tax expert. As I said, I am fourth from the bottom on the minority side. You are the experts, and it is terrifying for a country boy to come here to New York in the midst of this great organization, composed as it is of experts in the field of taxation.

One of the reasons why I am not an expert is that I have to consider not only taxes, but also many, many other problems that come to Congress. For example, when I leave the Ways and Means Committee and go to the floor of the House, I have to vote on whether or not we are going to have parity or price support in agriculture. I have to determine how many Polaris submarines we are going to have, and how much foreign aid we are going to need. I have to adjust my thinking on a tax-writing committee to some of the problems of spending.

I want to chat with you about some of the reactions and some of the thinking of the Ways and Means Committee as we at-

tempt to analyze what you present to us and try to come up with something constructive in this important field of taxation.

I recall that taxation has been called the price we pay for government services, but I think there are many services that are priced above the willingness of the taxpayers to pay for. At the very outset, we have this problem of whether or not our tax burden is increasing beyond the saturation point. Some twenty years ago federal tax collection was one-eleventh of what it is today. Immediately, one of the questions that comes to my mind is whether we are today eleven times better off than we were twenty years ago.

Reasons for Tax Reform

Tax rates are not the only tax factors that affect our free enterprise system. For example, I recall that in his book,[1] Professor Smith wrote something about the importance of considering depreciation. When we come to talk about this important subject of taxation, we get into many problems other than tax rates.

While listening as a member of the Ways and Means Committee, the thought that comes to my mind is that tax reform is needed for several reasons. I am reminded, first, of the long-standing prescription of Marx and Engels that socialism can probably be acquired first and best through an income and estate tax. That is one of the reasons that makes me think that we ought to reappraise our tax situation.

In the second place, I see the need of a strong economy in which we can build up a meaningful defense or military posture. It may be that our tax system is developing aspects that hamper or hinder our building up these tremendously important factors of a strong economy and a strong national defense today.

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[1] Dan Throop Smith, *Federal Tax Reform,* New York: McGraw-Hill Book Company, Inc., 1961, 328 p.

In the third place, I wonder if perhaps we are not using our tax system to advance certain social and economic programs that have no place in the tax structure.

These are questions that come to my mind as I sit up on the bench, and I think the importance of probing into the need for tax reform, because of these three reasons, is in the minds of all of us on the Ways and Means Committee.

I want to discuss then some of the problems that are interrelated with taxation and that affect our whole economy. We have to have taxes to keep our economy going, and those of us in Congress have to adjust the income to the outgo. We are told—and I do not question it—that we live in one of the richest countries of the world. Before leaving Washington I asked the Library of Congress for some data which I thought I needed to stabilize my thinking in this field. The Library staff gave me some information which was amazing.

In the first place, they told me that the gross national product of all of the other free countries of the world—outside Russia and outside of the Iron Curtain—in 1959, which were the latest figures I could get, amounted to about $540 billion. I think all the figures have gone up since 1959, but this will give you some idea. The gross national product of the United States at that time was about $482 billion.

They also told me that at the same time the national debt of all the other free countries of the world was about $197 billion, and that the national debt of the United States was about $290 billion.

That means, if you are going to compare our economic posture in the free world, that we are worth about $50 billion less than all the rest of the free world but yet we owe about $100 billion more than all the rest of the free world.

That is not all. Our national debt is increasing, as you know. We have had to raise the temporary debt limit to $298 billion; so our national debt is approaching $300 billion. In 25 of the last 31 years we have had national deficits, and from 1939 until now the value of the dollar has slipped to about 47 cents.

Nor is that all. Our national budgets have been constantly increasing. I think our national budget in the fiscal year 1961 was about $82 or $83 billion, and the budget for the fiscal year 1962 amounted to about $87 billion.

If you analyze the budget item by item, you will be amazed to see how each one of them creeps up. One item is defense spending. I always vote for defense spending because I think that in the world we live in today we must have a strong, solid defense. Defense spending was about $42 billion in 1961, and it is going up to about $45 billion in fiscal 1962. They say it will go up to $55 billion by fiscal 1965.

The second largest item in the national budget is interest on the national debt—about $9 billion. Welfare and labor expenditures have gone up from $5.5 billion to more than $6 billion next year. They are on the increase.

I am reminded of a recent statement by Senator Byrd that with this constant deficit and with this increasing budget and spending, our position is vulnerable and Khrushchev knows it. Long ago the Communists told us that they were going to bleed us white, and if they could not win by military strength they would get us through bankruptcy. That is one of the important problems that we have to consider when it comes to levying taxes: How are we to meet this constant growth in the budget and federal expenses without impairing our international position?

Balancing the Budget

What are some of the ways by which we up on the Ways and Means Committee bench try to analyze how we can balance this budget? Everyone here knows that the pressures for inflation that come from an unbalanced budget and from a constantly increasing national debt are considerable.

Through Expenditure Reduction

In the first place, of course, one way to balance the budget is to try to reduce spending. I want to emphasize again the im-

possibility of reducing spending for our national defense. It is interesting to note that when there is a defense budget under consideration, Congress is practically unanimous in approving it. I am going to be the last one ever to vote against a strong national defense, and that is the way most members feel.

But we must concentrate on reducing somehow the nonessential nondefense spending. Most Congressmen have some ideas about how to do it. I have such a pet proposal. At every session of Congress I introduce a resolution. The resolution never gets any place, but I keep on introducing it. It provides for a constitutional amendment which would apply 2 per cent of the revenue to the national debt. It would, of course, have some kind of escape clause, by which, in the event of an emergency, and on the recommendation of the President and two-thirds of Congress, the provision could be avoided.

If we are ever going to try to balance the budget, we are going to have to do something drastic. We could pass a law tomorrow which would balance it for a temporary period, but the next day we might increase the appropriations and thereby unbalance it. If we are honestly going to try to win the battle of balancing the budget, we shall have to do something drastic, such as enacting a constitutional amendment.

I was interested in reading on the train coming here that the businessmen and the bankers of the country are concerned about the deficit and the unbalanced budget, so far as our imbalance of payments is concerned. It means that more gold is going out of the country, so a balanced budget is our second line of defense. Naturally, the first line of defense is a strong military defense; but a strong economy through a balanced budget is, in my opinion—and in the opinion of many of us on the Ways and Means Committee—our second line of defense.

Through Tax Adjustments

The second consideration that we think about on the Ways and Means Committee, so far as balancing the budget is concerned, is in making tax adjustments.

Two years ago we had about six weeks of hearings on the question of loopholes. I think some of you here appeared before us at that time. I learned a lot from those hearings. I used to think "loopholes" was a bad word, but I learned that it has all sorts of connotations and that the term probably ought to be explained. I look at it this way. If A, who is a single man, has an income of $10,000, and beside him is B, who has an income of $10,000 and has six kids, and on the other side is C, who has an income of $10,000 and an invalid wife, the tax laws have somewhat equalized and adjusted their unequal economic situations. They provide exemptions for the man with the children and deductions for the man with the sick wife.

If you apply this concept of deductions and exemptions to the field of business and industry, you have a justifiable explanation of loopholes. I see nothing wrong about these benefits that have been given to various segments of industry over the years —depreciation, depletion allowances, etc. Members of the Ways and Means Committee and members of the staff tell me that every one of these so-called loopholes is the result of weeks of hearings and days of consideration by members of the Ways and Means Committee and their staff. They have been built into the economy. They are part of it. To take them away now would constitute a complete disaster to many industries. As a result of those weeks of panel discussions, we did absolutely nothing about loopholes.

The President sent up a tax message last year. It was pretty much in generalities. We discussed that for about five weeks. We listened to testimony, and we considered it in executive session. As a result we tried to come up with some tentative drafts on eight different items, but we did nothing.

It is hoped that perhaps between the adjournment of Congress and the time we convene, the staff, working with representatives of different industries, may reach some compromise or some common ground where we can legislate; but using the tax panel discussions as an example, I would say that the possibilities are slight.

When people ask me what the Ways and Means Committee is going to do about taxation next year, I tell them—and this is honestly what I think: There are going to be so many problems before the Committee, and we have had such bad experience with trying to solve all these many tax problems, such as loopholes and reforms, that I question whether we shall do anything.

We are going to have to do something about reciprocal trade because the Reciprocal Trade Law expires in June. The pressure is on to do something about medical care.

There is such a thing as politics, too, and Congressmen and Presidents are under pressure. I am a politician and I am proud of it, because I think our two-party system is important. It is through our political parties that we air these problems to the public.

Therefore, I question whether there will be any legislation in the area of the President's tax message. One of the suggestions he made that caused the greatest controversy was that of withholding income tax on dividends and interest. I think I got more letters on that than on any of the other proposals that he presented to Congress in his message. After weeks of consideration, it seems to me that the withholding question might be solved very easily. I do not think that the Treasury Department and Internal Revenue Service have ever done anything to try to educate the taxpayers on the necessity of reporting dividends or interest as income. They have asked banks and the corporations to do it. But perhaps by the simple expedient of stamping in red ink on the top of the 1040 form a question such as "Have you included as income your dividends and your interest?" 99 per cent of it could be collected without more legislation. If some of the problems can be solved in this way, perhaps others can also be solved through similar procedures.

Through Return of Functions to the States

In the third place, to try to balance the budget, we may have to concentrate on removing from the federal area certain func-

tions which properly belong back at the state level—such as federal aid to education and to depressed areas. These are examples of activity in the federal area that I think properly belong back at the state and local level.

These comments indicate some of the things that go through the minds of members of the Ways and Means Committee. As I said, I just wanted to chat with you a few moments about it, and to emphasize the importance to the Ways and Means Committee of the activities of this organization. We respect organizations such as this, and the members who appear before us. I do not have to tell you that that places upon you a responsibility—a responsibility to make sure that the solutions you have are the right solutions, because we rely on experts.

Responsibilities of a Congressman

I have often said—I don't think this is any tip-off, but if it is, I am glad to give it to you gratis—that when a Congressman decides how he is going to vote on an issue, there are three or four considerations to keep in mind. They are perfectly proper.

First, I think he has to remember that the Constitution gives him the title of Representative, and that means that to a certain extent he has to know the feelings of the people back in his district. This is by no means to imply that he has to count up the letters he gets for a measure and the letters he gets against a measure and then base his decision on the number for and against; but I do think he owes some responsibility as a representative to know what the thinking back in his district is on every important issue.

In the second place, I feel that he ought to use as a sort of guideline the position of his political party. It is not my purpose here to make a political speech, but I feel that in a democracy such as ours, where we have two political parties, the greatness of the country to a large extent has depended upon the strength of these two political parties. I think any legislator owes a certain loyalty to his party to follow its position. I do not mean that when a tax issue comes up I will run back to

the office and look up what my party said in its platform on that subject. I do not believe in being a blind partisan at all, but back in Ohio when we file for political office, we swear that we will abide by the principles of our party. To a certain extent that is a guideline that I have to follow in reaching a decision.

Third, I often say that in addition to those two criteria, we have to rely on the experts. They are divided into two types of experts—the staff of the committee and the people that represent organizations and appear before us.

I do not know whether you realize the importance and effectiveness of the staff organization of a committee. As I said, it is simply impossible for a Congressman to be an expert on any field, because he has to scatter his interests all over the range of agriculture, defense, and foreign aid, as well as taxes. To get to the fine points, he has to rely on the staff of his committee. The Ways and Means Committee has one of the finest staffs of any committee in Congress. I am sure that anybody that has been before Congress, or has had anything to do with the Ways and Means Committee, will agree with me. We have staff members who are doctors of philosophy in economics and who are experts in the field of taxation law. We have to rely on them.

We also have to rely on experts appearing before the committee, people who have dedicated their lives to important subjects that affect everybody, such as you folks here who have made a life study of taxation, represent great institutions, and are interested in the impact of taxation on our society and on our economy.

I leave you with these remarks with the hope that you will appreciate the responsibility—and I know you do—of thinking out these problems, because we rely on you. We look to you for the solution to many of the problems.

It has been a pleasure to be here, and if you ever come to Washington, I hope you will drop around and see me. My office is near the Ways and Means Committee room and the staff bring a lot of people down to talk to me about these problems.

So, if you ever come to the Committee hearings, I hope that you will look up me, or any other member of the Ways and Means Committee. If you have not done it before, I think you will find it is an education that you owe to yourselves to see how your ideas are transformed into living law. It is a pleasure to be here, and I thank you very much for this opportunity to participate in your symposium.

CHAPTER XVI

DISCUSSION OF TAX POLICIES IN RELATION TO INVESTMENT AND ECONOMIC GROWTH

CHAIRMAN NORMAN B. TURE, *Director of Tax Studies, National Bureau of Economic Research:* This is your chance to take our experts apart, I hope with trenchant and searching questions.

PROFESSOR WILLIAM VICKREY, *Columbia University:* I want to comment on Mr. Holzman's presentation in the following vein: He apparently would like essentially to get rid of the tax on accumulated earnings almost to the point, if I understand the tenor of his talk, of making it virtually a dead letter. If a corporation in the aviation industry can be allowed to accumulate earnings on the allegation that it is intending at some vague future date to invest in the cement industry, I can think of no way of assessing a tax on accumulated earnings of the present type, unless the taxpayer is so foolish as to admit frankly that it is done for the purpose of avoiding surtax on shareholders.

I think there is a legitimate beef here in that the tax does have a serious influence on corporate decisions and on diversification. I would like just to suggest the remedy for this that I have made elsewhere, and that is that we need a tax on the accumulation of surplus that will not be a penalty tax, but will be an approximate offset to the actual advantage that a corporation and its shareholders do receive from the accumulation of earnings in the corporation, whether or not there is a legitimate or illegitimate business purpose.

One form which this tax might take would be, for example, a tax levied at a rate of about 2 per cent per annum on the ag-

gregate accumulated undistributed earnings, so that in effect the corporation would be paying to the government something that would be comparable to an interest charge on the funds which it is obtaining in a sense as a tax-free loan from the government, through the postponement of the tax on the eventual distribution of the earnings to the shareholders.

PROFESSOR ROBERT S. HOLZMAN, *New York University Graduate School of Business Administration:* I very definitely do not agree, sir, that the accumulated earnings tax should be removed. I think it serves a very useful purpose, but I should like to see its application confined to its purpose, which is to penalize any effort to avoid shareholder surtaxes.

If a corporation has acquired earnings and it finds that it can't use these earnings in what has been the accepted form of business before, I do not see why the corporation has to go out of existence; nor do I think that the corporation should pay out these earnings, and then wonder how it is going to finance its growth into new fields. If the corporation cannot use its earnings in one way, I believe that it should be permitted to retain the earnings to use them in another way, providing always that the purpose of this is not to avoid shareholder surtaxes.

If we stick to this original and basic concept of the tax, which has existed ever since the Tariff Act of 1913, I think it will be serving a very useful purpose. I don't think the shareholders are being allowed to get out of taxes if a corporation says, "We are going to go into a new field."

PROFESSOR VICKREY: I would like briefly to ask how the Treasury could maintain a case against a taxpayer who has been reasonably clever in asserting a business purpose under the circumstances.

PROFESSOR HOLZMAN: I think the answer would be the same as the one we now have; namely, what is the corporation actually doing with its money? There is no reason whatsoever today why a successful corporation cannot have a policy of never paying the dividends as long as they are using the money for business purposes; namely, the carrying on of operations of

business. I think the matter can be resolved by looking merely at the article. I think it is the carrying on of *a* business, not the carrying on of *the* business.

MR. FRANK KEHOE, *Secretary, Detroit Edison Company:* I would like to ask Professor Smith what his opinion is on price level depreciation.

PROFESSOR DAN THROOP SMITH, *Harvard Graduate School of Business Administration:* It was not an oversight that I didn't mention it. In fact, I thought perhaps I should put in a paragraph to say that it was not an oversight, but my paper was already unduly long.

My feeling on price level depreciation is that if we once go beyond the monetary—the dollar—measure of income, in any respect, we have opened a tremendous field for other proposals by analogy for adjustments, including such things as individual investment in fixed income securities.

My belief is that for the extremes of inflation that have occurred in some of the European countries, the price index adjustments that were made were necessary and were well done and were effective and desirable. My feeling is that in this country we are substantially short of anything that justifies going into that area. I, of course, desperately hope that the situation will never develop where we would have to go into it.

DR. HENRY J. FRANK, *Fairleigh Dickinson University*: Would it pay business firms to give up the capital gains rate on the income from sales of overdepreciated assets and receive in return more realistic depreciation schedules? Since business firms claim that depreciation schedules are too long, they should never find themselves in a position where assets may be sold for an amount greater than their depreciated value.

PROFESSOR SMITH: It seems to me it depends on the business. There are many businesses, I believe most of the large widely-owned companies, where there is very little sale of plants. By way of example, steel companies don't sell steel plants to each other. I presume the automobile manufacturing companies don't sell automobile factories or automobile manufacturing

machinery to each other. So there I would say the faster depreciation would be of substantial importance, and the denial of the capital gains treatment would be a negligible offsetting burden.

On the other hand, there are certain areas where there is conspicuous buying and selling of properties. Reference was made earlier by Mr. Horne to the *Hertz* case of a year ago last June, in the auto rental business. There was a regular pattern of buying, depreciating, and selling, and getting a new fleet of cars.

In the one-building real estate companies, I suspect they would find themselves much worse off, even with faster depreciation. That is no reason that section 1231 should not be repealed with reference to real estate also. Perhaps Mr. Horne would comment.

MR. WILLIAM M. HORNE, JR., *Tax Counsel, Olin Mathieson Chemical Corporation:* I would just like to clarify what perhaps may appear as an element of disagreement between Professor Smith and myself on this question of partial repeal of section 1231. I don't think there really is any disagreement between us. I, with Professor Smith, would agree that if, in fact, depreciation is excessive, ordinary income treatment should be applied. I think the problem is one of determining when the depreciation is, in fact, excessive.

Certainly if you had a type of very liberal depreciation allowance, such as Mr. Gornick proposed, of 30 or 40 per cent the first year, you might very well need the ordinary income treatment in order to prevent tax avoidance or abuse. The question today is, I think, which is the cart and which is the horse? Do we enact the ordinary income treatment now and then hope to get a liberalization of depreciation lives or better depreciation policies, or do we wait and enact both of these provisions at the same time?

That seems to me to be the critical question. I don't think it is advisable, either from the standpoint of revenue administration or from the standpoint of industry, to have deprecia-

tion policies made on an industry-by-industry approach, on an ad hoc basis, where the rest of the industry cannot tell whether they are going to get any depreciation relief, and then ask the rest of the industry to accept a repeal of section 1231 on machinery and equipment.

MR. ALAN L. GORNICK, *Tax Counsel and Director, Office of Tax Affairs, Ford Motor Company:* As I understand the question, it was whether, assuming that industry was granted more realistic lives over which to depreciate property, business would generally be agreeable to including in income salvage that might be obtained on the sale of the property.

There are two elements involved here. As you know, in determining the amount of depreciation, the basis is usually adjusted under present law for any salvage that might be contemplated. I think that business is on record as stating that if salvage were eliminated from any calculation at the beginning of the period during which depreciation would be computed, there would not be any objection to including in ordinary income any gain that might be obtained from salvage.

Assuming that the depreciation rates are adjusted to more reasonable and realistic bases, and that salvage is not taken into consideration to begin with, in setting the rate of depreciation, I believe that there would be no objection on the part of business generally to including in income any gain that might be obtained from the sale of depreciable property. That would certainly seem to be true in the case of machinery and equipment used in manufacturing operations.

MR. TAYLOR H. SEEBER, *Ernst & Ernst:* Carrying Mr. Gornick's thought a step further, he refers to realistic rates. The proposal has been made—and I would like to ask Professor Smith to comment—that taxpayers be given wide latitude to take whatever depreciation they want to, within limits, something along the line of the Canadian system. This is assuming, of course, that section 1231 is changed. What is your opinion on that?

PROFESSOR SMITH: I am a strong supporter of the general con-

cept of the Canadian approach. That is the general use of broad brackets. I would want it to be operated in a manner such that the taxpayer could prove even shorter lives than those authorized. I believe in the Canadian system it is a minimum life that can be used. Would your treatment require as a prerequisite that it also be taken on the books?

MR. SEEBER: I think theoretically that presupposes that, but when the question came up in 1954, wasn't there considerable objection for other reasons, practical reasons, as to why it was not insisted upon?

PROFESSOR SMITH: No one was considering in 1954 going so far as saying that it is the taxpayer's option as to how rapidly the depreciation can be taken. If we were starting the income tax from scratch and there were not a budgetary problem, then I think there would be a good deal to be said for letting the taxpayers make the decision, at least in so far as the widely owned public companies were concerned, on the further condition that it also be taken on the books, because there would be a concern about stability of earnings.

In the closely controlled companies, however, where the reports are only to a few bank creditors, I think there would be a runaway rapid write-off, which would be an undue favoritism to closely controlled companies and which would have an impact on the budget, if one made the transition to that method, that would be completely unacceptable.

MR. SEEBER: May I just comment? You are assuming, of course, that there would be minimum lives and maximum lives.

PROFESSOR SMITH: I'm sorry, I missed that in your statement.

MR. SEEBER: My thought is that, say, a broad classification for machinery and equipment might have a range from 5 years to 20 years.

PROFESSOR SMITH: That would be too broad by my standards. If we are talking about 8 to 12 or 10 to 15 or something of that sort, that would be all right. But this is a matter of degree.

MR. GORNICK: In any event, it is quite clear that the bracket

system would have to be carefully developed. I think in the administrative field it is certainly one type of reform that should be given very serious consideration.

So far as the Canadian system is concerned, it is my understanding that they have established for different accounts what are not minimum rates, but rather, maximum. For example, I believe Canada has provided in certain areas a specification of different machines with a rate of, let us say, 10 per cent. The taxpayer could choose anywhere from between 1 and 10 per cent. But the 10 per cent for that particular category is the maximum, as I understand it.

The bracket system that has been under discussion recently in this country has been something similar to what Mr. Seeber mentioned. That is not to put a maximum and then take zero from that, but rather to fill in a range of 5 to 10 years, or 8 to 12 years, and let the taxpayer have his choice.

It is always a question of opinion as to whether the proper life of an asset is going to be 8 years or 10 years. I cannot see how anybody can, with any reasonable certainty, predict whether he is actually going to use a machine for 8 years or 8½ years, or 10 years. I think that what is more important is consistency. Once the life is chosen, the taxpayer ought to be stuck with it. If he picks 8 years, it ought to be 8 years and he should not be able later to say that it was 10 years or some other figure.

Establishing brackets along the lines of those suggested by Mr. Seeber might eliminate a great deal of controversy. I think that the administrative difficulties could be ironed out upon study. In this connection I understand the Treasury Department is studying, among other things, something along this line.

MR. WILLIAM J. STEINMETZ, *Tax Department, American Can Company:* Mr. Gornick, I understood you to indicate that the tax credit wasn't a very satisfactory way to handle depreciation problems, but that instead, it could be better approached in two ways, either by administrative changes, or by legislation.

My question runs to whether there is really any hope for

effective administrative action here. In the first place, if the Treasury would revise lives in Bulletin F, which is, of course, only advisory, to a point that would be substantially below those being actually used in tax returns, they would be under considerable attack by Congress for giving away the revenue; so that they would probably only revise Bulletin F down to the lives actually being used, and therefore it would be of no real benefit to anybody.

Secondly, if they were able to bring lives down to a point that would seem lower than might be justified in terms of historical experience—and this is because they are looking ahead toward the technological obsolescence that is difficult to measure and is in fact really only a guess on anybody's part—this would be transmitted in the form of Bulletin F, and would be challenged by any revenue agent who is examining a return on the grounds that the local situation does not conform with that type of technological obsolescence and, therefore, the agent would not in fact be bound by Bulletin F.

Let me make one more point. The concept is that if Treasury revises Bulletin F, they will do it prospectively only. I don't see how that is possible since mere revision of Bulletin F would not change any of the actual obsolescence. Thus, taxpayers would be able to revise depreciation for all open years. It seems to me it would take legislation to do any kind of effective job in this area.

My question is simply: Do you think there is any real hope for any administrative determination under Bulletin F as contrasted to legislation?

MR. GORNICK: I think there is real hope and, in fact, I think something is being done in this area right now. You may have read in yesterday's *Wall Street Journal* the announcement by the Treasury Department that they are now going to make a thorough study of six industries, in order to determine two things: What is the situation in that particular industry with respect to future obsolescence and present actual obsolescence? The purpose of that is to issue not a new Bulletin F, but a new

series of lives applicable to industry in general and certainly to the six mentioned. That is all scheduled, as I understand it, to be done by April 15, 1962, so there is something being done in this area.

On your second question, suppose the Treasury Department, for example, states that the average lives of machinery in the textile industry have been 40 years, and they lower it to 15 years. What is to prevent an agent from saying it is 15 years, even though a particular taxpayer can show it is 5 years in his case? In such cases, I quite agree with you that there is still bound to be some dispute between the taxpayer and the agent.

The bracket system could, however, very well eliminate a good deal of that controversy if the government were simply to say: "In this particular industry, and with this particular run of assets, we will let the taxpayer choose anything between 10 and 15 years. If he desires 10, let him have it. If he wants 11, let him have it, so long as he sticks with that and does it not only for tax purposes but book purposes as well." In other words, if his financial statement represents his financial situation on the basis of a category of assets having lives of 12 years, then for tax purposes he ought to do the same thing. That should be coupled with the further principle that that is binding on the taxpayer and the government alike for the life of that asset.

In this way, it might be possible to eliminate this area of controversy. I hope that eventually we might see administrative reform in this field.

MR. STEINMETZ: Could I ask one short question? I think you hit the problem right on the nose. You say that we should go to the bracket system. I say that with Bulletin F they can't go to the bracket system, not in the sense we want. Therefore, we can't do what you say should be done.

MR. GORNICK: Are you saying that it cannot be done by regulation; it would have to be done by statute? I think it can be done by regulation, but, even if I were wrong on that, I see no reason why Congress might not be asked to amend the law to

provide for the bracket system. I am certain that many taxpayers might welcome it as a possible method of eliminating controversy in this area. However, in my opinion, it can be done by regulation because, as you know, the law provides for reasonable depreciation deductions related to lives.

PROFESSOR SMITH: I am always puzzled as to the significance of the maximum life in a bracket. We are talking about 10 to 15 years. Does that mean the Treasury would not accept 16 or 18 years if the taxpayer wanted to use that, or do we have a sliding scale of minimum life implicit in the bracket? This is a rhetorical question that I throw out.

MR. SEEBER: Professor Smith, it was my thought that the bracket system should have a limitation on the maximum life that could be used, as well as a minimum life, in order not to get into difficulty on the question of the allowed or the allowable depreciation for accrued depreciation purposes.

CHAIRMAN TURE: Are there any further questions?

DR. LEROY DUNN, *Department of Economics, Trinity College:* If you assume that a capital allowance were introduced in a single industry, wouldn't you expect the market to revalue the assets so as to produce an effect on yield, so that you wouldn't really have to go into a process of expending capital allowances to industries at large? Wouldn't the market take care specifically of the yields in such a way as to produce a reallocation of investments all around, so as to produce the same effect as if you had had a general allowance scheme?

PROFESSOR SMITH: I'm sorry. I missed the implications. Is it that an allowance to one industry has a general effect?

DR. DUNN: Yes, if you enlarge the capital allowance in one industry, wouldn't you in effect change the net yield on investments in that industry with the result being a movement into that industry, and a movement out of other industries; with the effect being that one would pull up the yield in the industries from which capital was moving out?

PROFESSOR SMITH: This is obviously an extremely interesting idea. I am afraid it calls for more thought and reflection than

I can give it here, behind this microphone, in a few seconds. My first reaction is that though that might be the long-run effect, it takes a long time for things to work themselves out. In view of the concern which apparently is pretty widespread now about increasing capital investment for cost-saving purposes in a variety of industries, we probably don't have time, even if it might work out that way. I am afraid that that is as far as I can go.

CHAIRMAN TURE: I would like to extend our thanks to the gentlemen who have spoken this morning for an extremely interesting and clearly provocative discussion of some major features of the present tax system as they affect the processes of investment.

PART FIVE

RECONSTITUTION OF BUSINESS TAXES

"The Sixteenth Amendment is a very short paragraph, but Congress in its infinite wisdom has seen fit over the year to amend, modify, change, and rechange the income tax law by adding special provisions as situations have come up which at a point in history seemed to be important to the country. As a result, a practitioner today must have a volume of books about the income tax covering about fifteen feet, in addition to his excise tax services, gift tax services, stamp tax services, etc.

"As a result of this vast complication of our tax structure, we have a new profession—the tax man. He is one-third lawyer, one-third accountant, one-third soothsayer. Why has this profession developed—because business, being flooded with this mass of complicated material, various returns, forms, and schedules, was forced to create the tax man in self defense.

"The amazing thing about the whole situation is that in spite of these complications, in spite of the fact that we have a 52 per cent income tax rate—once we had an excess profits tax rate of over 80 per cent—business nevertheless has learned to live with our tax structure, but this doesn't mean that business is happy about it.

"Business has a legitimate complaint in these areas where originally you had a special situation but over the years, with the able assistance of these tax men, we have evolved preferential treatment. In fact, President Kennedy, in his message of April 20, acknowledged that special provisions over the years

have evolved into an area of special treatment for special groups.

"It seems to me, to draw a very seasonal analogy, that when West Point plays Yale, you don't have two sets of rules—one because West Point is government owned and the other because Yale is an eleemosynary institution. Similarly, if Pennsylvania played Lafayette, you wouldn't have two sets of rules because Pennsylvania is 16 times as big as Lafayette. They are competing. There should also be the same rules in the tax game."

—HARRY F. SCHROEDER
Vice President, Bankers Trust Company, and Chairman of Symposium Session

CHAPTER XVII

FLAT RATE CORPORATION TAX VERSUS PRESENT TAX

E. GORDON KEITH
Professor of Economics, Wharton School of Finance and Commerce, University of Pennsylvania

LIMITED graduation has long been a feature of corporation income taxation in this country. Except for the years 1913-1918, and 1932-1935, the federal corporation income tax has always been designed to impose somewhat lighter burdens on corporations with small amounts of income than on those with larger amounts. Furthermore, some 6 of the 30-odd states which have taxed corporate profits over the past 30 years have applied lower rates to the first few thousand dollars of net income than they have applied to income in excess of these amounts. No state, however, has a maximum rate greater than 7 per cent at the present time, and in each case the maximum rate is reached at an income of $25,000 or less.

HISTORY OF CORPORATE INCOME TAX RATES

From 1919 to 1931, the federal corporation income tax was nominally a flat rate tax. A mild degree of graduation was, however, effected by exempting from this levy the first $2,000 or $3,000 of corporate income. A graduated rate structure was first introduced in 1936, when the standard rate applicable to net income exceeding $40,000 was 15 per cent. Under the 1936 statute, the first $2,000 of corporate earnings was subject to an 8 per cent levy; the next $13,000 to an 11 per cent rate; and earnings of more than $15,000, but not exceeding $40,000, to

one of 13 per cent. The progression thus introduced into the corporate tax structure was still very slight; and it was much less extreme than in the personal income tax. Since 1939, both the minimum and maximum rates of tax on corporate profits have been increased sharply, and the point at which the latter rate applies has been lowered to $25,000. The benefits of graduation have, therefore, been felt mainly by small corporations, although they have not always been confined to these companies.

Indeed, one much criticized feature of corporate income tax graduation prior to 1950 stemmed from the desire of Congress to limit the benefits of progression to corporations with incomes not exceeding $50,000. This end was accomplished by the use of a "notch" rate which gradually brought the effective rate up to the maximum statutory rate as income rose from $25,000 to $50,000. Thus, under the 1942 Revenue Act, when the first $5,000 of income was subject to a combined normal tax and surtax rate of 25 per cent, the next $15,000 to a 27 per cent rate, and the next $5,000 to a 29 per cent rate, the levy on income in excess of $50,000 was 40 per cent. In order to get the effective rate up to 40 per cent at this income level, income over $25,000, but not over $50,000, had to be taxed at a 53 per cent rate. The taxation of many small companies at what then appeared to be a very high marginal rate was said both to be unjust and to be damaging to production and employment incentives.[1]

The notch provision was eliminated in 1950, and since that time corporations have been subject to a normal tax (currently 30 per cent) on total taxable income, and to a surtax (currently 22 per cent) on income in excess of $25,000. Under this rate structure, all corporations enjoy the benefits of the surtax exemption up to a maximum tax saving of $5,500. Moreover, since a corporation does not risk the loss of this saving if its income should exceed $25,000, the new rate structure has encouraged the multiple incorporation of what are essentially integrated

[1] This method of graduation also made it very difficult to change the alignment of rates in order to increase the spread between the preferential rate on small companies and the standard rate.

business enterprises. Consequently, in resolving the notch problem, we have introduced a new problem of tax avoidance. I shall return to the multiple incorporation problem at a later point in this paper after considering the reasons why it has been thought desirable to graduate a tax on corporate profits.

Attitude of Economists on Graduation of Corporate Income Tax

Although the practice of limited corporation income tax rate graduation extends back to the early 1900's, it was not until the 1940's that this practice found much favor among students of taxation. When Roy Blough discussed this question of flat versus graduated rates for business net income taxes before a symposium of this organization exactly 25 years ago, he had little difficulty in reaching the conclusion that the taxation of corporation income is less likely to achieve generally accepted tax aims at progressive rates than at flat rates.[2] Whether the corporation tax was viewed as a personal tax collected at source, or as an impersonal levy on the corporation as such, he could find little merit in the argument that progressive rates were more equitable than flat rates, or that they were either an efficient or an effective way of attacking the problem of socially undesirable bigness. As a personal tax—and at this time the burden of the corporation income tax was generally believed to fall on the stockholders—a progressive tax on corporate income could be justified under the ability-to-pay principle only if it could be assumed that the stockholders of large corporations have greater ability to pay taxes than those of small ones. This was, however, an assumption that appeared to have little basis in fact, except possibly in the cases of extremely small companies.

On the other hand, as an impersonal tax on the corporation as such, neither the ability-to-pay principle nor the benefit principle appeared to Professor Blough to support the justice of

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[2] Roy Blough, "Flat Versus Graduated Rates for Business Net Income Taxes," *How Shall Business Be Taxed?* New York: Tax Policy League, Inc. [now Tax Institute, Inc.], 1937, p. 85.

progression. Size of income was clearly not a fair measure of corporate taxpaying ability unless the amount of capital invested in the business was also taken into account. Nor did it appear to him that the benefits derived by business firms generally from the government, or that the special benefits associated with the use of the corporate franchise, were conferred in such a manner that corporations with large incomes were more favored in proportion to income earned than those with smaller profits. Finally, it was reasoned that a progressive business income tax of the usual type was much too crude an instrument to be used effectively as a means of controlling the economic power of large corporations. Certainly, the mild forms of graduation then in effect could not accomplish much in this direction; and it appeared that steeper graduation could not be justified unless it could be applied under some variant of the excess profits tax principle.

While much of what was being said on this subject 25 years ago can still be accepted as sound, the weight of authority appears now to accept the reasonableness of some differentiation between large and small firms in taxing corporate profits. This shift in opinion among students of taxation may be traced in part to the fact that the impact of a 52 per cent tax rate on businesses of different sizes may be quite different from the impact of a rate of less than 20 per cent. But it also reflects a better understanding of the incidence and effects of corporate income taxation, and of the role of this tax in the federal revenue structure. During this period when the standard corporate rate has been ranging between 38 per cent and 52 per cent, much attention has been given to the impact of this levy on small businesses, and especially to its impact on new firms and on those with growth potential. As a result of the studies which have been made, the conclusion seems inescapable to many that a flat rate corporate tax, at least within this range of rates, imposes a greater burden on small enterprises than on large ones.

In the first place, we know that small businesses are peculiarly dependent on retained earnings as a source of funds for develop-

ment and expansion. Not only is it more difficult for them to secure capital from external sources, but, to the extent that they can tap such sources, they usually have to pay a high price for the privilege. Consequently, the taxation of income of small and large corporations at uniform rates is believed to limit the growth of small firms more than it does large ones. Furthermore, this disadvantage is held to be accentuated by the fact that small companies, which usually operate under conditions of intense competition, are unable to shift any substantial portion of the taxes imposed on them. On the other hand, it is now generally accepted that some part of the corporation income tax can be, and is, shifted by large corporations both in the short and long run.[3] If indeed, small companies do find it more difficult to pass their taxes on to their customers than do large ones, their income after taxes would of course tend to be lower than that of their larger competitors.

Second, taxes on earnings tend to be more severe for small businesses than for big ones if the earnings of the former fluctuate more than those of the latter. Although variability of income is not peculiar to small corporations, it is especially noticeable among them. Furthermore, to the extent that small companies are less able to offset any losses they may incur against other income, their risks are increased more by taxation than are those of larger enterprises. This is because the Treasury stands ready to share in any prospective profits, but shares losses only to the extent that a company has income to offset them. For example, a large corporation with diversified sources of income takes much less risk in undertaking to produce and sell a new product than does a small company organized to produce and sell a single line.

Other Ways of Alleviating Burden on Small Business

There are, of course, ways other than rate graduation by

[3] For a survey of recent opinion concerning the shiftability of the corporation income tax, see B. U. Ratchford and P. B. Han, "The Burden of the Corporation Income Tax," *National Tax Journal,* X (December, 1957), 310-24.

means of which the greater burden of income tax on small corporations can be at least partially alleviated. The extension of loss carry-forwards and carry-backs since the war, so as to permit profits and losses to be averaged out over a period as long as seven years, has made it easier for small firms to derive tax offsets from their losses, and to some extent mitigates the problem of fluctuating income. Congress has also introduced modifications into the tax laws which were designed to make it easier for small businesses to finance their development and expansion. By making any loss sustained by an original investor in a small corporation deductible as an ordinary loss rather than as a capital loss, Congress undertook, in 1958, to increase the attractiveness of the stock of small corporations to individual investors.[4] And by permitting a deduction of 20 per cent of the first $10,000 invested in depreciable tangible personal property, Congress made it easier for such corporations to finance limited purchases of machinery and equipment out of earnings. Finally, some 25,000 small, closely-held corporations have, since 1958, been able to avoid the impact of the corporation income tax by electing to be taxed as partnerships.[5]

These and other measures which have been adopted in recent years with a view to mitigating the burdensomeness of income taxes on small business have undoubtedly been helpful, but few persons would contend that they have resolved the tax problem of small business. In 1958, fewer than 1 out of every 24 corporations with incomes of less than $25,000 were able or willing to use the partnership option. And, helpful as the other small business tax relief provisions may have been, it is generally conceded that they do not remove the need for continued rate differentiation between large and small corporations. Indeed, there are

[4] A small corporation for this purpose was defined as one in which the total capital stock did not exceed $500,000 and net worth $1 million. For a discussion of this provision and of other types of tax relief extended to small business in recent years, see Dan Throop Smith, *Federal Tax Reform,* New York: McGraw-Hill Book Company, Inc., 1961, pp. 261-63.

[5] United States Treasury Department, Internal Revenue Service, *Statistics of Income, 1958-59, Corporation Income Tax Returns with Accounting Periods Ended July 1958-June 1959,* Washington, 1961, Table 7.

many spokesmen for small business who contend that this form of relief should be extended by assigning a larger part of the 52 per cent rate to the surtax and by increasing the amount of the surtax exemption.

The Tax Avoidance Problem

Before we can consider proposals such as those, however, we shall have to give some attention to the tax avoidance problem that has arisen under present rates and exemptions, and to which reference was made earlier. As we noted, the $25,000 surtax exemption at a surtax rate of 22 per cent makes possible an annual tax saving of $5,500 for each corporation with income equal to or greater than the exemption. This has made it advantageous for what are essentially single business enterprises to carry on their business through multiple corporations. For example, each store in a retail chain can be separately incorporated; a construction firm may establish separate corporations to carry out each of its contracts; or a manufacturing enterprise may split up so that a different company carries out each stage in the production process. Moreover, to the extent that split-ups or spin-offs can be effected without adverse tax consequences for the individual owners of the enterprise, the breaking up of an integrated enterprise into two or more corporate entities presents few difficulties.

Congress was not unaware of the tax avoidance opportunities which it had opened up under the new split rate provision of the corporation income tax, and under the minimum excess profits credit provision of the 1951 excess profits tax statute. Hence it lost little time in moving to limit closely related corporations to a single surtax exemption and a single minimum excess profit credit.[6] Only if a corporation could establish by the

[6] Section 15 (c) of the Internal Revenue Code as amended by the Revenue Act of 1951. Specifically, this section disallowed both the credit and the exemption in the case of a corporation which was created for the purpose of acquiring property other than money transferred to it after January 1, 1951, or which was not actively engaged in business at the time of such a transfer, if after the transfer the transferer corporation or its stockholders, or both, were in control of the transferee corporation during any part of the latter's taxable year. The credit and the exemption could, however, be allowed if the transferee cor-

clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose of its separate incorporation, would more than the single credit or exemption be allowed the two corporations.

At the time that section 15 (c) was under consideration, objections were raised to it. Some persons argued that the separate incorporation of various parts of a business enterprise was not necessarily tax motivated, but could serve a sound business purpose, while others maintained that some separate although affiliated corporations were not interconnected economically, but acted independently. It was presumably objections such as these that induced Congress to recognize the possibility of exceptions from the general rule of a single surtax credit for affiliated corporations. In any case, section 15 (c) and its counterpart, section 1551 of the Internal Revenue Code of 1954, appear not to have been very effective instruments in preventing tax avoidance through multiple incorporation. Commenting on the inclusion of section 1551 in the 1954 act, a group of lawyers with considerable experience in tax administration stated flatly that the "old section 15 (c) was of questionable effectiveness in preventing the obtaining of more than one surtax or excess profits credit, and there is no reason to believe that section 1551 will be of greater effectiveness."[7] And within the past few months, a former Treasury official has called attention to the need for legislation to require multiple corporations owned by the same

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poration could establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For the purpose of this subsection, control meant the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote, or at least 80 per cent of the total value of shares of all classes of stock of the corporation.

[7] Edwin S. Cohen, Paul A. Phillips, Stanley S. Surrey, Thomas N. Tarleau, and William C. Warren, "The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax," *Tax Law Review,* X (March, 1955), 303. The observations of these men regarding section 1551 gets some support from a statement by Harry A. Wardenburg, in an article entitled "Business Reasons for Dividing Businesses," *Taxes—The Tax Magazine,* XXXVII (February, 1959), 163. He wrote: "Taxpayers have been very successful in substantiating that reasons other than federal income tax savings were controlling in the formation of additional corporations."

groups to be combined for tax purposes.[8] Clearly, in this case it is one thing to recognize an avenue for tax avoidance and another thing to close it up.

Problem of Securing Necessary Differentiation

We have seen that a good case can be made for the graduation of the corporate income tax at the lower income levels as a means of relieving small business from the unfair burdens of a high flat rate tax, and as a mild stimulus for the growth of small dynamic enterprises. In fact, there may be some question whether the present split rate structure goes as far as it should in promoting tax equity and economic growth. The present 30 per cent normal tax rate was intended to be strictly temporary when it was placed on the statute books in 1951, and it was expected to drop back automatically to 25 per cent in 1954. Even if we still cannot afford to let this intended rate reduction take effect for all corporations, it has been argued that we could and should allow it to do so for small companies simply by cutting the normal tax by 5 percentage points, and at the same time raising the surtax rate from 22 per cent to 27 per cent. From the standpoint of many small companies, the relief afforded would be substantial, while the revenue loss would be only a fraction of that which would be incurred if only the normal tax rate were to be changed.[9]

Still another suggestion that has been made with a view to reducing the tax burdens of small business is that the surtax exemption might be increased to, say, $100,000. This second proposal would, however, presumably cost considerably more

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[8] Dan Throop Smith, *op. cit.*, p. 264.

[9] It was estimated in 1959 that the revenue loss from a reduction of the normal tax to 25 per cent, accompanied by an increase of the surtax to 27 per cent, would be about $250 million on a full year basis at 1959 levels of corporate income. On the other hand, the scheduled rate decrease, involving only the normal tax rate, would have cost about $2.25 billion on the same basis. United States, Congress, Joint Economic Committee, Staff, *Federal Revenue System: Facts and Problems 1959*, 86th Congress, 1st Session, Washington: Government Printing Office, 1959, p. 36.

than the first, and a fairly high percentage of the benefit derived from it would go to corporations with incomes of over $100,000.[10] On the other hand, we have seen that the present split rate corporate income tax structure encourages corporate split-ups, and we can hardly fail to observe that the attractiveness of this practice would certainly be enhanced by any further increase in the corporate rate differential, or in the size of the surtax exemption. Our problem, then, is this: How can we best secure the necessary differentiation between large and small firms under our corporation income tax, and at the same time prevent large enterprises, by means of split-ups, from enjoying rate advantages not intended for them?

So far as the rate structure of the tax is concerned, there would appear to be three major alternatives to choose from: (1) a flat rate tax with or without a specific exemption, (2) a split rate tax with a specific exemption, and (3) a graduated rate structure with or without a "notch" provision. Taking these alternatives in order, it is clear that there would be no inducement to set up multiple corporations under a flat rate tax with no exemption. On the other hand, since a flat rate tax would not differentiate between large and small firms, asking Congress to enact such a tax would be asking it to turn its back on the tax problem of small business. Because it seems to me extremely unlikely that Congress would be willing to do this, I do not view this as a practicable alternative.

A flat rate tax with a specific exemption would afford some relief to small businesses, but it would seem less attractive than a split rate tax in that it would wholly exempt some corporations from tax and would subject others to rates well below the starting rate under the individual income tax. Even though the exemption would presumably be smaller than under a split rate tax, there were over 350,000 corporations which reported net incomes of less than $10,000 in 1958. Furthermore, even

[10] The 1959 estimate of revenue loss from this proposed change was $850 million. Corporations with incomes over $100,000 would have received 61 per cent of this tax saving. *Ibid.*

if the exemption were no more than $10,000, its value to each corporation with income of at least this amount would, of course, be $5,200 under the present corporate rate, or not much less than the $5,500 which can be saved under the present law provisions. So there would be no appreciable lessening of the incentive for multiple incorporations under this alternative approach.

We now have, as we have seen, a split rate tax with a specific surtax exemption. This provides a fair amount of relief for relatively small firms without actually introducing a graduated rate structure into the statutes. Furthermore, the relief extended at the bottom end of the income scale can easily be increased or diminished by varying the size of the specific exemption, or by adjusting the surtax and normal tax rates without changing the total rate. On the other hand, this approach places a high premium on multiple incorporation, and therefore poses an administrative problem for which no one seems to have a good solution.

Some persons fear that a graduated rate structure without a "notch" provision would ultimately lead to full-scale graduation such as we have in the case of the individual income tax, a development which most students of taxation would view with some concern, and one which would certainly do nothing to discourage corporate split-ups. These fears may or may not be justified, but even if graduation were strictly limited to the lower end of the income scale, the avoidance problem might not be any less serious than under the split rate approach. The introduction of a "notch" provision is undoubtedly a safeguard against carrying progression too far up the scale, and makes less certain the advantage to be derived from multiple incorporation. For if corporations that were set up to take advantage of the low bracket rates did too well, the anticipated tax savings would be lost. On the other hand, a graduated rate structure with a notch provision introduces the problem of above-standard marginal rates in the notch bracket, and does not lend itself readily to alterations in rate alignment.

Conclusion

After weighing the advantages and disadvantages of each of the above alternatives, it seems hard to avoid the conclusion that the present split rate structure offers the best means of differentiating between large and small businesses under the present federal corporation income tax. But if this conclusion is accepted, it appears that something more has to be done to check the abuses that have arisen under this provision during the past 10 years. Although the Treasury has been able to disallow multiple surtax exemptions in some cases, the requirement that affiliated corporations must establish by "the clear preponderance of the evidence" that the securing of an additional exemption was not the major purpose of separate incorporation has, as we have seen, not been difficult to get around. Since there is no reason to believe that the courts will interpret this major purpose test any more strictly in the future than they have in the past, it may be necessary to adopt a more arbitrary rule for determining whether or not multiple exemptions should be allowed, or to require multiple corporations controlled by the same interests to be combined for tax purposes.

CHAPTER XVIII

MANUFACTURERS' OR WHOLESALERS' TAX VERSUS PRESENT EXCISES

FRED S. GILBERT, JR.*
Hedrick and Lane

PROFESSOR Scott of the Harvard Law School tells the following story. He had been out of law school a few days and had just begun his first job as a lawyer with a large New York law firm. Naturally, he was quite excited, although somewhat puzzled, when he was called to the office of the senior partner. When he arrived, he was introduced to a man whom he instantly recognized as the president of one of the firm's largest clients. His senior told him that the client had a problem, and that they would like to have his opinion as to its solution. I need not tell you his feeling—pride mixed with an apprehension that his answer would not be a satisfactory one. But the problem seemed rather easy, and he quickly rattled off an answer. As soon as he had finished, the senior partner turned to the client's president and said, "There you are, Jim, I told you that any young punk fresh out of law school would give you the same answer I did."

Except for the fact that I am not fresh out of law school and that the problem on which I have been asked to speak is not easy to solve, my feelings today are rather akin to those possessed by Professor Scott then—pride at being asked to speak before such a learned group; apprehension that my "answer" will not be altogether satisfactory.

* The author gratefully acknowledges the assistance of his colleague, Theodore R. Groom, in the preparation of this paper.

Despite this reservation, I am going to advance what I believe to be the proper approach to the federal excise problem. I do not believe that a general federal sales tax—regardless of the level at which it is imposed—is the proper solution to this problem. I do believe that the underlying structure of present selective excises needs to be evaluated, redefined, and redirected along the lines which I shall presently suggest.

History and Development of Present System

First, however, it may be instructive to glance briefly at the history of federal excise taxation.

With the exception of minor use during the War of Independence and the War of 1812, excises were first incorporated into our system of federal taxation during the Civil War.[1] These taxes—principally liquor and tobacco excises—produced substantial revenue then, and today produce in excess of $5 billion of revenue or, excluding highway taxes, are responsible for well over half of the present revenue from all excises.[2] Interestingly enough, a general federal sales tax was proposed but not accepted shortly after the enactment of selective excises during the Civil War.[3]

A wide range of excises was imposed during World War I, but most of these were repealed in the decade immediately following that War.[4] During this same period, different types of federal sales taxes, including a manufacturers' sales tax, were

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[1] United States, Congress, Joint Economic Committee, "Federal Excise Taxation," *The Federal Revenue System: Facts and Problems 1961*, 87th Congress, 1st Session, Washington: Government Printing Office, 1961, p. 134. This report, and pages thereof, will be referred to hereafter as J.E.C., *supra* note 1, p. —.

[2] J.E.C., *supra* note 1, p. 135. Excluding highway taxes, total revenue from all excises in 1960 was approximately $9.7 billion.

[3] United States, Treasury Department, Division of Tax Research, *Considerations Respecting a Federal Retail Sales Tax*, Hearings Before the Committee on Ways and Means on Revenue Revision of 1943, 78th Congress, 1st Session, p. 1097. This paper, and pages thereof, will be referred to hereafter as Div. Tax Res., *supra* note 3, p. —.

[4] J.E.C., *supra* note 1, p. 134.

considered by Congress as an alternative to selective excises. In 1921 a 3 per cent manufacturers' sales tax was voted on and defeated.[5]

In the revenue bill of 1932, H.R. 10236, a 2.25 per cent manufacturers' sales tax, proposed as a temporary measure to balance the budget, was reported favorably by the House Committee on Ways and Means.[6] The bill provided for the taxation of sales by licensed manufacturers of articles sold for "final" consumption or use. Articles subject to the tax included gas and electricity, but excluded farm products, seeds, fertilizer, specified foods such as meat, fish, poultry, bacon, ham, milk, cheese, butter, sugar, tea, coffee, and salt, newspapers and magazines, school books, and certain religious articles. Canned foodstuffs were taxable, however, on the theory that they were manufactured articles. Exceptions were also made for sales for further manufacture, sales for export, and sales to states and municipalities. If a manufacturer's sales in a given year were under $20,000, he was to pay no tax. It was predicted that 140,000 manufacturers would be subject to the tax which was to be in addition to the tax on admissions, stock transfers, telephone, gas, and so forth.

This bill was defeated on the floor of the House for a number of reasons including the belief held by some members that such a tax would further depress industry to the detriment of the entire depression economy,[7] and that a tax on certain selected nonessential items would be preferable. In lieu thereof, the present system of selective manufacturers' excises was enacted.

A general federal tax upon the sale of commodities and services was again seriously considered by Congress in connection with the Revenue Acts of 1941, 1942, and 1943.[8] But no action

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[5] Div. Tax Res., *supra* note 3, pp. 1097-98.

[6] The textual discussion following is based upon the debate on the floor of the House of Representatives, 75 *Cong. Rec.*, 5692 *ff.* (1932).

[7] See *e.g.*, the remarks of Rep. Mouser, 75 *Cong. Rec.*, 5703-4 (1932).

[8] Div. Tax Res., *supra* note 3, p. 1101.

was taken on these proposals; instead, existing selective rates were increased and new articles made subject to the tax.

After the Korean War, Congress again considered certain excise revisions, reduced some rates in 1954, and repealed the tax on transportation of property in 1959.

In considering the development of the federal excise system, three points are worthy of emphasis. First, excises have evolved to a considerable extent as the result of sudden demands for increased revenue in time of war. The tax imposed upon the sale of articles during wartimes has not, however, generally been removed at the termination of hostilities. Second, articles selected for taxation have been chosen largely upon the basis that they are "luxuries" rather than "necessities." Third, a general federal sales tax has been proposed to and rejected by the Congress repeatedly.

Some Criticisms of Present Excises

Even though the present system of excises has received considerable criticism, Congress has been reluctant to make changes. The following are some of the major arguments advanced in opposition to the present selective system.

1. The selective excise discriminates against the taxed industry in favor of the untaxed industry, particularly in marginal areas of competition.[9]

2. Among the taxed industries, discrimination results because of lack of uniformity in rates.[10] For example, the sale of cameras is taxed at 10 per cent while the sale of projectors is taxed at 5 per cent.[11]

3. Even in the same industry, the tax imposes different burdens on different businesses, depending upon their internal structure. Thus, a business which is integrated may bear a heavier burden than a non-integrated concern, since the tax may be imposed on a sales price which reflects distribution as well as manufacturing costs.[12]

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[9] J.E.C., *supra* note 1, p. 136.

[10] J.E.C., *supra* note 1, p. 140.

[11] I.R.C. 1954, § 4171. All references hereafter made to the Code and to statutory sections refer to the Internal Revenue Code of 1954, or sections thereof, unless otherwise indicated.

[12] Arguments may be advanced that a manufacturers' excise is less of a burden on the highly integrated company since the tax will enter cost structure at a later stage between production and sale, thereby avoiding markups by wholesalers based upon a price which includes a tax. See J.E.C., *supra* note 1, p. 136. This argument seems the weaker of the two, however.

4. Technical and administrative difficulties, familiar to us all, abound. Since articles taxed are only those specifically named, each article must be defined. Innovations escape the tax because of this problem of definition. The television receiving set and the electric can opener are ready examples. The problem of pyramiding of tax is avoided only by complex provisions for exemption certificates.[13] There are a host of other problems—who is the manufacturer, what is the sales price—to name a few.

These criticisms are insufficient to persuade me that *a* selective system should be abolished and a general federal sales tax substituted in its place.

It is true that under a general tax with a uniform rate, discrimination between and within industries would be abolished. But selectivity is not an evil in itself any more than uniformity standing alone is a virtue. Congress by necessity *selects* modes and subjects of taxation. It prefers, in one area, the income tax to others, and there selects the progressive system as the fairest mode. But within that system it provides for exemptions and exceptions in specified situations.

We see then that selectivity, or lack of uniformity, is not a valid criticism.

With regard to the other criticisms listed above, I concede that tax burdens should not vary with the internal structure of a business; but a general manufacturers' tax would leave this problem untouched. The question here is not general versus selective but a manufacturers' tax versus a retailers' tax.

Similarly, those who advocate a general tax, too often it seems, overlook some of the technical and administrative difficulties that would continue to exist. As we have seen, proponents of a general tax customarily except a number of items from the tax, such as certain food and clothing articles. Also, certain selected articles and services, such as liquor, tobacco, and entertainment are usually treated separately under most general sales tax proposals. As Dan Throop Smith has pointed out,[14]

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[13] See chapter 32, subchapter G, §§ 4221-4227.

[14] Dan Throop Smith, *Federal Tax Reform,* New York: McGraw-Hill Book Company, Inc., 1961, p. 300.

each time special treatment is accorded an article, that article must be defined and distinguished from related articles. The person upon whom the tax is imposed, whether manufacturer, wholesaler, or retailer, must be defined and ascertained. Nor would a general tax necessarily avoid the elusive problem of price or of pyramiding. Moreover, an increase in the number of articles subject to tax, with a corresponding increase in the number of manufacturers, wholesalers, or retailers upon whom the tax is imposed, would result in greater difficulties in collection, and an increase in the number of personnel required.

The basic difficulty with present excises is not selectivity but the fact that the selection is not consistent, coherent, or meaningful. Or, to put it very simply, one cannot look at a list of articles subject to tax, and, after research and inquiry, explain why Congress decided to tax these articles instead of others. Perhaps all that can be ascertained about the reason for the taxation of a particular article is that revenue was quickly needed and the particular industry appeared to be a ready and continuing source of substantial revenue.

Where one does glimpse a connecting thread of reason, it is usually the traditional distinction between "luxuries" and "necessities," a dichotomy which is deficient in a number of respects:

1. "Necessity" varies with individual choice patterns. High quality music may be "essential" for a person to the extent that he would rather have a stereophonic set than decent meals every day in the week. On the other hand, a gourmet may prefer expensive food to professional entertainment or an adequate car.

2. Closely related to the first reason is the fact that a luxury item for one person is a commercial necessity for another. For example, a salesman may depend upon a car or a telephone for his daily bread, while the car is a luxury when in the possession of a teen-ager and the telephone a luxury when in the hands of a gabby wife or young daughter.

3. Most items commonly possessed by Americans are neither luxuries nor necessities. Americans could no doubt get along without electric refrigerators, yet how can an item owned by 95 per cent of American families be accurately termed a luxury?

4. Perhaps even more important, the distinction has not been consistently applied. An article which was once a luxury and taxed as

such loses its luxurious character as it becomes commonly owned. But Congress usually fails to recognize this changed status in so far as the taxability of the article is concerned. Moreover, Congress has failed to recognize the fact that the same article may be either a luxury or a necessity depending upon its cost of production and sale. In our time and place, an automobile costing $2,000 is usually not a "luxury,"[15] while one costing $6,000 probably is. Both automobiles are taxable articles, however.

It is proper to say, I suppose, that a uniform tax would be fairer than a tax on selected articles whose choice was governed by considerations of expediency. But I believe that a selective system can be developed upon rational principles and by which national and individual interests, outside the tax realm, are promoted. Such a system can be developed without radically changing present excises or radically shifting away from the "luxury-necessity" dichotomy.

A Proposal

All forms of taxation have at least two common goals.

First, a given amount of revenue is sought from a particular source or mode. In 1961, for example, about $13 billion was the quota allocated to excises. There are those who argue that most or all of this burden should be shifted to other modes, such as the income tax. One need not be a mathematician, however, to understand what would occur to a progressive income structure if an additional burden of raising $11 or $13 billion were placed upon it. But perhaps even more important is the view held by some commentators,[16] a view with which I concur, that a revenue structure should not rely completely on one mode of taxation. Each mode has its advantages and disadvantages, and the proper use of different modes tends to result in a well

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[15] It may be if purchased as a second car for a teen-age boy.

[16] See *e.g.*, Smith, *supra* note 14, pp. 300-1. Compare John F. Due, "The Appropriate Role of Commodity Taxation in the Federal Tax Structure," *Tax Revision Compendium*, Compendium of Papers on Broadening the Tax Base Submitted to the Committee on Ways and Means, Washington: Government Printing Office, 1959, p. 201.

balanced, fairer system.[17] Accordingly, the revenue burden presently allocated to excises seems a proper one.

The second common goal is to distribute the revenue burden in the most palatable or least harmful manner. Here the approach is essentially negative. Mr. Rich is taxed more than Mr. Poor not so much because Congress likes Poor more than Rich, but because Congress needs to raise money and Rich can afford to pay more than Poor.

Were these the only relevant considerations affecting the amount and distribution of the excise burden, I might agree with those who advocate a general federal sales tax.

But taxation may also be used, and in fact is quite frequently used, to accomplish specific social purposes and national objectives other than raising revenue. The tax on narcotics is one example, the estate tax another.[18]

I believe that the excise tax should be used to encourage the growth of industries manufacturing certain types of desirable and important articles and discourage the production of others which are harmful or virtually useless to Americans and the American economy. Articles should be selected for and excluded from taxation depending upon the extent to which they promote the collective and individual well-being of Americans.

It is obvious that adoption of this principle would result in the retention of present liquor and tobacco excises. While a

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[17] Income tax is favorably regarded by many because of its progressive structure while a general sales tax is considered regressive, and unfair. See authority cited *supra* note 16. Moreover, a progressive income tax is considered to have a built-in stabilizing factor for the economy as a whole—increases in income are set off by increases in tax thereby impeding inflation—while it is sometimes thought that a commodities system does not have this advantage. On the other hand, a large percentage of Americans completely escape, honestly and dishonestly, an income tax, and it is justifiably felt that they should bear part of the common burden of taxation. There are also those who feel that ours is a society which—notwithstanding certain depressed areas—has overabundant private consumption, and that a tax directly affecting consumption is desirable. See *e.g.*, John Kenneth Galbraith, *The Affluent Society*, Boston: Houghton Mifflin, 1958.

[18] It should be noted that these two taxes raise little or no revenue, and are in this respect different from many excises.

nation which consumed neither would undoubtedly be a healthier one, individuals enjoying these products should be free to do so. But there is little justification for providing tax treatment to the manufacturers and consumers of these articles equal to that accorded manufacturers and consumers of more useful articles. The point need not be belabored; it is generally agreed upon, not only in the United States, but elsewhere.[19]

The type of change that would be effected by the application of this principle may be best understood, however, in connection with the taxation of other articles. As already mentioned, the automobile is taxed without regard to the function it plays, the manner in which it is equipped, or its cost. One can effectively contend that motorized vehicular transportation is essential to the American individual, business, economy, and even defense. But, to what extent do tail fins, chrome, or a 300-horsepower rating contribute to national or individual well-being? Would it not be more appropriate, then, to distinguish between the two? This might be readily accomplished by progressive excise taxation; for example, no tax on automobiles selling for under $2,000, a 10 per cent tax on automobiles selling for $2,000 to $3,000, and a 15 per cent tax on automobiles selling for more than $3,000.[20]

The progressive approach might be applied to other items or services, or distinctions might be made which would turn upon the manner in which an article or service is employed. For example, business telephone conversations might be exempted from tax because of the importance of the telephone to the economic segment of the American society. At the same time, home telephone conversations might be taxed upon a progressive basis depending upon units of use. In this manner the cost of home telephones for essential purposes, *e.g.*, emergency calls, would not be increased by tax, while luxury calls, *e.g.*, a chat-

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[19] Smith, *supra* note 14, p. 299.

[20] It should be remembered that what has been stated is merely an example. No attempt is made to say that the rates used are proper or that they would produce the necessary amount of revenue.

ting session by a teen-age daughter, would bear a tax burden.

Articles and services within the entertainment area may be susceptible to the same analysis, although more difficult problems are posed for the tax planner. An attempt should be made to determine whether distinctions can be made between entertainment which makes a cultural or informational contribution and entertainment which does not. Newspapers, books, stereophonic recordings, opera, and the legitimate spoken drama,[21] to mention a few, seem to satisfy the former requirements. On the other hand, burlesque, night clubs, and other forms of entertainment in a lighter vein would seem to fall into the latter category. Perhaps distinctions might be made even within the two categories upon individual types of programs or material. Whether problems of definition or categorization are too great, or whether the right to unfettered communication[22]—even of material possibly unworthy of reception—outweighs the tax incentives to promote information and culture, are problems which need further exploration.

The sale of some items not presently subject to tax would be taxed under the proposed tax revision. What reason is there, for example, to distinguish between a tax on cosmetics and a tax on expensive lingerie? Since the essentiality of underwear, like that of the automobile, varies according to its cost, it seems appropriate to exempt the one of low cost, while subjecting the high cost item to the tax. Similarly it is difficult to understand why foods whose cost largely reflects such factors as attractive packaging or precooking should not be subject to tax. One might go so far as to say that these items are less essential to individual well-being than such things as refrigerators and other articles presently taxed.

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[21] In 1926 the House of Representatives proposed to exempt the "legitimate spoken drama" from the entertainment tax, (S. Rep. No. 52, 69th Cong., 1st Sess.; 1939-1 (Part II) Cum. Bull. 339 [1926]); but the Conference Committee rejected this provision of the House bill. See H. Rep. No. 356, 69th Cong., 1st Sess.; 1939-1 (Part II) Cum. Bull. 377 (1926).

[22] It is possible that a selective tax upon entertainment might be overturned by the courts for constitutional reasons. This problem is beyond the scope of this particular paper.

It may be appropriate at this point to try to clarify two or three miscellaneous questions that I am sure some of you have formed in your minds. First, the system contemplated would require an establishment of priorities. Not all articles that have a neutral social value would necessarily be subject to tax. Those articles with the least social value would be taxed first until the revenue goal for excises is obtained. At the same time, no article, except those positively injurious such as narcotics, would be "taxed out of business." The purpose of the system is to guide business and individual choices, not to control or eliminate them.

Second, it is apparent that the system proposed would not eliminate most technical and administrative problems. These problems might be decreased if, upon final tally, the number of taxable articles is decreased. More likely there would be some increase in technical difficulty. Definitional problems would become more critical, particularly in the area of price. Manufacturers of those articles subject to a progressive tax according to price would certainly try to ease their product under the line. The Service seems to accommodate itself to similar problems in progressive income taxation. Therefore, such an accommodation here would not seem to be beyond reach.

Technical and administrative factors are, of course, one of the determinants of the fairness of any tax. In the final analysis, the question is whether the increased technical difficulty, if any, engendered by the system would be outweighed by the other advantages of the tax.

Third, since the tax proposed depends for its effectiveness upon a high degree of flexibility within the general framework, the level of sale upon which the tax is imposed would vary with different articles and situations. A retail tax is generally advantageous to the extent it eliminates or minimizes: (1) problems of pyramiding and markups based upon a price figure including the tax; (2) problems of price definition; (3) problems of identifying the taxpayer and taxable transactions. On the other hand, a manufacturers' tax involves fewer administrative

problems because of fewer, more responsible,[23] taxpayers.[24] Certain items such as automobiles, with a high unit cost, might be more appropriately taxed at the retail level. Similarly, industries such as the telephone system, which are already established on a unit call basis, may adequately be taxed at the retail level. Where, however, such a system does not exist and where there is a large volume of sales at a low unit price, it may be more feasible to tax at the manufacturers', or in some cases the wholesalers', level.

Finally, there may be those who will argue that the system proposed reeks too much of state control to the extent that it deprives individuals of free choice and regiments industry. As I have tried to indicate, the objective is incentive, not command; discouragement, not prohibition; guidance, not control.

The point which I hope to make may be articulated in at least two ways. America as a nation and Americans as individuals do not possess many products and services which should be possessed. Our education, our culture, and even in some cases, our basic items of health and sustenance, are deficient. So long as we possess items and services which are completely or nearly valueless, or at least unnecessary, why should not tax policy encourage a shift from the latter to the former. Or, if you feel more comfortable phrasing the idea in terms of allocating an undesirable but necessary tax burden, why should not those items and services which contribute the least to the national good, first feel the tax bite?

Not too long ago, the Chairman of the House Committee on Ways and Means, after introducing the Committee Bill, summed up as follows:

> I believe, my colleagues, that it is absolutely indefensible that the budget of the United States in peace times should aggregate $4,100,000,000. [Applause]. It is unjustifiable. It is crushing. It is destructive of love of government, and it must be reduced. . . . The masses of the people have

[23] From the standpoint of maintenance of accurate accounts and records.

[24] For a general discussion of the advantages and disadvantages of taxation at the several levels, see Div. Tax Res., *supra* note 3, pp. 1115-23.

been long suffering. The inarticulate voice of the masses has not been heard. When that inarticulate voice is heard it will roll as thunder, and it will sweep all before it. I know not but what that hour has arrived. [Applause, the Members rising].[25]

Then referring to the duty of Congress to raise taxes to balance the budget even though it be an election year, he continued:

The boys in the war at the zero hour went over the top for their country; it is now our turn![26]

You will excuse me if I do not urge your duty upon you with the same fervor or exact from you the same degree of sacrifice. It is readily apparent that I have not advanced a code but an approach. Nor do I urge immediate enactment, but instead I ask only further examination. I believe that the approach suggested deserves your further consideration.

[25] 75 *Cong. Rec.*, 5696-97 (1932).
[26] *Ibid.*, p. 5703.

CHAPTER XIX

COOPERATIVES AND MUTUAL FINANCIAL INSTITUTIONS

REUBEN CLARK
Wilmer, Cutler & Pickering

IN REAPPRAISING the taxation of cooperatives and mutual financial institutions, I take it that my job is to evaluate, in some respect, the present income tax treatment of these particular methods of doing business. The term reappraisal implies a point of view. From what perspective should it be made? Are, for example, cooperatives and mutual financial institutions to be judged, taxwise, by the social contribution which they are deemed to make to the general welfare? Or should a tax system be tailored to their particular necessities and requirements, such as these are thought to be?

Let me say at once that I do not think so. Such an approach —and I hope I shall show why—is peripheral to the problem of how properly to tax a given entity, although there are times when it cannot be avoided. One's point of departure must, it seems to me, rest on a structural tax system that refuses to discriminate between comparable businesses and comparable types of income. I appreciate immediately that this statement begs many complex questions: What are comparable businesses? What are comparable types of income? But it has the immense advantage of refusing to embroil tax policy—and, more significantly, tax-writing committees—in what one writer has described as "the big, unsettled issues involving social and political judgments." Furthermore, one should recognize that the problem of taxing cooperatives, at least, can only be considered within the general framework of the corporate tax structure.

Fundamental decisions made with respect to the nature of corporate taxation must profoundly affect the taxation of cooperatives. This aspect of the problem cannot, in my judgment, be overemphasized.

First, what are we talking about? I propose to discuss the taxation of nonexempt cooperatives, on the one hand, and mutual savings banks and savings and loan associations, on the other. There are, of course, other types of cooperatives and mutual financial institutions. But they are considerably less important for our purposes. I think the problem of taxing exempt farmer cooperatives is, for example, a subsidiary one for tax policy, as is the problem of taxing exempt credit unions. The problem of taxing mutual insurance companies is sufficiently unique that it should not be confused with the question of taxing other forms of mutual enterprises. Accordingly, I shall limit my remarks to the taxation of nonexempt cooperatives and of mutual savings banks and savings and loan associations.

It should be borne in mind that there are substantial differences in functional operation between cooperatives and mutual financial institutions. Therefore, these two types of enterprises should be considered separately.

History of Special Tax Treatment for Cooperatives

A cooperative is a business organization, usually incorporated, owned and controlled by shareholders or members for the stated purpose of operating at cost for their mutual benefit as producers or consumers. After allowing for expenses, a cooperative generally returns to its members a pro rata share of its profits, or net margins, existing at the year's end. This share is generally determined on the basis of the volume of business each member does with the cooperative and is known as a patronage refund or patronage dividend.

Special tax treatment for cooperatives goes back to the earliest days of our modern income tax laws. In the first income tax act, Congress exempted from tax the income of certain farm cooperatives which met stringent qualifications as to in-

come received and business done. These cooperatives have since been known generally as "exempt" cooperatives, but they have not emerged as a truly significant factor in the competitive picture. Of far more importance has been the activity of the so-called "nonexempt" cooperatives which have earned a tax exempt status rivalling that of the exempt cooperatives themselves without specific congressional legislation.

Nonexempt cooperatives have obtained, for all practical purposes, exemption from federal income taxation as a result of recognition by the Treasury Department and the courts that patronage refunds are an exclusion from income for tax purposes. The rationale here is that such refunds constitute price rebates. It is important to note, however, that not necessarily the *entire* amounts of such refunds have constituted exclusions —for example, distributions of nonoperating income, or of capital gains, or of profits attributable to business done with nonmember patrons who are not entitled to refunds have historically *not* been regarded as exclusions, even though distributed as part of a patronage refund. On the other hand, distributions of operating income from business done with members has always been regarded as excludable, even though such income might in fact be attributable to manufacturing, processing, or mining activities, or constitute a return on substantial invested capital.

In 1951, Congress enacted what are now sections 521 and 522 of the Internal Revenue Code for the purpose of bringing the tax treatment of exempt cooperatives more closely into line with that of nonexempt cooperatives. In doing so, it proceeded on the assumption (shared at that time by cooperatives as well) that the rules for the exclusion of patronage refunds operated in effect so that the earnings of cooperatives were taxed either at the cooperative level (i.e., if not distributed as a patronage refund), or at the patron level (if so distributed). This legislation allowed the cooperatives an exclusion for patronage dividends allocated on their books to members instead of actually being distributed in cash.

The courts interpreted this legislation in such a way that it quickly became possible for cooperatives to allocate earnings to members on their books, resulting in exclusions to them which were not included in the member's income because such allocations did not necessarily have any fair market value. This resulted in the advantageous situation that earnings so treated could be retained by the cooperatives for investment purposes without any current tax whatsoever. Accordingly, presented with a remarkable opportunity to accumulate tax-free earnings, the cooperatives entered into an era of great expansion, with both marketing and purchasing cooperatives using tax-free retained earnings to expand widely into mining, manufacturing, and processing activities.

Current Administration Proposal

The Administration has now advanced a proposal for taxing cooperatives that would assure one tax on their earnings. Subjecting both exempt and nonexempt cooperatives to essentially the same tax treatment, this proposal would allow a deduction for the distribution of patronage refunds only if distributed in cash or its equivalent. (In addition, such refunds would be withheld on by the cooperative in the same manner as other dividend and interest payments.) But it should be noted that this proposal would leave unchallenged the historic principle that patronage refunds represent tax exclusions (now deductions) to the cooperatives—that is, that cooperative earnings would continue, in a significant manner, to be taxed differently from corporate earnings.

Although some cooperative spokesmen continue, apparently, to assert that a cooperative should be allowed to exclude its allocated net margins from income even if the allocation is not includable in the patron's income, it is my impression that a wide consensus exists today, shared in by many cooperatives, that the earnings of cooperatives should clearly be taxed at least once when earned, either to the cooperative if not distributed or to the patron if distributed. I suggest that there

can be no real dispute as to the desirability of the existing Treasury proposal, although debate may continue with respect to certain details thereof, such as, for example, the provision requiring that a member's consent to leave funds in the cooperative must be made annually. Accordingly, I do not think it profitable to spend much time in considering the question whether cooperative net margins, if retained but allocated, should continue to be allowed to be accumulated without tax.

Comparability of Cooperatives and Corporations

The real question with respect to the taxation of cooperatives is whether cooperatives are sufficiently comparable to corporations, and patronage refunds are sufficiently comparable to corporate dividends, so that any deduction whatsoever should be allowed at the cooperative level when they are distributed. It cannot be denied that most cooperatives bear all the earmarks of a joint stock enterprise—continuity of life, limited liability, centralized management, and so forth—indeed, all the factual attributes which have historically justified imposition of the normal corporate tax on associations. Most cooperatives, generally speaking, earn their profits in the same manner as ordinary corporations, sell and buy their products at prevailing prices, and their relations both with the public and their employees are generally no different from those of the ordinary corporation. Accordingly, the question turns on whether patronage refunds are comparable to corporate dividends.

First, what can be said about the competitive relationship of cooperatives and taxpaying corporations, if patronage refunds continue to be treated as deductions at the cooperative level? If the Treasury proposal is enacted, it would seem clear that retained earnings of both cooperatives and their corporate competitors would bear substantially the same rate of tax. To this extent, therefore, a previously existing tax advantage of cooperatives would be substantially eliminated. Undoubtedly, however, considerable further competitive advantage lies in a tax structure where reinvested profits are subject only to one

tax instead of the double tax on corporate earnings. Indeed, there are certain cooperative practices that rather spectacularly underline this fact. Accordingly, notwithstanding enaction of the Treasury proposal, a substantial residue of competitive advantage would undoubtedly continue to inure to cooperatives, particularly in the manufacturing and processing areas.

Cooperatives, of course, have historically argued that their earnings, which are obligated to be paid out to patrons, do not constitute income within the meaning of the 16th Amendment; or that a cooperative acts only as the agent of its members so that the cooperative's income is really that of the members; or that cooperatives are more closely analogous to such conduits as partnerships, trusts, personal holding companies, regulated investment companies, and similar entities; or that patronage refunds are really price rebates. I am not impressed by these arguments, except for the last one. The constitutional argument is not, I believe, taken seriously today. The agency theory has been repudiated by the courts at every opportunity. With the conspicuous exception of the recently enacted subchapter S corporations, Congress has historically refused to extend the conduit principle to entities which bear the factual attributes of a corporation and at the same time are actively engaged in a trade or business. Justification for special tax treatment for cooperatives must turn, I submit, on a determination of what constitutes a patronage refund.

Analysis of a Patronage Refund

To begin with, a patronage refund bears many of the attributes of a normal corporate dividend, except that it is distributed on a patronage basis instead of on an invested capital basis. In most instances—certainly in the case of cooperatives other than the simplest type of purchasing or marketing cooperative—a patronage refund can be clearly distinguished, conceptually, from a price rebate or discount. The latter seems to me to be a pre-existing obligation to make a fixed payment to a customer if certain conditions are met—for example, an

agreement that a certain percentage of the purchase price will be refunded if a particular volume is achieved or, for that matter, discounts for cash or bonuses for prompt delivery. I have no real difficulty in distinguishing this type of payment from a payment representing a distribution of a pro rata share of corporate earnings which are computed in the normal accounting manner—i.e., gross income less expenses—at the end of an accounting period. Such payments seem to me clearly to be analogous to a corporate dividend, regardless of what they are called.

But a patronage refund may be something other than this. In the case of the marketing cooperative that simply effectuates sales for members, the amount received as a patronage refund may in part represent the difference between the value of the commodity at the time of delivery and the initial amount paid therefor by the cooperative. In this case, particularly if the cooperative is accounting individually to its members, a patronage refund would appear to be a genuine price adjustment or rebate and, hence, properly deductible to the cooperative when paid.

Depending on the facts involved, a patronage refund may also include profits or earnings attributable to savings effectuated through the pooled method of doing business; this element would clearly seem to constitute a distribution of profits from joint business activity—i.e., normal corporate earnings. Also, a patronage refund may include a distribution of earnings arising from the use of invested capital—and, to the extent that capital is jointly used and centrally managed, a cooperative patron would seem to be in receipt of exactly the same payment as any other investor. Thus, the conceptual similarity between a patronage refund and corporate dividend is at most points clear, but at others less clear.

Possible Approaches to Taxation of Cooperatives

Pursuing, therefore, our basic approach that comparable entities with comparable incomes should be comparably taxed,

the question is: How does one go about taxing cooperatives in light of the foregoing analysis of a patronage dividend? Remember, I am assuming that a distribution of patronage refunds is taxable at the patron level.

For example, it would be possible to tax cooperatives as corporations, without allowing any deduction whatsoever for patronage dividends distributed to patrons. This would seem to me to be an unrealistic step, since it would result in taxing many small consumer marketing and purchasing cooperatives that may have retained many of the elements of a real principal-agency relationship between themselves and their individual members; and it would treat as a dividend that portion of many patronage refunds that might in fact bear a close resemblance to price rebates. Particularly, such a step would encourage many cooperatives, especially the less sophisticated marketing and purchasing cooperatives, to "price out"—that is, to adopt pricing policies which would minimize net margins. We may note that Denmark attempted this extreme step in 1940 and was subsequently forced to retreat to the Canadian system after many cooperatives apparently succeeded in eliminating net margins through pricing policy.

A different approach would be to adopt the existing Canadian—and present Danish—system of taxing cooperatives. This method requires a cooperative to pay the regular corporate tax, although a deduction is allowed for patronage dividends *in excess of* the amount of 3 per cent of the capital employed in the business. The rationale here is that patronage refunds represent, at least in part, a distribution of profits derived from invested capital; and an arbitrary rate of return is assumed to differentiate this element of the refund for purposes of treating it as a nondeductible dividend. This system presents difficult definitional problems, however, as well as very serious problems in determining fair rates of return for individual companies within given industries. As a solution to our problem, it would be both arbitrary and complex.

Another approach to the taxation of cooperatives would be to

follow the general Swedish pattern, which is to tax all cooperatives as corporations, except certain "open" cooperatives which are deemed to have retained what are thought to be socially desirable attributes, such as "one vote per member," and so forth. This approach, however, would seem to introduce new criteria of social relevance into the tax laws which, however desirable they may be, should be excluded from considerations of tax policy.

A final approach to the problem of taxing cooperatives would be to segregate those earnings attributable to manufacturing, processing, mining, and assembling and simply to exclude them from the definition of a patronage refund (in the same manner that the nonoperating income of a cooperative is excluded today). This approach would subject such earnings to the full corporate tax, whether or not they are distributed. Comparable to the "unrelated taxable business income" approach to taxing charitable institutions, it would tend to place profits arising out of those activities (where the competitive problem is greatest) on a similar basis with corporate earnings. This approach would, of course, present certain difficulties of its own, particularly definitional problems in borderline areas surrounding the proscribed activities.

Also, the cooperatives might continue, to some extent, to avoid the impact of the tax by "pricing out." I am strongly inclined to suspect, however, that "pricing out" in these more sophisticated areas of activity—as distinct from the more simple marketing and purchasing type of situation—would be very difficult; in any event, if this should prove to be the case, "pricing out" would seem to reflect an inherent advantage of the cooperative method of doing business with which the tax system should, in so far as possible, be unconcerned. Remedies, if they are desired, lie elsewhere.

The foregoing approaches, which seek to place the earnings of cooperatives on a comparable basis with the earnings of private corporations, are based on the assumption that the present double tax treatment of corporate earnings will continue. It is most important to realize that, if the law is first clarified to

assure one tax on cooperative earnings either to the cooperative or the patron, any reform of the corporate-shareholder tax structure that would allow a corporation a deduction for dividends paid (on the grounds that they represent, like interest on borrowings, the cost of obtaining capital) would render moot the question of how to tax cooperatives. It is ironic that the problem of taxing cooperatives arises, in the last analysis, out of a basic deficiency in the method of taxing their competitors.

Taxation of Mutual Financial Institutions

Mutual financial institutions are nonstock corporations which serve substantially the same economic function as commercial banks—that is, they are institutional intermediaries between ultimate lenders and ultimate borrowers, converting the illiquid debts of the latter into the more liquid holdings of the former. Although originally they differed substantially in concept from commercial banks, in that their members were both borrowers and lenders, today this mutuality no longer exists. Mutual financial institutions are of two types: mutual savings banks and savings and loan associations.

Mutual savings banks are an ancient form of mutual financial institution, originally organized for the purpose of serving as a savings institution for wage earners of moderate means. Generally speaking, they are organized with no capital stock and all of their income is either paid out to their depositors or is held in surplus or reserve accounts. They have traditionally invested heavily in government securities, although their real estate mortgage portfolios have risen sharply in recent years. Savings and loan associations, on the other hand, are of more recent vintage. Their primary purposes have been to encourage home building and home ownership and the promotion of thrift. They have invested very largely in residential mortgage loans. Like the savings banks, they are typically nonstock corporations, they sell "shares"—i.e., withdrawal savings accounts —and set aside sums out of income in surplus or reserve accounts for the protection of their depositors. Both mutual sav-

ings banks and the savings and loan associations are generally required by supervisory authorities, whether federal or state, to accumulate and retain a certain level of reserves in proportion to their deposits.

Until 1951, mutual savings banks and savings and loan associations were entirely exempt from federal income taxes, because of their mutual form of organization and because of their original social purposes. Congress found by 1951, however, that few of these institutions any longer retained their mutuality; that is, depositors and customers were no longer the same —and no longer, as a general rule, were loans limited to members. Accordingly, Congress provided for the taxation of these institutions, taxing them as corporations on their net normal earnings, but in addition allowed them to accumulate, free of income tax, a reserve in the amount of 12 per cent of deposits. These reserve provisions have proved so liberal that, since 1951, the mutual financial institutions have paid very little income tax, certainly when compared to their arch competitors, the commercial banks.

Accordingly, the mutuals have continued to operate under severe criticism from the commercial banks, who contend that the tax laws have given them an unfair advantage in competing for savings accounts—although it is by no means clear that the relatively greater success of the mutuals in this competition has not been primarily due to their lower operating costs and more aggressive management. In particular, the banks have argued that, since they are stringently limited by statute as to the interest rate they can pay, the tax structure should equalize this disadvantage by limiting the amount of interest that the mutuals can deduct. Also, they contend that the 12 per cent reserve limit is much too liberal and permits unjustified tax-free accumulation of earnings.

Equity in Taxation of Mutuals

If we approach this problem once again from the point of view of tax equity, we can note that obviously the mutual finan-

cial institutions bear all the attributes of corporations and, in fact, are markedly similar, functionally, to commercial banks. Once again, comparing them as entities, it would appear that these institutions should be taxed in substantially the same manner as their competitor financial institutions.

The commercial banks, however, appear to be seeking an unjustified subsidy of their own in arguing that a limit should be placed upon the deductible amount of interest or dividend payments made to depositors by mutuals. Interest paid by a mutual organization, as long as it is a pre-existing obligation in a fixed amount and is not a distribution of a pro rata share of earnings computed at the end of an accounting period, would appear to be as legitimate a tax deduction as any other cost arrived at in the market place. Obviously, when competing for savings funds, the level of interest that a bank can pay will ultimately depend upon its own profitability. More profitable banks can pay a higher rate of interest. But this fact does not, for tax purposes, convert a fixed interest payment into a nondeductible distribution of earnings.

Therefore, the mutual financial institutions should not be limited taxwise with respect to interest or dividends paid to depositors, as long as these payments are not in fact pro rata distributions of earnings. Whatever advantage inures to the mutual thrift institutions by virtue of inherently lesser costs arising out of the mutual form of doing business is an advantage of which a neutral tax system should take no notice—just as it should not take notice of the commercial banks' own competitive advantage—if, in fact, it is such—arising out of their access to capital markets.

The propriety of the existing 12 per cent reserve provision is an entirely different matter. Any provision for accumulating reserves tax-free out of income is clearly a subsidy to the extent that it is unrelated to the costs of doing business. It constitutes, in other words, a distortion of the common definition of taxable income. It seems altogether clear today that the existing reserve provisions for mutual thrift organizations,

geared to a rigid percentage of deposits, bear no relationship to a true bad debt reserve and, in effect, have had the principal result of permitting the mutual thrift institutions substantially to avoid income tax.

It is argued that these reserves are required by supervisory authorities and that the mutual financial institutions should be permitted to accumulate reserves tax-free because they do not have access to capital markets; and, furthermore, that the savings and loan associations in particular require heavy reserves because of their substantial investment in mortgage loans, which have historically shown bunched losses periodically. All these arguments constitute no more than special pleas to the taxing system for preferential treatment, i.e., exceptions to the common definition of taxable income and, hence, subsidies.

If the problem is approached from the point of view of a neutral tax system concerned only with the definition of taxable income, there seems no doubt but that no taxpayer should be permitted to accumulate reserves tax-free, particularly if another, similarly placed and in direct competition, cannot. There is no more reason, for example, to permit mutuals to accumulate tax-free reserves because supervisory authorities require reserves than it would be to permit any other corporation to accumulate tax-free working capital because such reserves are needed to stay in business. The real question is: What additions to a reserve are reasonable in terms of computing taxable income? Here, the problem is simply that of estimating future losses properly chargeable against current income; and, in establishing such reserves, investigation should be limited to the analysis of past loss experience or reasonably anticipated future losses.

The overriding reason why the taxing authorities should resolutely reject claims for preferential treatment on the basis of social and economic assertions is this: The tax-writing committees of Congress cannot properly evaluate the necessity of tax subsidies or the actual effect of tax benefits once they are in operation. A determination of cause and effect between a tax bene-

fit and the purpose served is, almost always, so lost in a maze of variables and lack of data that the taxing system cannot fairly or efficiently employ tax subsidies, except to serve the very broadest national purposes. A good example of this can be seen in the current controversy over the taxation of mutual thrift institutions.

Many such institutions and, most specifically, the Federal Home Loan Bank Board, are arguing against the current Treasury proposals to reduce the present 12 per cent reserve allowance on the grounds that such a restriction would result in a decrease in the interest rate payable to depositors, with a resulting constriction in savings flowing into the home construction industry. It seems more probable than not, however, that the effect of the 1951 tax legislation, which increased the taxes of mutual thrift institutions, resulted, paradoxically, in an actual *increase* in such interest rates, with a resulting stimulation of the flow of savings into home building. The fact is that one cannot predict with certainty what would be the effect on savings available to residential construction if the 12 per cent reserve figure were to be cut. We can guess but we just do not know.

Reason for Neutrality

A tax system should at bottom be neutral, not because it is fair but because the standard of fairness—as expressed in a basic concept of taxable income applied across the board to the comparable income of comparable taxpayers—offers the only method whereby the taxing system can be rationally grappled with. The only way that tax authorities can determine what is in fact "preferential" is to have a basic standard by which a preference is tested. This standard can only be the concept of taxable income.

Furthermore, the principle of rigid conceptual impartiality offers tax-writing authorities their only real protection against the pressures of private group and lobby—pressures which are generally most effective when underlying criteria of judgment

are confused—and it eliminates many definitional problems which place an enormous administrative and compliance burden on the tax system. It may be—on account of the existing corporate tax structure and the definitional complexity involved in separating dividends from price rebates—that the problem of taxing cooperatives cannot be resolved entirely within a framework of defining taxable income; but the problem of taxing mutual financial institutions really involves no more than this.

CHAPTER XX

BUSINESS INCOME OF EXEMPT ORGANIZATIONS

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THE TOPIC "Business Income of Exempt Organizations" frequently excites strong and varied reactions, some of which are very emotional. Because of this, and the breadth of the subject, it is necessary first to establish the frame of reference and the premises upon which this paper will be based.

The statement of the subject brings into focus the question for consideration: In a system of business taxation, how shall exempt organizations with business income be treated?

This paper will consider the question as it relates to the federal income tax, and on the premise that the exemption of certain organizations will continue as part of the basic law. For purposes of practical limitation, this study will be restricted to organizations of the type which are exempt under the familiar provisions of section 501 (c) (3) of the Internal Revenue Code (charitable, religious, educational, scientific, etc.) and which, for convenience, will be called "charitable organizations." This is not to treat the wording of present section 501 (c) (3) as inviolate, but rather to use it as a base (since this subject assumes there is some exemption) and not to complicate the matter unduly by adding other categories of exempt organizations, which may present other problems but do not affect the basic principles.

THE DEFINITION OF THE PROBLEM

In determining the proper treatment of charitable organiza-

tions, conclusions may vary substantially because they are based upon different approaches or premises. It is necessary first, therefore, to examine various approaches and determine their soundness and relevancy as proper criteria under a tax system.

Revenue Approach

One approach to this subject is that of raising revenue. From a dollars and cents viewpoint, there is considerable question whether there is a significant amount of income escaping tax through exemptions of charitable and related organizations, and, more particularly, through exemption of income from activities (as distinguished from passive investments) which might be considered as "business." The arguments generally presented for changes in the law in this field have not been based on direct losses of revenue, but usually on other concepts (which are discussed herein). If this subject is approached as a matter of revenue, then the question must also be asked whether subjecting certain activities of organizations to tax will so change their patterns as to deprive the public and the government of benefits and require, in turn, greater governmental expenditures.

Competition

Another approach is that this subject involves the question of whether the tax laws afford an unfair competitive advantage to exempt organizations. The so-called "competitive advantages" are sometimes said to involve (1) lower prices to the public and/or higher compensation paid to attract employees presumably enjoyed by exempt organizations because they do not have taxes as a cost of operations; and (2) management advantages through perpetuation of management, interlocking management, and lack of stockholder pressures to which corporate businesses are generally subject. These arguments indicate that the full scope of this approach to the subject can carry us far beyond the tax field. On the pure question of prices and compensation, there are obviously factual arguments to be presented on both sides; and the disinterested observer may well

wonder whether there are not so many factors involved in each particular case that the emphasis on the tax factor may be misplaced. Moreover, the fact that someone else may be engaging in the same activity for profit has never been a criterion for tax exemption; witness the existence of tax-exempt schools and hospitals as compared with similar taxable institutions operated for profit.

Regulation of Charities

Another concept is that this subject involves the regulation of charitable and similar organizations; and, on this basis, the question is the extent to which such organizations should be regulated and who should do it. It is said that the tax laws provide a vehicle for such regulation because (1) status as a "tax exempt organization" is important to such institutions; (2) withdrawal of the tax-exempt privilege and of the deductibility of contributions are potent financial weapons in the hands of the government; and (3) the Internal Revenue Service is feared and respected as an arm of the federal government. While of course the enforcement of the tax laws has a policing effect, there is a serious question whether tax officials should be given the responsibility and authority to regulate such organizations. The skills and competency called for in tax collection may have little relation to qualifications that are desirable for regulation of charitable institutions and, in fact, may be inconsistent with public policy toward the latter.

Definitional Approach

Another concept is to approach this matter as involving the question: What is the permissible scope of activities of an exempt organization? Under this approach no special problem exists in this area; the proper resolution of difficulties will come from applying sound legal concepts to the terms used by the legislature in providing exemptions. Thus, if Congress exempts charitable organizations from the income tax for policy reasons, then the permissible scope of activities of such organizations claiming exemption is to be determined by the legal definition

of "charitable." Under this concept, the matter is no different from that of any other tax issue, i.e., it is to be resolved by applicable legal principles already existing or to be determined by the courts.

This of course is more of a legal approach than a new policy approach. It does, however, have the virtue that it is based on a framework of long standing, i.e., the special role of charitable organizations in our society; and it carries with it the appeal that matters that appear to be problems as to the proper scope of activities of charitable organizations can be resolved in due time by the application of existing legal principles rather than by new enactments that may produce more confusion than correction. In brief, this approach is that no great crisis exists, that the public has been served by the encouragement given to charitable organizations, and that efforts to resolve such problems as may exist should be based on determining and applying proper legal principles.

Exemption Policy Approach

Another approach to the subject is to treat it as involving a re-examination of the basic question of whether there should be any exemptions. This is based on the concept that if exempt organizations have "business income" then perhaps the time has come to re-examine the fundamental question of whether the public is really being served by having exemptions in the tax law. This approach is sometimes the springboard for an attack on the exemption of a particular group of organizations, and to that extent at least is beyond the scope of this paper. This approach, however, is also frequently the basis for the question of whether curbs should be placed on activities of exempt organizations in order to "maintain confidence in the tax system." In the final analysis, this involves the question of whether we can devise a proper line between the activities of exempt organizations that serve a public purpose justifying exemption and activities not justifying exemption. The emphasis here should be on whether the legislature, in its wisdom, can devise

the terminology that will draw such lines clearly and effectively.

These five different concepts indicate the necessity of agreement on approach to the subject before agreement can be expected on solutions. Some observations on these approaches may be helpful. The approaches based on revenue, competition, and regulation of charitable organizations bring in certain extraneous matters, *if one accepts the basic premise that exemption of certain organizations serves a public purpose which is worth the loss of revenue.* If the activities of such exempt organizations "get out of hand," however, then of course everyone may be properly concerned that any such improper actions are not encouraged by or privileged under the tax laws. Therefore, in the final analysis this subject should be approached as one involving exemption policy or definitions: What is the concept of a charitable organization and the proper scope of its activities?

Concepts of Charitable Organizations and Business Income

This in turn requires the answer to another question: What is meant by "business income"? There seems to be a feeling that the realization of business income is inconsistent with exemption. This is not necessarily so. It depends on what is meant by business income and what kind of business is involved. The term "business" is broad enough to encompass any series of activities, and, in a tax sense, generally includes any activities having income and expenses. In this sense, the conduct of charitable activities may itself be a business. Moreover, as public desires and needs for services change, activities which may have been clearly "charitable" at one time may now be considered by some to be businesses, because others have entered the field with a profit motive.

To test these concepts, let us relate them to realistic factual situations. Consider the following as a case which will raise these issues.

A corporation with the improbable name "Hibrow Educational Fund, Inc.," is organized under its state's nonprofit cor-

poration law by a group of high-minded citizens who made substantial contributions. Hibrow's purposes are stated, in its charter, to be charitable and educational, including for such purposes the contribution to charitable and educational organizations exempt under section 501 (c) (3) of the Internal Revenue Code and the contribution to and support of research and literary projects for such purposes. The corporate charter also contains the usual restrictions, in compliance with the provisions of the Internal Revenue Code, against legislative activities, engaging in political campaigns, distributions of earnings to private shareholders, etc. The corporation has powers under the state corporation law that are necessary and appropriate to carry out its purposes.

Hibrow, in fact, provides college scholarships for worthy students; makes grants for research projects, conducted by students and others, in the fields of economics and education; conducts or supports lectures and seminars, to which the public is invited, on subjects of current interest in the fields of education and economics (as to which Hibrow is not an advocate of any particular point of view but is attempting to provide a forum for public enlightenment); and publishes reports, resulting from the aforementioned research and other materials, written by members of its staff, lecturers, and others, all of which publications are intended to be for the education of the public and are recognized to be of a high quality. Hibrow derives its income from interest, dividends, and gains on securities, which it holds in a principal fund, and from the sale of the aforementioned publications. The income from the publications department constitutes 50 per cent of Hibrow's total gross income and results in an excess of income over expenses for this activity. This excess (or profit) and Hibrow's investment income and contributions together support the other activities of Hibrow.

While there are many other details we should know about Hibrow's activities, the foregoing gives us an ample start in

seeking to determine the proper method of tax treatment of the income involved.

We can assume for purposes of discussion that Hibrow's purposes as stated in its charter satisfy requirements as an exempt charitable (or educational) organization; that its activities in providing scholarships, research, lectures, and seminars are all activities for exempt purposes; and that its income from securities is properly derived and used. The principal question is the policy to be applied with respect to or on account of the publication and sale of educational materials and the use of the income therefrom.

From our prior discussion, this question should be approached as involving these issues: What is the concept of an exempt organization, and what practical methods can be devised under a tax system in keeping with such concepts?

Methods of Treatment of "Business Income" of Tax Exempt Organizations

The methods available are derived from varying concepts as to the nature of the "business" problem and how to meet it.

The Exempt Purpose Test

One method is to treat an organization in its entirety as either exempt or taxable based upon its primary purpose. Under this method, business activities incidental to exempt purposes will not adversely affect exemption.

This in effect was the concept under the federal income tax law prior to 1950. The problem, of course, was whether the so-called business activity was incidental to the exempt purpose under the statute. In this connection it should be noted that the concept of what is a business was not so important as the question of whether the activity was incidental to an exempt purpose. Thus, a majority of the courts passing on the issue approved exemption of organizations based on the destination of income rather than source of income.

In our hypothetical case, the fact that the publication depart-

ment of Hibrow realizes income from the publication and sale of materials would not under these "destination of income" cases deprive Hibrow of exemption.

Congress, in 1950, in effect recognized this as the law and continued the recognition of the *exempt status* of organizations having such business income, but added to the law the tax on their income from unrelated business activities regularly carried on, except in those extreme cases where exemption was withdrawn for feeder corporations organized primarily for the purpose of carrying on a trade or business for profit.

In more recent years we have witnessed a re-examination of fundamental concepts as to whether an organization can have business income and be exempt. In the development of the new Treasury Department regulations finally issued in 1959, there was a clear attempt made to redefine an exempt charitable organization. The approach under the regulations requires not only that stated purposes be affirmatively limited to exempt purposes, but also that the organization not be empowered to engage, otherwise than as an insubstantial part of its activities, in activities not in furtherance of exempt purposes.

Thus, this language of the regulations seems to require that an organization in order to be exempt must not have, as a substantial part of its activities, activities that are not in furtherance of exempt purposes, and for this purpose it may be assumed that the regulations do not regard mere destination of income as in furtherance of exempt purposes. At another point in the regulations, this concept is made clear by the rule that an organization may be exempt "although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. . . . "

It will be noted, therefore, that under the regulations "destination of income" apparently is not sufficient, but rather the test becomes whether or not the "business" is in furtherance

of exempt purposes. In our hypothetical case, therefore, it would appear that Hibrow would be treated as an exempt organization under the regulations if the publication and dissemination of materials by the publication department is in furtherance of a charitable and educational purpose of Hibrow. How is this to be determined?

The present Treasury regulations give some indication of the view of the Department by in effect laying down these tests as to whether a "business" is in furtherance of exempt purposes.

> 1. In the usual case, the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption.
>
> 2. A business is considered in furtherance of exempt purposes if operated primarily as an *integral part* of the educational program of an organization for educational purposes.
>
> 3. A business is considered not in furtherance of exempt purposes if operated in substantially the same manner as a commercial business.
>
> 4. A business not otherwise in furtherance of exempt purposes does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose.

It is apparent that these guides in the regulations are not wholly complete or consistent. If they are applied to our hypothetical case, they do not necessarily supply clear answers. Thus, on size alone, if that is relevant, it would be difficult to determine whether the publication department's activities would result in denial of exemption. Furthermore, while it would appear clear that the work of the publication department of Hibrow is an integral part of the educational program of Hibrow, nevertheless, it probably cannot be denied that such publication department may be operating in the same manner as a commercial establishment in the sense that (we trust) it is operating efficiently and that in the sale of the literary output it is not deliberately seeking to lose money.

Without attempting to comment further on the regulations,

it would seem safe to say that in substance the regulations do not change the basic test from one of attempting to determine the primary purpose of the organization, because while the regulations recognize that an organization may carry on substantial business activities and be exempt, it requires such business activities to be in furtherance of exempt purposes.

Therefore, in the final analysis this method basically involves the matter of applying appropriate legal definitions of exempt purposes. The present regulations reflect a narrowing from the prior concept which permitted business activities where the destination of income was charitable. This method, however, permits no compromise where it requires an organization to be either completely exempt or completely taxable.

The Dual System: Exempt But Subject to Tax on Unrelated Business Income

The present Internal Revenue Code suggests a second method of handling the problem of exempt organizations with business income, namely, to treat the organization as exempt if its primary purpose falls within the category of exempt purposes, but to subject the organization to tax on income derived from those activities which are considered to give rise to "unrelated business income." In this sense the federal statute is similar to, but not the same as, certain state property laws which permit the exemption from the real estate tax of property directly used for exempt purposes but not of other real estate owned by a charitable organization but not so directly used. The present rule under the Internal Revenue Code is derived from the legislation in 1950, in which Congress sought to cut through the legal dilemma of exempt organizations with business income where a clear-cut rule was needed to prevent continuing controversy as to whether such an organization was wholly taxable or wholly exempt.

The concept under the present statute, as spelled out in provisions which have been in effect since 1950, is as follows:

1. In the case of an organization organized for charitable purposes, its exemption is determined, in the first instance, under section 501 (c) (3) of the Internal Revenue Code and its exemption is not lost even though it carries on substantial trade or business activities, unless it is a feeder corporation.

2. In the case of an exempt charitable organization which is engaged in a trade or business, its "substantially unrelated trade or business activities regularly carried on" are carved out and treated as if conducted by a separate entity, which is subject to tax on the net income from such activities (without, however, affecting the exemption of the organization's income from its other activities or its characterization, as a whole, as an exempt organization for purposes of the deductibility of contributions to it).

3. In the case of a feeder corporation (defined as an organization operated for the primary purpose of carrying on a trade or business for profit) the exemption of such organization is denied and the organization is subject to tax.

Thus, at first blush it might be assumed that the concept and treatment under the present federal income tax law in our Hibrow example would be to treat the organization as exempt under section 501 (c) (3) of the Internal Revenue Code and impose, or not, a tax on the net income from the publication department, dependent upon whether, on consideration of all the facts, it is determined that the activities of the department are substantially unrelated to the charitable and educational purposes of the organization.

If the publishing department is subject to tax as an unrelated business, then its situation is equated to that of a taxable publishing company, that is, it is subject to the same federal income tax as a private corporation for profit, including a limitation on the deduction of its net income contributed to Hibrow's exempt purposes; but Hibrow will be entitled to $1,000 exemption, and contributions to it will still be deductible for federal income tax purposes. Thus, under the present law, the taxable activity is treated, in part but not wholly, the same as if it were conducted in a separate taxable corporation which is a wholly owned subsidiary of the exempt organization.

Admittedly, the solution provided by Congress in 1950 is an anachronism in that it treats a single organization as having

both exempt and taxable characteristics, but nevertheless it is a solution which in many ways is preferable to an all or nothing approach. At least the present law permits reasonable compromise without the pretense that there are clear standards by which all activities can be classified as entirely exempt or entirely taxable.

Narrow Definition of Exempt Organization

Another method is to restrict the definition or concept of an exempt organization so as to minimize the possibility that it will engage in "business" activities. This may take the form of requiring that the exempt organization either (1) have no sources of income except from passive investments, or (2) fall within a narrow class of exempt institutions such as a school with a regular curriculum and faculty, a church, a hospital, etc. As part of such a narrow approach an organization would either fall within the exemption or it would not; there would be no middle ground of being partly exempt but having some taxable activities.

This approach of course would require very careful definitions, for it basically raises the question of whether it is possible to define "business income" and whether there would be any sound policy in permitting certain types of "businesses" to be exempt but not others. Thus, for example, if exemption required the organization to have income only from interest, rents, and dividends, it presumably would also be necessary to exclude those organizations which carry on such a financial program that it could be said that "investments" constitute a business. In fact, the Revenue Service has in recent years denied exemptions in some cases on the ground that the foundation was in a business other than for charitable purposes. But even assuming this could be overcome, the problem would naturally arise as to the treatment of those "businesses" which in their very charitable and educational operations produce income, such as a college, a hospital, or a social welfare agency which "requests" welfare patients who can to pay small fees

for services rendered. This of course basically raises the question of whether it is a sound policy to treat an organization as no longer exempt merely because it seeks to become self-supporting. It is believed that proper policy would indicate that the fundamental test should be the purposes of the organization and the public benefit which it serves; and if it can provide this service and benefit and at the same time be self-supporting, then the public interest and exemption would seem to be served.

The second type of limitation, namely, to define the exempt category so narrowly that business activities are not likely to creep into the organization's work also misconceives the purpose of the exemption. Thus, while of course a legislature could limit the exemption to schools, churches, or hospitals, which otherwise meet the test for exemption, nevertheless this would be a step backward in our concept that the country is served by private philanthropy and by the dedication of nonprofit institutions to charitable, educational, and similar purposes. Certainly a college is engaged in the "business" of educating, and there is no reason to deny exemption to other organizations for educational purposes on the ground that their activities may constitute a "business."

Thus, in our example of the Hibrow Educational Fund, Inc., its service to the public warranting exemption may be as great as that of a more formalized educational institution such as a school or college. The mere fact that Hibrow may have a publications department is no reason to deny exemption to such an organization where such department is in furtherance of or is, in fact, its exempt purpose, any more than it is to deny the exemption to a college or a university because of a university press. In the final analysis, the matter of seeking to eliminate the "business" problem by very narrow definitions of exemption is an attack on the basic concept of the exemption itself. Either the purpose of the exemption in seeking to promote public purposes by private means is sound and such activities are given a reasonable range, or there is little purpose in the

exemption itself. Limiting the exemption to more formalized institutions confuses the form of the exemption with the substance of its purpose.

Business Relationships

Another aspect of the "business" problem is the relationship that may exist between a tax exempt organization and a private business. This relationship may arise from the ownership by a tax exempt organization of a substantial interest in a business corporation. The possible effects of such ownership upon the corporation, its competition, and the community should be considered. There are some who believe that this is a major problem area, requiring new legislation, although the form which it would take is not clear.

The evils sometimes cited are (1) exempt organizations, particularly "private foundations," may be used as a device for perpetuating control of private business corporations through substantial stock ownership lodged in a foundation which has perpetual existence; (2) the interlocking of corporations through foundations where the same trustees of the foundation or foundations can vote the stock of a number of businesses to the advantage of those businesses and to the disadvantage of others or their competitors; (3) the foundation control of private business may in other ways give the business a competitive advantage over others which have to be responsible to private stockholders and may not enjoy the benefits which accumulated funds in a foundation may provide for the business or its employees.

These charges have been made from time to time with, to say the least, differences of opinions as to whether they have been proved and how serious the problem may be. The Treasury Department, in 1950, recommended legislation as to one aspect of the control feature, namely, the disallowance of the deduction for charitable contributions and bequests when made to controlled foundations. This approach could have a long-range effect of eliminating the foundation as a device for

perpetuating family control of a business. The Reece Committee, in 1954, considered a somewhat different approach, namely, legislation limiting the investment by a tax-exempt foundation in the stock of a corporation. This would permit only a certain percentage of the assets of the foundation to be invested in a business and the foundation could own only a certain percentage of the total equity of a business; a foundation violating these rules would be given a certain period of time to extricate itself by disposing of such interests.

Such a method of dealing with the "business" problem of foundations is easier to state in general terms than it is to place in practical operation by law. Aside from the transition problem which would obviously exist if new rules as to investment were required as a condition to tax-exempt status, there is the problem of determining the extent to which a foundation may possess an interest in a business corporation and should, in order to protect its investment, exercise some degree of control (*e.g.* representation on the Board of Directors). Or is it intended that a charitable foundation should not exercise its rights as an investor? Moreover, since many charitable organizations seek out responsible leaders in a community to serve as their trustees, as they should, are they thereby prevented from holding an investment in a business in which such leaders may also have an interest? The present attitude of the Internal Revenue Service would not seem to go this far, as long as the trustees handle the affairs of the foundation in accordance with its exempt purposes and not for private benefit.

The method considered here, i.e., placing such restraints upon investments of charitable foundations, appears based more on a desire to regulate foundations than to apply relevant tax considerations. The Treasury Department recommendations in 1950 were tax oriented in that they were based on disallowing deductions for contributions which the donor continued to "control"; but rules more recently proposed appear to have a different purpose. In this connection it is interesting to note that under such rules the publications department of Hibrow

might be an exempt function as a division of Hibrow, but that if it were a separate corporation Hibrow might not be able to "control" it.

Conclusion

In summary, these conclusions seem apparent.

We should approach the subject of "business" income of exempt organizations on the basis of a proper concept of exemption under a tax system.

The extremes, on the one hand, of establishing a very narrow set of rules for permissible exempt activity, and, on the other hand, of focusing only on regulating foundations' investments, do not provide a basis for a soundly grounded method for treating exempt organizations with business income. This is not to say that the legislature should not enact specific legislation to curb abuses; an example of appropriate legislation of this type is the federal income tax on rents in certain sale and lease-back transactions of charitable and educational organizations. Such shotgun efforts are not a substitute for a basic policy, however.

The choice then lies between having a basic policy of a broad concept of exemption with organizations qualifying as wholly exempt, or not at all, or a basic policy similar to the present federal income tax rule treating organizations with business income as possibly having a dual character. Although the dual concept may be attacked as unsound in theory, it is a practical approach which permits compromise of many otherwise insoluble problems.

This policy survey has not sought to resolve many of the difficult problems in this field, such as the treatment of business income of religious organizations, the matters of abuse by organizations and donors in using "gimmicks" for deductible contributions, etc., because first it is necessary that some rational philosophy be agreed upon as to the concept and role of exemptions for charitable and similar organizations. It is believed that our tax systems are not harmed and the public is

generally benefited by a concept recognizing the dynamic and growing functions of charitable organizations in meeting community needs. New developments and services for these purposes should not be throttled simply by labeling them as "business." There is an obligation to taxpayers as members of the community to continue to balance the role of government in public service, supported by the tax system, and the role of nongovernmental institutions serving the public and supported by private means.

CHAPTER XXI

DISCUSSION OF RECONSTITUTION OF BUSINESS TAXES

CHAIRMAN HARRY F. SCHROEDER, *Vice President, Bankers Trust Company:* At this time we will have the questions and answers.

PROFESSOR C. LOWELL HARRISS, *Columbia University:* I don't want to take any time at this session, but I would like to submit a comment later on the general subject of the excise taxes, especially the differentiation in the taxation of common carriers, notably public transportation and telephone service.[1]

MR. GEORGE L. BLISS, *President, Century Federal Savings Association:* I would like to ask Mr. Clark the basis for his statement that the mutual savings banks and savings and loan associations were no longer mutual because of the fact that the borrowers and the savers are not the same persons. I would like to ask if he is prepared to document that as the test of mutuality?

MR. REUBEN CLARK, *Attorney, Washington, D. C.:* I am afraid I don't quite understand the question. The original test of mutuality, as I understand it, was that a financial institution took savings from members and in turn loaned back to members but, that over a period of years, this mutuality between the depositors on the one hand and the borrowers on the other hand substantially disappeared.

MR. BLISS: I don't assume you desire debate on the subject, but I don't think that that can be substantiated.

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[1] See comment inserted on pages 237-42.

MR. CLARK: Would you have a comment on it as not being an accurate fact?

MR. BLISS: It is a statistical impossibility.

MR. CLARK: As a matter of fact, I believe that was found as a finding back in the Senate Finance Committee Report in the 1951 act.

MR. BLISS: That was rejected by the Senate.

MR. CLARK: It was not rejected by the Senate, as I recall. The Senate Finance Committee, in fact, taxed the mutual financial thrift institutions, but imposition of a 12 per cent tax on reserves was provided on the floor of the Senate. If you are interested, I think I can locate here the actual language of the Senate Finance Committee Report, which found that as a fact.

There was a joint staff report of the Treasury Department in 1950, which was the basis of this legislation. This joint staff report stated that the cooperative savings institutions had long since lost the mutuality that characterized their original formation. I believe that this was found certainly as a fact by the staff of the Treasury Department.

MR. BLISS: I raise the question because you stated it as a fact, as I understood you.

MR. CLARK: I would refer you, sir, to the report of the Senate Finance Committee on the Revenue Act of 1951.

MR. BLISS: I am familiar with this, although I haven't read it recently.

MR. CLARK: Since the question has been asked, let me read what the report stated, because you asked for a factual statement as to the basis of what I said.

The Finance Committee stated that "few of these institutions had retained their mutuality, that mutual savings banks traditionally made loans to non-members, and the savings and loan associations were rapidly departing from the principle that guided their early organization, of loaning to their members." That is the Senate Finance Committee Report, pages 22-29. This, as a matter of fact, is the source of my statement.

MR. BLISS: Thank you very much. I would just like to make

an observation for the record that that cannot be substantiated, that the people who borrow and the people who save obviously cannot be the same, because those who have savings don't have the need for borrowing, and there must be others than the savers who do the borrowing.

MR. CLARK: As a matter of fact, let me make the point further. As far as I am concerned, in trying to judge how a taxing system should be applied to a taxable entity, I would not regard mutuality really as being significant. It is the fact of operating through the joint association form that brings the entity within the scope of the corporate tax. As long as taxable income is created during any particular accounting period of time, I would conceive that that income should be taxed.

If, on the other hand, a particular mutual form can operate in such a way that net margins are substantially eliminated, as I say, I believe I would regard that as an inherent advantage of the mutual form of doing business, concerning which I don't think a tax system should take notice.

MR. BLISS: With that I have no objection. In other words, that is a matter of proof then.

MR. CLARK: I think it is a matter of opinion and a matter of the basic premise from which you start.

MR. BLISS: Mr. Chairman, may I ask one other question of Mr. Clark? That was his reference to the reserves—bad debt reserves—sanctioned by the act of 1951 as tax-free reserves. An institution may use a charge-off method. The reserves are for the purpose of absorbing losses, and those losses may be charged off as they are incurred, or a reserve may be established to meet them as they occur, as with any other allowable reserve.

MR. CLARK: You can charge off your losses against the reserves and that is entirely proper.

MR. BLISS: I am objecting to the description of them as tax-free reserves. They are not more tax-free than any other allowable reserve.

MR. CLARK: If I understand you sir, I wouldn't agree with that statement. I think that where an entity is able to take out

of income and add to reserves deductions against taxable income, which reserves are not justified in terms of loss experience or assets held at risk, I suggest that is unreasonable and is not justified in terms of normal concepts of tax accounting. That is the basic premise from which I have been approaching the problem.

MR. BLISS: I agree with that statement. I have no objection to that statement. In other words, whether it is a reserve for depreciation or depletion or bad debts, it is not of itself a tax-free reserve.

MR. CLARK: I suggest it is tax-free in any result. I suggest the reserve for depreciation is a tax-free reserve. You are setting aside out of income, income which is not taxed, as a reserve.

MR. BLISS: I raise the question as a characterization that is not commonly applied. It is only recently that it has been applied in regard to the argument.

MR. CLARK: I am sorry, then, Mr. Bliss. I would certainly apply the term "tax-free reserve," in the sense I have been using it, to a depreciation reserve, bad debt reserve, or any other kind of allowable reserve under the tax system.

PROFESSOR VICKREY, *Columbia University:* There is a possibility of some confusion, I think, in the matter of the taxability of the patronage refund or dividend to the customer. It seems, at least offhand, to me, that when the customer is an individual customer buying for his personal use, that there would be no occasion for the taxation of such a dividend; but in practically every other case that this would appear either as a reduction in cost of what is purchased or an increase in the proceeds from what is sold, and would almost automatically be included in the income of the patron, if the patron is a business entity, rather than a private entity. Am I wrong in that?

MR. CLARK: I did not go into the details of the distinction between a patronage refund which relates to nonbusiness and business transactions. A patronage refund in consumer buying does not result in taxable income to the patron under existing law. Only a patronage refund that relates to business items

would result in taxable income under existing law. The Treasury proposal, as I understand it, continues to maintain that distinction.

PROFESSOR VICKREY: Thank you.

MR. F. CLEVELAND HEDRICK, JR., *Attorney, Washington, D. C.:* I would like to ask Mr. Clark a question with respect to savings and loans associations if I may. I hope you don't feel discriminated against here. I take it that a basic assumption in your approach to savings and loan associations is that they are in competition with commercial banks. I wonder if that assumption is actually sound when you consider that savings and loan associations have a limited objective with respect to their loans. That is, it is almost entirely limited to home loans; whereas the commercial banks may use their savings for all types of loans, including short-term business loans and things of that kind.

MR. CLARK: The savings and loan associations have attracted a great deal of personal savings, which, in fact, are reinvested substantially in mortgage loans over a long period of time. They have not really, as I understand it, been in acute competition with the commercial banks for those types of savings accounts.

I think the competitive problem has been greatly overstated by the banks, and that to a very large extent the success of the savings and loan associations in attracting savings has been due to operating efficiencies and to aggressive policies and, to a substantial extent, to the complete failure of the banks to respond to this particular challenge in serving as a financial intermediary. I understand that commercial banks are getting increasingly into the area, and I understand that the pension trusts also may be getting increasingly into the area of investing their portfolios in residential loans.

Of course, the return on such a portfolio is substantially higher. I would say, to answer your question, Mr. Hedrick, that the competition is becoming more acute because of the fact that banks are getting more into this area. But, basically, from my point of view, I don't think you really have to prove whether

close competition does or does not exist. I think a tax-writing committee cannot actually grapple with the factors that you mention. The only way that you can develop a taxing system that can be rationally applied across the board is to try to use the basic concept of what constitutes income, and then try to apply the definition rationally across the board.

Once you get into the question of who has what savings and who gets what savings from where, you are bringing before a tax-writing committee these incredibly complex questions upon which the experts disagree. You pick your data by your predisposition to the answer, and it is a system I find myself disenchanted with.

MR. HEDRICK: Thank you for your answer and redirect statement.

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Editorial Note:

Following is the comment by Professor Harriss to which he referred on page 232.

PROFESSOR C. LOWELL HARRISS, *Columbia University:* The discussions of business taxes and of excise taxes prompt me to suggest certain points which seem to me inadequately considered in some current debates.

The federal excise taxes on passenger transportation and on communications now discourage use of the common carrier.[2] The Treasury's investment credit proposals would not grant credit to public utilities providing power and communications, while giving credit to businesses which invest to provide such services for themselves.

The public utility—the common carrier—is often subject to higher rates of tax than apply to business and consumption in general. If the utility has a very extensive and firm monopoly,

[2] The Administration in January, 1962, proposed elimination of the tax on railroad and bus passenger transportation and reduction and eventual elimination of the tax on air travel.

if there is no significant competition for its services, then appraisal of the tax discrimination will rest on more or less familiar considerations. Is the consumption of this service an unusually desirable base for getting revenue from consumers? Or if the tax in fact burdens the supplier, will net earnings be reduced below a level which is in the long-run public interest? Such questions, though clearly important, are not my concern here. Rather, I suggest that explicit attention be paid to the possible effects of taxes in encouraging the establishment of private sources of supply. If so, what will be the effects of any such development on the public as a whole?

Some competition, i.e., substitution, for some of the supply of a railroad, electric, or telephone utility is always possible. Potential substitution is, of course, partly a physical or technical and partly an economic matter. Taxes are among the factors affecting the choice among alternatives.

Ordinarily, as in the case of taxes on telephone and telegraph services, there is nothing in the spending of the tax revenue (nor, of course, in the tax itself) which makes the taxed service more attractive. Conceivably, spending of the specific revenue might serve users directly—if the tax on rail passengers were used to improve the quality of rail service. But we ignore such a possibility. We can assume that the tax on the utility does not benefit those who pay it in any way they can discern. Anyone who escapes the tax sacrifices no public service. The direction of his incentive is obvious.

The demand of most users may be so inelastic that the effect of the tax on quantity will be imperceptible in the short run. Though the effects over the long run will be greater, they, too, may be so intermixed with others as to defy measurement.

For at least one group, however, demand may have significant elasticity. This group consists of businesses (and some units of government) which can set up their own facilities for supplying the service—or part of it. The possibilities depend, among other things, upon the scale of the company's own operations, its resources, and technological conditions. Even a giant manu-

facturing company is not likely to establish much of a railroad, but it can use its own trucks and airplanes as well as those of the common carrier. No manufacturing, mining, or financial business, no state or city government, would think of setting up its own complete communications system. But they can, and many do, set up communications systems. Some generate their own electric power, and more have this as a realistic alternative.

Private individuals, small businesses, and small governments, and various others do not in fact have comparable opportunity. They must rely upon the common carrier. Their interest is served by, among other things, policies which enable the common carrier to reduce costs. This large group of consumers is likely to benefit from policies which tend to favor, rather than discourage, the common carrier—except where it is operating under conditions of increasing cost.

The determination of unit costs of supplying rail, electric, communication, and other utility services is notoriously difficult if it is possible. Typically, however, total unit costs (as reasonably interpreted) vary over a considerable range—peak-hour service and that rendered to distant and thin markets may cost significantly more per unit than services from facilities which are used more nearly all the day or year. Public utility rates which are set to cover something approaching average cost—or which reflect estimated value of service—will be above total unit cost in some cases and below it in others.

As a result there will sometimes be an attractive opportunity for a business which can supply its own services. A form of "cream skimming" is possible. The firm can set up facilities for supplying services where its costs would be below the charges of the public utility, while perhaps relying upon the latter for other services.

One consequence for the economy as a whole, I suspect, will be the building of some duplicate capacity which is excess. The common carrier is a sort of giant pool of facilities. Dozens, hundreds, or thousands of individually owned systems can hardly be integrated as effectively as the facilities of the single supplier.

The cost to the total economy will be increased. The majority of consumers will suffer if average costs of the common carrier are higher than if it supplied all the service.

Many years of growth in the usage of privately owned (not common carrier) trucks, pipelines, and airplanes, to say nothing of automobiles, leave no doubt about the technological and economic possibilities of such substitution for the common carrier. The private supplying of electric power has long been recognized as a competitor for the public utility. (This consideration played a part in the elimination of the federal tax on electricity.)

Today, private communication facilities—those not supplied by the common carrier—are growing rapidly. These provide services some of which are directly competitive with some offered by public utilities. Some systems are relatively small internal devices. Others, however, are extensive installations covering large areas. Microwave radio has opened up new technical possibilities for private communications systems, and business and government are taking advantage of the opportunities.

The new private facilities are separated physically as well as economically, from those serving the general public. I do not venture to comment upon the problems involved in connecting such facilities with those of common carriers. Unquestionably, the problems of adjusting the rate schedule, and especially those of controlling quality are difficult, but they may not be insuperable. Be that as it may, these private facilities must often be at least a trifle less satisfactory to their owners than comparable facilities which are hooked up with the national system of communications. Moreover, in the absence of interconnection, outsiders do not have access to such facilities even when dealing with the owner.

Can the public interest be served by the development of such private communications systems? Perhaps technical features are superior or quality of service better or price lower than common carriers offer. I make no pretense to competence to evaluate such matters. But one point seems probable—the subject is worthy of explicit consideration by the Treasury and Congress.

Present and proposed federal taxes create a preference for the *non*-utility supplier. The firm with its own communications system need not pay the 10 per cent federal tax on communications. (Moreover, state-local taxes will often be lower.) In addition, under the investment credit proposal, communication and electric facilities supplied by public utilities would not qualify for the credit while those supplied by a manufacturing, mining, financial, or other business would receive credit. Whether such differential treatment has significant or tiny effect at the margin on the allocation of resources, the presumption seems to me that the direction of the effect is against the broad public interest. If one is to be favored over the other, does not the concern of the majority of the public seem to call for favoring the public utility?

Yet the problem of rate regulation would appear at once if utility taxes were reduced. The complexities would be great. Moreover, only a small portion of total communication and power service may be affected by significant competition of substitutes. Perhaps the rates on this part of the market can be high enough to permit public utilities to compete effectively with any sources aided by the investment credit. This possibility, however, does not strike me as an unqualified good.

In transportation, the tax on passenger service favors the use of the private, rather than the common, carrier. Does the substitution which follows serve the public interest? Under the investment credit proposal, railroads, airlines, and other transportation facilities would receive benefits—if they have tax against which to offset it. By no means all companies in this industry earn profit. Conceivably, or probably, the investment credit would hurt part of the industry by encouraging expansion and intensifying competition. Even though there may now be an excess of some forms of transportation capacity, some nontransport firms might use part of their investment credit to buy transportation facilities they would not otherwise acquire—duplicating what is already in existence somewhere. A free price system, or possibly one with prompt, rational, and brilliant regu-

lation, might just possibly keep the waste tiny. Yet in transportation neither exists.

If the tax system is not to be neutral as between common carrier and private suppliers of services, I suggest that the bias be *in favor of the public utility*. Heaven knows that tax policies have long favored governmentally owned utilities. Perhaps neutrality, difficult as that concept may be to define, is a wiser goal and guide. The present and the proposed tax discriminations against common carriers seem inconsistent with the interests of the majority of the public.