

1989

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## **Abstract**

In this tax policy article, Professor McNulty reviews many of the broader tax reform issues presenting themselves in the United States after the major efforts made in 1986. After a brief description of the US tax system, he focuses on the most prominent individual income tax policy problems and proposed solutions, with the author's own recommendations, including some for major structural reforms.

Then he turns to the corporate income tax, its place in the US income tax system and its relation to the individual income tax. He compares the 'classical' unintegrated US taxes with the Australian shareholder imputation credit system and with other forms drawn from the US international and domestic tax regimes and US tax policy literature, including the new US Passive Foreign Investment Company model and the expanded S Corporation election for closely-held corporations.

Finally, he summarises his conclusions and overviews the package. Readers will gain a sense of the ongoing tax policy debate in the US and will find parallels with both reform discussions and recent legislation in Australia.

## **Keywords**

tax policy, United States, income tax, Australia

# THE UNITED STATES' INDIVIDUAL AND CORPORATE INCOME TAX: FUTURE REFORM POSSIBILITIES



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Despite extensive recent 'reforms', the basic structure and characteristics of the United States' income tax system, as applied both to individuals and corporations, raise important policy issues and possibilities for future reform. (Some comparisons with the law and reform issues in Australia and in other countries will be ventured; most will be left to the reader.) The United States' income tax, called the *Federal* (or national) Income Tax, is the most important and most interesting of all the tax laws in the United States. It should first be viewed in its place within the overall Federal/State tax system.

Some taxes are enacted by the federal or national government, and some by state, and local (city or county), governments. Federal taxes include:

- (a) the Income Tax (on individuals);
- (b) the Corporate Income Tax;
- (c) the Estate and Gift Taxes (and a new 'Generation-Skipping Transfer Tax');
- (d) the Social Security Payroll Tax (FICA; for Federal Insurance Contributions Act);
- (e) Excise Taxes, Customs Duties and some others.

State and local taxes often include a state income tax, retail sales taxes, real property taxes, other taxes and special assessments. There is no national Value Added Tax or other consumption or expenditure tax.

## Revenue and finance

In recent years, federal, state and local taxes have amounted to more than US \$900 billion, or about 30% of Gross National Product (GNP). About 65% of this total consisted of federal taxes. Among the federal taxes, the individual income tax has been by far the largest revenue source, each year. Social security payroll taxes (formerly called 'contributions') have become increasingly important.

Part of the general income tax, the *corporate* income tax, has diminished in revenue importance, as have excise taxes, estate and gift taxes and customs duties. The biggest changes are the decline of the corporate income tax and the growth of the payroll (social security) taxes. In total, the ratio of taxes paid to all governments in the United States to gross domestic product is lower than in most other industrialised countries.

The United States is a low tax country, and for some, a tax haven. Nationally, private saving persists at a rate lower than that in many other countries. And, the country has been spending much more than its government revenues for some years, especially the 'President Reagan years'. Consequently, there have grown both a huge federal budget deficit and an international trade deficit or imbalance. The dollar is worth less in foreign currency than at any time during the last 40 years. These factors will influence the future of tax reform in the United States.

## The Federal Income Tax: some history

After two brief attempts earlier (1862-1871; 1894-1895), the present Federal Income Tax was first enacted in 1913 and has been in effect since then, when it was constitutionally authorised by the 16th Amendment to the United States' Constitution. That amendment allowed the national government to tax 'incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration'. This amendment lifted a powerful restriction on the taxing power of the national government in the United States. (One of the important causes of the American Revolution, the war of independence from Great Britain, was the rebellion of British colonists against taxes that were thought to be unfair, and against 'taxation without representation'. A British ambassador to the United States years ago asked his United States' audience how well it had come to like taxation *with* representation.) Interestingly, the 16th Amendment (authorising a 'radical' tax) was submitted to the people for approval during a Republican (conservative) presidency. Alabama (a conservative Southern state) was the first to approve it and it was adopted in approximately the same words that Republican President William Howard Taft had suggested.

At first, the rates were low: a normal tax of one percent and a 'surtax' (on higher incomes) that progressed from one to six percent. Rates went up to 65% during 1914-1924. They were reduced to a top of 20% in the 1924-1931 period. They again rose to a top rate of 91% during the 1941-1945 years and the Korean war. Rates have been reduced since, beginning in 1964 and most recently in the 1986 Tax Reform Act, to a top rate of 28% (or sometimes 33%) for individuals and 34% for corporations. (State income tax rates, in contrast, usually range from about 1—10%.)

## The basic structure and characteristics of the Federal Income Tax

The 'base' of the tax is income. 'Income' is conceived broadly (a 'global' approach), as 'gross income from whatever source derived'. It nearly amounts to net gain or accretion to wealth, but with some important exceptions. Exceptions ('exclusions') include those for income from the ownership, occupancy and use of a personal residence, a car or other durable goods (imputed income), receipts of gifts and bequests, some 'fringe benefits' from employment, interest received on municipal (state or city) bonds, and some income that is saved in special ways for retirement.

The tax rates, which now range from a rate of 0% on exempt income (amounts thought to be necessary just to buy food, shelter and clothing, amounts such as US \$3,000 or more per person), to 15% on income up to about US \$30,000, and 28% on income over that. (A special added tax rate of 5% is imposed on some income of moderately high income persons to phase-out the lower 15% bracket and the personal exemptions—so the top marginal rate can be 33%, in some income ranges).

Thus, the tax rates are graduated or 'progressive'. Single (unmarried), married and other special categories of taxpayers have slightly different tax brackets, but the framework is the same. A special, preferential rate of tax on one particular kind of income, called 'long-term capital gain' was repealed (at least temporarily) in 1986. Formerly, such gain—as on the sale of an investment held for more than 6 months or a year—was taxed at only 40% of the normal income tax rate. (President Bush proposes again to favour capital gains by re-introducing a rate limit of 15%.)

Deductions are allowed for costs of producing income (such as for wages, raw materials, machinery, factory or office costs, advertising and, fortunately, fees paid to lawyers for business or tax work). Such deductions are allowed so as to determine net income, or 'gain', thought to provide the proper measure of ability to pay tax. Some other deductions are allowed for personal expenditures or costs such as medical and dental expenses, charitable contributions, state income and property taxes or interest paid on loans incurred to purchase a home for the taxpayer. These are sometimes called 'tax expenditures' or tax 'subsidies' or tax 'incentives' or 'relief'. Revenue is foregone in order to accomplish social or economic aims. Several of these categories of expenditure are not deductible in Australia.

Income is calculated annually, by each individual or corporation, and the progressive rates are applied each year to the total taxable income 'realised' in that year. So each person is a separate taxpayer and filer (with children often not having to file separately unless they have enough income so that they have to pay tax). The law normally treats a corporation as a separate 'person'.

The tax is *self-assessed*; each taxpayer is supposed to report all his income, calculate and pay his tax. (Many taxpayers have to get help from lawyers, accountants or tax preparation services to perform this task, especially since the tax law, and tax return forms, have become so much more complicated.) Many taxpayers think the taxes are too high, or unfair, and that the burden of determining their own taxes is too

difficult. (Even the Government makes many mistakes in answering taxpayer requests for guidance.)

So the tax rates are applied to each individual's taxable income each year. Income is taxed only when it is *realised*, not when it accrues. Income is taxed when it 'comes in' as cash or property in a market transaction. All income is lumped together, as a general principle, and taxed at the same rate. (It is not a 'schedular' system, at least in the first instance.) 'Gross income' or 'gross receipts' are reduced by deductible costs and other allowances. (A corporation goes through much the same process as does an individual taxpayer to determine its income tax liability.)

## INDIVIDUAL INCOME TAX POLICY OR REFORM ISSUES

Some tax experts would like to improve the present income tax, without changing its basic structure. Some of them believe rates should be increased, or made more progressive, in order to raise more revenue (to help balance the budget) or to increase national expenditures (for defence or for social benefit programs), or to redistribute wealth from high-income persons or corporations to lower-income persons. They believe these steps would increase the *equity* of the tax. Others would prefer lower or flatter rates, to minimise the influence of taxes on economic, financial or personal behaviour, or because they prefer a smaller, less active national government, or for other reasons. Arguably, lower or flatter rates would increase the efficiency of the economic system and allocation of resources.

Some income tax reformers would like to broaden the *base* of the income tax, by repealing many exclusions and including in income all employee fringe benefits (as in Australia), all scholarships, the 'imputed income' from living in one's own home, municipal bond interest and all gifts and bequests. Some would like to change the rules so that there would not be a deduction allowed for any state taxes, or for interest paid on mortgage debts undertaken to buy a personal residence, or for charitable contributions or medical expenses.

In 1986, tax rates were lowered and the progression was made flatter, the base of the income tax was made broader, and 'capital gain' income became taxable at the same rate as 'ordinary' income—on the theory that capital gain increases a person's 'ability to pay' tax just as much as any other income. However, capital losses are restricted in their deductibility.

Other reforms in the income tax might be desirable. Such reforms might improve the fairness, redistribution, efficiency, economic stimulation or stabilisation power and revenue of the tax law.

The income tax is built on the idea that income is the best measure of 'ability to pay' taxes, and that a fair tax system is one that increases or decreases the tax burden of each taxpayer according to his, her or its ability to pay. Some believe that income is not the only measure of a person's ability to pay taxes and to bear part of the burden of the cost of government. They would prefer to add, or substitute, one or more other taxes, such as a tax on consumption, or on wealth, or on sales

(such as a sales tax, a turnover tax or a value-added tax), or on wealth transmission (a heavier gift, estate or inheritance tax). The most important current debate is over whether the United States' income tax should be replaced by a tax on consumption, or should have a consumption or expenditure tax added to it.

Even if 'net income' is the best single measure of 'ability to pay' and the income tax is the best single tax, it may not be sufficient in a modern tax system. Perhaps too much reliance has been placed on the income tax in the United States. Might it be better to have tax laws that cover more bases because each tax will prove to be imperfect and insufficient to some extent? Not everyone agrees.

### Consumption vs income taxation

Some tax reformers propose that the Federal Income Tax be changed into, or replaced by, a consumption tax. They argue that the income tax is unfair, that it creates costly inefficiencies in the economy, and that it discourages saving and investment. They also claim that the Internal Revenue Code (which now contains over 9,600 sections, and entails many books of regulations, rulings, cases and interpretation) has become too complex, contributes to tax evasion, rewards tax accountants and lawyers, does not redistribute income or wealth enough, and is too costly to comply with and administer.

They make more fundamental arguments. For example, Thomas Hobbes and Irving Fisher argued long ago that it simply is fairer to tax individuals according to what they take from society (that is consumption) than according to what they contribute to society (that is, their production as measured by income).<sup>1</sup> John Stuart Mill argued that taxing income from capital (such as dividends, interest or royalties) is unfair, because it means imposing a 'double tax' on savings—one income tax when money is earned, even though it is saved or invested, and another income tax on the income from that saving or investment.<sup>2</sup> (Many think that this double taxation argument has been discredited, since the tax on dividends or interest can be viewed as a tax on new or different income. Yet many admit—or insist—that an accretion-model income tax, one that taxes all inflow whether spent or saved, overtaxes income that is saved, and discourages saving.)<sup>3</sup>

Consumption tax theorists also have argued that a consumption tax is fairer because it taxes an individual over his lifetime, rather than separately in each year or other accounting period. They say that the

1 See T Hobbes, *The Leviathan* (New York, Collier Books 1962); I Fisher, *The Nature of Capital and Income* (London, Macmillan 1906) 51-52, 324; *Constructive Income Taxation* (New York, Harper & Row 1942) 25, 121-129. And see N Kaldor, *An Expenditure Tax* (London, G Allen 1965). Perhaps income taxation would be more appealing if it could tax what an individual *can* (or could) contribute to society, rather than actual market production only.

2 See J S Mill, *Principles of Political Economy* (London, Longmans 1921).

3 See Andrews, 'A Consumption-Type or Cash Flow Personal Income Tax' (1974) 87 Harv L Rev 1113; Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (Meade Comm Report) (London, Allen & Unwin 1978); S Lodin, *Progressive Expenditure Tax—An Alternative?* (Rept of Gov Comm on Tax) (Stockholm, Liber Forlag 1978); Feldstein, 'The Welfare Cost of Capital Income Taxation' (1978) 86 J Pol Econ.

(present discounted) value of an individual's lifetime income (including inheritance) is equal to the (present discounted) value of his or her consumption plus bequests. This is true simply because income equals consumption plus savings. Therefore, what a person inherits plus what he earns or otherwise receives as income during life, minus what he bequeathes to others, will equal his consumption during life. If he neither inherits nor leaves anything at death, he will have consumed all his lifetime income during life. Lifetime income and lifetime consumption can both be reduced to a present discounted value, and they will be equivalent in the no-inheritance and no-bequest instance, if interest rates and tax rates are constant. Thus a lifetime income tax is equivalent to a consumption tax plus a bequest tax. However, a consumption tax is said to be fairer vis-a-vis the timing of income. An income tax is said to overtax taxpayers with 'early' income even though, or when, it has the same present value as the income of a taxpayer who receives greater nominal income later in life, because it also taxes the interest or return earned by the saving of income received early in life.<sup>4</sup>

They add that an income tax distorts choices: (1) between leisure (untaxed consumption) and work (that is, other taxable consumption) and (2) between present and future consumption. They say a consumption tax involves only the first distortion and therefore is superior to an income tax.

Consumption tax advocates admit that a consumption tax also distorts the work-leisure choice, because spending the wages paid for work is taxable consumption, whereas the tax would not apply to the consumption of leisure (the pleasure or benefit of leisure). They claim that it does *not* distort the present-future consumption choice because consumption enjoyed earlier is taxed earlier (and hence more heavily because the tax paid cannot be invested by the taxpayer) and consumption enjoyed later will not be taxed until later, and so the deferred tax can be paid out of dollars earned earlier and invested at interest to produce a yield of income.

Although not everyone agrees with each of these arguments, or with their conclusions, it is worth contemplating how a consumption or expenditure tax could work.

Such a tax might require each person to count and add up all of his or her consumption expenditures during the year and apply a single tax rate, or a progression of rates, to this total. Can one imagine that every taxpayer would be completely careful and honest enough to report all these taxable expenditures? If not, some monitoring and checking could be done, as it is with a retail sales tax. The tax could be collected or withheld at every point of purchase or spending for consumption. This system probably would not catch all consumption expenditures (much less consumption by other than spending). (It could apply different rates, or exemptions, to purchases of different items, such as food, clothing, shelter or to luxuries, or travel or disapproved spending.)

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<sup>4</sup> See Klein, 'Timing in Personal Taxation' (1977) 6 J Legal Stud 461; Bradford & Toder, 'Consumption vs Income Base Taxes: The Argument on Grounds of Equity and Simplicity' (1976) 69 Nat Tax Assoc Proc 25; United States Treasury Department, *Blueprints for Basic Tax Reform* (1977; 1984). But see A Warren, 'Fairness and a Consumption-Type vs Cash Flow Personal Income Tax' (1975) 88 Harv L Rev 931.



Another approach would be to measure consumption by measuring total receipts (or income) and subtracting all savings or investment. This would involve many of the reporting problems of an income tax. It also would entail distinguishing between real business expenditures and personal consumption. And it would have to take account of dis-saving, that is of consumption from savings made before (or after) the consumption tax came into force.

Since a tax designed this way would involve a total measure of consumption (income minus savings) for the year or other accounting period, it could be personal and it could therefore be made progressive. That is, graduated rates could be applied so that high levels of consumption would be taxed at more than proportionately higher rates than low consumption, or than spending for necessities—such as a minimum amount paid for food, housing, clothes and medical needs. Professor Sven Olof-Lodin of the University of Stockholm has shown convincingly how an expenditure tax can be progressive, either alone or when added on top of a proportional income tax.<sup>5</sup> Professor Earl Rolph, at Berkeley, has also shown that a tax credit could be used to make a flat rate income or consumption tax progressive.<sup>6</sup> This would exempt or relieve the poor people who need all, or most, of their consumption power just to survive.

One model for converting the United States' income tax into a tax on consumption is the 'cash-flow income tax' proposed by Professor William Andrews and by the United States' Treasury in 1976 in *Blueprints for Basic Tax Reform*.<sup>7</sup> In such a model, all cash and property inflow is totalled, and it includes more than income. For example, it includes the proceeds of borrowing. Then outgo or outflow into specified savings or 'accounts' is first added up and then subtracted from the inflow total. The difference would be taxable 'consumption'.

The result of any of these approaches is to exempt savings or saved income from tax, whether it be called an 'income' tax or anything else. There are some such allowances in the United States' income tax now for certain retirement savings plans called 'qualified pension plans', 'individual retirement accounts' (IRA's) or 'Keogh plans'. Expanding such allowances to permit a deduction from income for every form of saving would eventually convert the income tax into a tax applied only to *consumed income*. (If consumption from savings were also taxed, the result would be a quite comprehensive consumption tax.)

It is important to observe that a consumption tax is equivalent to an exemption from taxation of income from capital. That is to say, the value of a deduction from income for income saved is equal in value to taxing the income from which the saving is derived but excluding the income derived from that saving or investment from income tax in the future. For example: as background, suppose there exists an *accretion model income tax*, with a 30% tax rate, and under conditions of a prevailing 10% interest rate.

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<sup>5</sup> See above n 3.

<sup>6</sup> See E Rolph, 'The Case for a Negative Income Tax Device' (1967) 6 *Indust Rel* 155; Rolph & Break, *Public Finance* (New York, Ronald Press 1961).

<sup>7</sup> See Andrews, 'A Consumption-Type on Cash Flow Personal Income Tax' (1974) 87 *Harv L Rev* 1113; *Blueprints*, see above n 4.

- A If a taxpayer has \$100 income, he or she will have \$70 to invest after payment of income tax. The \$70 invested will grow to \$77 at year end, minus a 30% tax on the \$7 interest income (\$2.10), leaving \$74.90 net after tax.
- B If there is instead an income tax with a *deduction* for saving (which is much the same as a 30% *consumption tax*), a taxpayer with \$100 income who invests it will have \$110 at year end. A 30% consumption tax upon disinvestment of \$110 will impose a \$33 burden. \$110 minus \$33 will leave \$77 net after tax to spend.
- C If instead there were a 30% *income tax* with an exemption for income from capital, a taxpayer with \$100 income would have only \$70 to invest. That investment would leave \$77 at year end, net after tax, to spend.

This example shows that an exemption from income tax for income from capital equals an income tax with a deduction for saving (or a consumption tax) and that both regimes tax savings more lightly than does an accretion-type income tax without either such allowance.

And, as has been pointed out by Stiglitz and Warren and others, in a world in which individuals consume all their incomes during their lifetimes, and tax rates and interest rates are constant, a consumption tax is equivalent to a wage tax.<sup>8</sup> This equation suggests the alternative method of levying the consumption tax—as a tax on wage income alone. Using this approach, the tax system would not tax any return to capital, but no subtraction would be allowed for savings. (The United States' Treasury *Blueprints* report used a version of the cash-flow approach.)<sup>9</sup>

The equivalence of a cash-flow income tax used as a consumption tax to an income tax applied only to wage income also projects serious objections to such a tax. Who would write the press release for a politician who supported an income tax that would tax all of a worker's wages but none of an investor's dividends, interests, rents, royalties or capital gains? To be sure, exempting capital income from tax would induce greater saving and would remove some of the inefficient economic allocative influences that taxation of some or all such income introduces. But that is not a sufficient argument for abolishing income taxation of income from investments. Savings and saved income are relevant to a person's ability to pay tax, and much too important to be disregarded.

Nevertheless, it may be that the United States should *add* a consumption tax (and possibly a wealth tax) at the national level, or should broaden and increase the income tax allowances for saving, in order to raise more revenue, tax the 'ability to pay' as measured by consumption (and wealth) as well as that measured by income, and to add more progressivity to an overall tax system that has become proportional or even regressive. [It has become so particularly since the Social Security payroll tax (a flat

8 See A Warren, 'Fairness and a Consumption-Type vs Cash-Flow Personal Income Tax' (1975) 88 Harv L Rev 931; Andrews, 'Fairness and the Choice Between a Consumption-Type and an Accretion-Type Personal Income Tax: A Reply to Professor Warren' (1975) 88 Harv L Rev 947; J Stiglitz, 'The Consumption-Expenditure Tax', Ch 5 in Pechman (ed), *The Promise of Tax Reform* (Englewood Cliffs NJ, Prentice-Hall 1985); Warren, 'Would a Consumption Tax Be Fairer Than an Income Tax' ? (1980) 89 Yale L J 1081.

9 See *Blueprints*, above n 4.

tax with no exemption, applied to only the first US \$43,800 of wages) has become a higher-rate tax producing a larger share of federal tax revenue.]

How could such a tax be added on consumption or spending, other than as an annual expenditure tax on retail sales tax, mentioned above? One popular proposal is for a tax on 'value added'.

### The value added tax

The 'value-added' tax (VAT) or 'tax on value-added' (TVA) has been studied extensively in the European Community, Japan and the United States, and has been adopted in many other countries. The United States has much to learn from the research and experience with the VAT in Asia and in Europe.

Some in the United States (such as the late Professor Stanley Surrey) have argued that a VAT is the same as a national retail sales tax.<sup>10</sup> Others, including myself, disagree. We think it is different in its ability to work internationally, in its incidence and economic effects, and in its enforceability and administration. During the 1984-1986 tax reform period, the United States' Treasury did not recommend that the United States adopt a VAT, and none was adopted.

The Treasury decided against a VAT or a national sales tax on grounds of:

- (1) regressivity;
- (2) inflationary price increases;
- (3) administration and costs, and
- (4) deference to state and local governments, many of which have relied on sales tax systems of their own.<sup>11</sup>

The large budget deficit in the United States may force another serious reconsideration of the VAT as a national tax in the next two to five years.

A tax on valued added is, as Professor George Break of Berkeley has put it, a tax on the contribution or addition that a business firm makes to the nation's total economic output. That addition, the 'value added', is equal to the firm's gross receipts from its sales of its own output minus the value of inputs it buys from other firms. Stated another way, value added equals the firm's total payments to the factors of production (such as land, labour, capital) used in its operations.

Consequently, value added can be computed by a *subtraction* method (sales receipts minus input purchases) or by an *addition* method (add up wages, salaries, profits and interest payments). Still a third method is often used in practice. It is called the *invoice* method. Each firm is taxed on its gross receipts from sales, with a credit allowed against that tax liability for all taxes paid by the firm's suppliers and invoiced on its purchases. This matching of records of one firm with another makes taxpayers chase each other and help government enforce the tax!

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10 See S Surrey, 'Value Added Tax: The Case Against' (1970 Nov-Dec) *Harv Bus Rev* 86; S Surrey, 'The Value Added Tax for United States—A Negative View' (1969) 21 *Tax Exec* 151.

11 See United States Treasury, Vol III (Value-Added Tax) *Tax Reform For Fairness, Simplicity, and Economic Growth* (Nov 1984).

There are, of course, several variants of the VAT from which the United States might choose. The *consumption* method means that business investment in capital assets is deducted, or the tax on them credited, in computing VAT liability. The base of the VAT then becomes consumption. In contrast, the *income* method means that capital expenditures (such as for a factory or equipment) must be ‘capitalised’ and ‘depreciated’ or spread over the useful life of each asset, as depreciation is employed in an income tax. The base of the VAT then will be net income.

The consumption-type VAT is widely used in Europe and is the one of greatest policy interest in the United States. Perhaps this is because an income-type VAT might better be rejected in favour of improving the existing federal individual and corporate income taxes. But if the federal government wishes to place more weight on taxing consumption and less on saving, a consumption-type VAT may recommend itself very strongly, instead of a national retail sales tax or a personal consumption-expenditure tax.

Another policy choice for the United States: the VAT can be origin-based or destination-based. An origin-based tax covers all production in the country, even if exported, but not imports. A destination-based tax excludes exports but includes imports, since the tax base is to be consumption within the taxing country. It is the destination-based form that has been used in the European Common Market—soon to change, in 1992?—and one that would fit best in the United States, whether as a VAT or as a national sales tax.

Studies by Break and others in the United States have researched the revenue potential and tax base of a VAT, its incidence (consumers or producers), its inflationary and price effects, its justification on either a ‘benefits-received’ or ‘ability-to-pay’ theory, its regressivity (and remedies for that problem), how it could be handled, and its likely impact on federalism—the respective sizes and functions of the national as compared to the state and local governments.<sup>12</sup> The economists have focussed on the probable impact of a national VAT on private saving, its simplicity and efficiency, its neutrality on capital income, and its economic effects on labour supply, exports and imports, international capital flows and economic stabilisation. Concluding that a VAT has both strengths and weaknesses, and that all its economic effects cannot be predicted with certainty, many economists look on the VAT as a possibly very attractive policy alternative for the United States. And the politicians may, or may not, prefer to advocate a new national tax rather than to increase the rates of the old ones.

Economists admire the VAT for its neutrality toward different kinds of investment, its favourable treatment of saving and investment, and its horizontal equity (equal treatment of equally-situated taxpayers) compared to an individual income tax or a personal consumption or expenditure tax. They criticize its lack of vertical equity. Although some degree of progressivity can be built in, that possibly can be done only at lower income levels.

A national sales tax in the United States, possibly such as that suggested by the United Kingdom Meade Commission Report in 1978, could

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<sup>12</sup> See G Break, ‘The Value-Added Tax’, Ch 6 in Pechman (ed), *The Promise of Tax Reform* (Englewood-Cliffs, NJ, Prentice-Hall 1985).

combine a federal VAT with a progressive consumption-expenditure tax that had high personal exemptions in order to apply mainly to higher income groups.<sup>13</sup> Or, a consumption-type flat tax plan, such as that suggested by Hall and Rabushka (under the guise of an income tax reform) could be restructured by adding higher tax rates at the top of the range and by strengthening the federal estate and gift taxes on gratuitous transfers to attack the problem of inherited wealth.<sup>14</sup>

### The United States' estate and gift taxes

The United States' taxes on donative transfers, during life (gifts) or at death (bequests, legacies), have never been big revenue raisers or powerful redistributive forces. They have become even less important in recent years. Large exemptions, careful tax planning by wealthy families, some non-reporting and non-compliance and low rates deprive these taxes of much of their potential impact.

Many states have inheritance taxes of their own, and they too are generally ineffective. My home state, California, repealed its inheritance tax six years ago.

How can one explain the fact that the voters in a state such as California would repeal a tax that applied only to the relatively rich and was designed to equalise rich and poor, to redistribute wealth from a few rich families for the benefit of the poor or middle class? Was it because the tax's revenue was low, administrative costs and planning or compliance costs were high, and estate-planning lawyers should be prevented from making big incomes by advising wealthy families how to avoid (to plan around, not to evade) the tax? Possibly. Or was it because each factory worker secretly thought that there was just some chance that he or she could save a lot, or strike it rich (in the state lottery?) and become subject to the tax, and would rather it did not exist? Or, do average people actually like having old, rich families in our society—for entertainment value and style setting? The answer is not certain.

In any event, even if rates were increased and exemptions lowered, the wealth transmission taxes could not raise enough revenue to help much with the budget deficit. And limiting transmission of wealth at death would not alone remove all big differentials or inequities in income or wealth, since opportunities still exist in the United States to make a fortune during a lifetime.

My own view is that the estate and gift (and generation-skipping taxes) should be repealed, but only on the condition that the recipient of a gift or bequest be required to include the money or property in income.<sup>15</sup>

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<sup>13</sup> See Report of the Meade Comm, *The Structure and Reform of Direct Taxation* (London, Allen & Unwin 1978). And see Lodin, above n 3.

<sup>14</sup> See Hall & Rabushka, *Low Tax, Simple Tax, Flat Tax* (Colo Sps, Colo, McGraw-Hill 1983).

<sup>15</sup> See J McNulty, 'Fundamental Alternatives to Present Transfer Tax Systems', Ch 6 in Halbach (ed), *Death, Taxes and Family Property* (Essays and American Assembly Report) (St Paul Minn, West Pub Co 1977); Kragen & McNulty, *Federal Income Taxation* (4th edn West Pub Co 1985) 764; McNulty, *Federal Estate and Gift (and Generation-Skipping) Taxation* (4th edn West Pub Co 1989) 470-479. See also J Dodge, 'Beyond Estate and Gift Tax Reforms: Including Gifts and Bequests in Income' (1978) 91 Harv L Rev 1177; W Goodhart, 'Too Good to be True? a Proposal for the Reform of Taxes on Gifts and Inheritances' (1988) 12 British Tax Rev 473.

This would tax the benefit as income, at rates that correspond to the increased ability to pay off the person who receives the gift. It would improve the base of the income tax and remove three costly and inefficient taxes from the law books and the burdens of the Internal Revenue Service.

Now that United States' income tax rates have been lowered and made flatter (less steeply progressive) by the 1986 Tax Reform Act, the bunching effect of a once-in-a-lifetime gift or bequest received in one year or accounting period and subjected to high and steeply graduated income tax rates has been minimised, and I think the time is ripe for my proposal to be adopted.

Another reform possibility is adoption of an *accessions* tax, to tax progressively to each individual the amounts received by donative transfer during a lifetime. Some such proposals appear from time to time.<sup>16</sup>

### Fresh-start basis at death

Another related reform of the United States' income tax law that relates to my proposal and to death taxes is the rule called 'fresh-start basis at death' (see IRC para 1014). Under this rule, if father bought some land many years ago for a price of \$100,000 and it increased in value to \$1,000,000 at his death, his heirs are given a 'basis' in the land of \$1,000,000 for income tax purposes. This means that they can sell the land for what it is worth, \$1,000,000, and pay no income tax. The father paid no income tax on the \$900,000 increase in value during his lifetime—because he did not 'realise' the gain by selling or exchanging the property. His heirs should therefore take a basis of \$100,000 equal to father's cost, so that they at least would eventually be taxed when they sell the land. And that would be the result in the United States if he gave the land to them during his life. But if he holds it until death, the land's basis will be equal to its (higher) fair market value at death. This gives the rule its name: a 'fresh-start' for the heirs.

Congress tried to change this rule to a 'carryover' of (father's) basis rule like that for gifts. But that rule didn't work, partly because of record-keeping problems. After father's death, it often was impossible to find out how much he had paid for the land many years before.

My solution—taxing the recipients on the bequest as income—would be more practical, since it would only involve estimating the fair market value at death, as is done now for the fresh-start basis rule and for estate and inheritance tax purposes. And my rule would tax the right people, the recipients, on their increased ability to consume or save—on their income—and at the appropriate rates.

[Possibly a theoretically better solution, to tax father each year on the unrealised appreciation in the land even if he doesn't sell it, seems too impractical and has always been rejected by the United States' income tax system. (However, that solution or a simple substitute may be made workable for corporate shares, as discussed below, or for all assets.) Another worthy possibility is to tax the owner at death as if he had sold the property for a price equal to its fair market value, and give the heirs

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16 See J McNulty, 'Fundamental Alternatives', see above n 15 at 89-93; E Halbach, 'An Accessions Tax' (1988 Fall) 22 ABA Real Property, Probate and Trust J 211.

a basis equal to such value. Still another idea would be to give the heirs a zero basis in all inherited property.]

As a substitute for taxing the person who really had the income, to whom it accrued during his life, my plan would tax those who receive the appreciation (gain or income) and the capital itself. I would tax them as having received income, in other words, even if when they received the land it was worth only the original \$100,000 that father had paid for it. In other words, I think not only that his unrealised gain, but that his entire gift is income to those who receive it, and it should be taxed as income to them, just like any other 'gain' or profit or net receipt.

## THE CORPORATE INCOME TAX

Another reform recommended for the United States, one that received considerable attention some years ago, also should come up again now, in the new tax environment after the 1986 reforms. It has to do with reforming the United States' corporate income tax and, as I will argue, it really has to do with improving the individual income tax.<sup>17</sup> In this, the United States has much to learn from Australian and European experience.

Let me begin by describing the probably familiar structure of the tax on corporate income in the United States. A corporation, a domestic one or a foreign one, is generally treated by United States' tax law as a separate entity, a separate taxpayer. So are the individual shareholders of the corporation. Both are subject to the general income tax.

If a corporation earns \$100, it must pay tax of up to \$34 [the top corporate rate].<sup>18</sup> When it wants to pay a dividend, a distribution of profits, to its investors, it consequently has only \$66 left after taxes. If it pays out the \$66, those shareholders who receive the payment are taxed on their dividend income of \$66, at a top normal rate of, let us say, 28%. So their tax will total \$18.48. As a result of tax at the corporate level at a maximum rate of 34% on \$100 and a shareholder income tax of 28% of the \$66 dividend, a total tax of \$52.48 will have been paid on \$100 of distributed corporate income. That rate is 24.48 percentage points higher than the top rate the law usually applies to an individual's income of \$100 (\$28 or 28%). (A top 33% rate applies to a limited range of income, not the highest range.) It is more than the top corporate rate of 34% by 18.48 percentage points. This is simply the consequence of a classical, unintegrated system of corporate and individual income taxation like that in Australia from 1940 until 1987.

In contrast, if the \$100 were earned by a partnership or proprietorship in the United States the total tax burden would be much lower. A partnership is *not* treated as a separate taxpayer by United States' income tax law.<sup>19</sup> Its income is not taxed to the partnership, but is passed through to the partners. So, \$100 of partnership income will be taxed once, at the 28% rate, to the partners (whether or not the income is distributed to them). This is much lower than the 52.48% rate that applies to

<sup>17</sup> See J McNulty, 'Integrating the Income Tax' (1983) 31 Am J Compar Law 661.

<sup>18</sup> Actual rates are 15% on taxable income up to \$50,000, 25% on income from \$50,000 to \$75,000 and 34% on taxable corporate income over \$75,000.

<sup>19</sup> So long as it is not one of the new breed of 'publicly-traded partnerships', as defined in IRC para 7704, enacted in 1987, in which event it is taxed as a corporation.

distributed corporate income (34% plus 18.48%). It is less even than the corporate rate on undistributed, retained corporate earnings (34%).

Similarly, if an individual proprietor or investor received \$100 income directly, he or she would pay just 28% in tax, assuming the \$100 were taxable at the usual top rate.

Why does the United States tax distributed corporate profits so much more heavily? Is it because the situation resembles that of an employer who earns \$100, pays tax of \$28, then pays his employee the remaining \$72, in which event the employee is taxed (again) on the \$72 wages at 28%? This cannot be the answer, because if the employee's wages are a cost of the business or profit-seeking activity, the employer can deduct the wages from his income. The deduction of \$100 paid in wages leaves the employer with no tax liability to pay on the income from which the wages are paid out, and the income is taxed once, to the employee, at a 28% rate.

Should not the corporation be allowed to deduct its dividend? Is it not a cost of capital or funds used in the business? In fact, if the corporation has borrowed its funds and paid \$100 of its income as interest to a creditor such as a bank, the corporation would be allowed to deduct the interest (as in Australia). So, the \$100 income of the corporation that it used to pay the cost of borrowed funds would be taxed only once, to the lender, at its normal rate.

But the corporation cannot, under United States' law, deduct its dividend payments. So, business planners sometimes avoid the corporate form and, for tax reasons, use the less desirable partnership form.<sup>20</sup> Or, if a corporation is formed, it borrows most of its capital, so as to pay interest, which is deductible, rather than dividends, which are not deductible, as a cost of its capital. Or, a corporation may refrain from distributing any dividends in order to save or postpone the second (shareholder) income tax. Also, United States' corporations seek ways to make non-dividend distributions so as to avoid either the corporate-level or shareholder-level tax; they attempt to use stock redemptions, liquidations, stock sales or other transactions to get assets out of corporate solution without a dividend tax. Some United States' corporations have recapitalised with increased debt or have used leveraged buyouts (or have been acquired in such transactions), in effect substituting debt for equity and 'eroding the corporate tax base'.

The United States' income tax treats the corporation that pays dividends like the employer who earns \$100, pays \$28 in tax and then pays \$72 in wages to a person, a non-business employee such as his gardener or barber or housekeeper. No deduction is allowed for such wages because they are a personal, consumption expenditure. And, the wages are taxed again to the employee, as wage income to him.

This result does not make sense when applied to corporate dividends. It discriminates between equity and debt capital, between corporations

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20 For eligible corporations having no more than 35 shareholders, it may be possible to elect S-corporation status, which means a single tax regime even on distributed corporate profits much as with a partnership, for Federal (and sometimes also for state) income tax purposes. See IRC para 1361-1379; Kragen & McNulty, *Federal Income Taxation* 995-1012 (St Paul, Minn, West Pub Co 1985).



and partnerships, and between retained and distributed earnings. It 'over-taxes' \$100 of corporate income earned by low-income or tax-exempt shareholders by \$34. It overtaxes the income of even a rich, high-income shareholder by \$24.48. It leads to excessive corporate borrowing, undue retention of corporate profits for expansion, avoidance or deferral of shareholder tax or to attempts to convert the income to capital gains (if and when a special, lower, rate applies to capital gains) or to untaxed income under the fresh-start basis at death rule. It also produces costly and inefficient under-investment in the corporate sector of the United States' economy.

### Corporate tax incidence

The separate corporate income tax is based on the mistaken notion that corporations are legal persons or aggregations of capital that can, do and should pay taxes and bear tax burdens. That is a false idea, economists tell us. Only humans bear taxes. Corporations do not. Only humans can consume, so only consumption by humans can be reduced by taxes. Corporations don't eat or drink, so tax burdens can't force them to eat or drink less. Corporations don't bear taxes and should not be taxed and cannot be taxed. The point is one of the incidence of the corporate income tax.

Perhaps the justification for the United States' corporate income tax is based on the idea that the shareholders bear the corporate tax. But if so, why should they be taxed at much more than the maximum rate the law generally says individual taxpayers should pay on their income, namely 28%? And why 52.48% on an individual's income from the corporate sector and 28% on all his other income?

Is it because the United States' Congress thinks all shareholders are very rich people who should be taxed at especially high rates? Statistics show that, in the United States, many corporate shares are held by low or middle income persons or tax-exempt institutions such as charities or pension funds. Why should they be taxed at extra high rates? And as to rich, high-income shareholders, why should they be taxed at 52.48% on only their income from investment in dividend-paying corporations, and not on their interest income, rents, wages, royalties or capital gains? At best this would be a very crude and inefficient effort at enhancing progressivity.

Shouldn't all United States' corporations be treated like partnerships, and their income (or loss) be passed through to shareholders, to be taken into account just like any other income in their individual income tax returns? [Or, should partnerships be made taxable like corporations?<sup>21</sup>]

Moreover, economists *do not* convincingly tell us who actually pays the corporate income tax. It may not be shareholders at all, but employees of corporations, through lower wages. Or the corporate tax may be passed on to consumers of corporate products in the form of higher prices. Possibly, in the long run, the tax may be borne by all holders of capital

21 Some 'publicly traded partnerships' in the United States have become taxable as corporations as a result of 1987 amendments to the Internal Revenue Code. See IRC para 7704.

in the economy, not just by those having capital invested in corporations. The economists do not agree or give us a definite answer.<sup>22</sup>

### **Justification for a corporate income tax**

Just as the question has been asked in Australia in recent years, we ask why the United States should retain a separate corporate income tax, if no one knows who bears it and if it over-taxes shareholders (if they do bear it), or becomes an erratic sales tax or payroll tax if it is shifted? And if it biases investment, financial structures and distribution policy? Or if it taxes all capital, when the United States needs to encourage saving and investment?

One answer is simple: it produces revenue. And it produces revenue from an ultimately uncertain or unidentifiable source, so there is no heavily burdened person to complain about the legislators who enact it or who raise its rates. (Paradoxically, the United States' Congress lowered the top corporate rates from 46% to 34% in 1986.)

The revenue from the United States' corporate tax has been shrinking, as a result of lower rates and investment allowances such as the investment tax credit (now repealed) and accelerated depreciation. Also debt finance and retention of earnings have contributed to the decline in revenue from the 'double tax' system for distributed corporate profits. The deduction for interest has led to highly leveraged buy-outs of corporations, which shrink the base of the corporate income tax.<sup>23</sup>

Another good reason for retaining a separate corporate income tax is so that the law can use it to control financial and economic behaviour—by creating exceptions, allowances, rate differentials and penalty provisions in the tax. And, it exerts some macroeconomic control, an anti-cyclical influence. With progressive rates the corporate tax, like an individual income tax, soaks up more of profits in inflationary or profitable times and leaves more profits in private hands during a depression or recession.

### **Integrating the corporate and individual income taxes**

If it is desirable to leave the corporate income tax in place, in the United States, what can be done to improve it? The policy alternatives will be familiar to followers of the debate in Australia in the 1980's, the Asprey (1975) and Campbell (1981) reports and the 1986 Draft White Paper on Tax Reform. Of course, the 'double tax' aspect could be removed by eliminating the corporate tax entirely and taxing dividends when they are distributed to shareholders. But that would not only decrease or defer revenue but it would also permit investors to delay individual tax

22 See generally Ballentine, *Equity, Efficiency and the United States Corporation Tax* (Wash D C, American Enterprise Institute for Pub Pol 1980); Klein, 'The Incidence of the Corporate Income Tax: A Lawyer's View of the Problem of Economics' (1965) *Wisc L Rev* 57; Pechman, *Federal Tax Policy* (Wash D C, The Brookings Institution, 5th edn 1987) 141-146 .

23 See M Graetz, 'The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions', 6 February 1989 Tax Notes 721; Jacobs & Rudnick, 'ABA Tax Section Task Force Looks At Passthrough Entities', 30 January 1989 Tax Notes 607. But see Jensen, Kaplan & Stiglin, 'Effects of LBOS on Tax Revenues of the United States' Treasury', 6 February 1989 Tax Notes 727.

indefinitely by causing their corporations to retain profits, an intolerable unfairness. And it would forego the regulatory function of the tax.

Instead, the individual tax on dividends could be abolished, at least to the extent tax had been borne at the corporate level, leaving only the corporate tax in effect.<sup>24</sup> (In fact, the United States had a very small dividends-received exclusion in its law at one time, but the exclusion was limited to just \$100 per person, a tiny tax relief designed for small investors.) However, corporate taxation and complete dividend exclusion usually would mean taxing the income at the wrong rate. For example, the low-income or tax-exempt shareholder's share of corporate earnings would be taxed at 34%, the same rate as that applied to the rich shareholder's share of corporate earnings. When corporate income tax rates are much lower or higher than individual income tax rates, this effect becomes accentuated.

Alternatively, perhaps dividends should be deductible, like interest payments, by the corporation. This would make distributed corporate earnings taxable at the correct rate, that of each shareholder. But, while this would correct for the debt/equity bias, it might induce corporate managers to 'overdistribute' corporate earnings so as to get the largest deduction and show maximum after-tax income. Retained profits, after all, would attract and 'bear' the corporate tax. And they would continue to be taxed incorrectly until they were distributed. A deduction for some, or all, dividends paid has been recommended by the United States' Treasury Department (in 1984) and other prominent sources in the United States in 1989, but has never been enacted.<sup>25</sup>

Another solution is the partnership or transparency method. This means taxing shareholders on corporate income whether or not distributed, and not imposing any entity-level or corporate tax. This method actually is in use in the United States, on an elective basis, for corporations having no more than 35 shareholders. A regular corporation that is eligible can elect this treatment, under Subchapter S of the Internal Revenue Code, and become an 'S corporation'. (See IRC para 1361-1379.)

This election for a small corporation to be taxed almost exactly the same as a partnership has worked very well. It gives small businesses the opportunity to combine the non-tax advantages of using a corporation with limited liability and the income tax advantages of a partnership, which avoids the double layer of corporate and shareholder taxes on distributed earnings.

Subchapter S could serve as a model for mandatory partnership tax treatment of small corporations, or for elective or mandatory treatment

24 V Thuronyi, 'Tax Reform for 1989 and Beyond', 20 February 1989, Tax Notes 981, 984; the author mentions that such a system is in place in Columbia, where dividends are exempt to 7/3 of the (30%) corporate tax paid. Ibid note 8.

25 The House of Representatives, in 1985, passed a partial deduction for dividends to be phased in, but the bill did not become law. See Tax Reform Bill of 1985, H R 3838, 99th Cong, 2d Sess, para 311.

for large corporations in the United States.<sup>26</sup> For years when individual tax rates rose much above corporate rates, such transparency or partnership style taxation of shareholders would actually have increased tax revenues. However, in the case of large corporations many new complications and difficulties would be encountered, such as how to attribute corporate earnings to shareholders in complicated capital structures with preferred stock, participating debentures, etc, or with affiliated corporate groups, and it is not entirely clear whether they can be solved satisfactorily in the United States. And, the partnership or Subchapter S method creates a liquidity problem that causes shareholders to request or demand actual distribution of corporate earnings in order to have funds with which to pay the tax. This makes the partnership method unattractive to corporate managers who want to retain earnings for expansion, and it worries economists who want the tax system to be neutral with respect to dividend distribution policies.

Probably a better solution for large corporations, or perhaps for all corporations, would be a shareholder imputation credit approach, perhaps along the lines of the system recently adopted in Australia. This method of integrating the corporate income tax with the individual income tax has been used, in one form or extent or another, not only in Australia, but also in parts of Asia, Europe, the Common Market, and elsewhere, and has been recommended in the United States.<sup>27</sup> Under this method, familiar by now, United States' corporate income tax would be collected on corporate income. When and if the after-tax corporate profits were distributed to shareholders, they would be taxable on the amount of the

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26 See Kragen & McNulty, *Federal Income Taxation* (St Paul, Minn, West Pub Co 1985) 995-1012, 1241-1258; V Thuronyi, above n 24 at 984. The United States already has experience with mandatory transparency systems in the international arena, for controlled foreign corporations with 'tainted' foreign income, para 951-964, and foreign personal holding companies, para 551-558; undistributed corporate income is taxable to controlling United States' shareholders as constructive or 'deemed' dividends. The United States' international tax system also contains some *elective* or partly elective transparency systems, as with foreign investment companies (para 1246-1247), passive foreign investment companies (para 1291-1297) and DISC's (para 991-994). The FSC legislation (para 921-927) includes, in contrast, an exemption from United States' tax for part of its foreign trade income and qualification for a 100% dividend received deduction when the FSC's parent receives a dividend distribution from the FSC. Some authors recommend integration only for small or non-publicly traded corporations, to be taxed on a flow-through method or by excluding dividends from such companies if full corporate tax had been paid. See, eg V Thuronyi, above n 24 at 984, who then would repeal the corporate tax for publicly-traded corporations and tax shareholders annually on any increase in value of their shares. Others would argue that, while integration makes sense for small, closely-held corporations, in a flat tax world publicly-held corporations should pay the extra corporate income tax, without integration, because the demand for liquidity, which characterises investment in them, is inelastic and hence the higher tax burden will not distort economic choices or allocations. See Rudnick, 'Corporate Tax Integration: Liquidity of Investment', 27 February 1989 Tax Notes 1107.

27 Somewhat similar imputation credit integration plans have been proposed in the United States, by the Treasury Department, by Al Ullman (former Chair of the House Ways and Means Committee) and by scholars including economists and lawyers like myself. See generally, C McLure, 'Must Corporate Income Be Taxed Twice?' (Wash D C, The Brookings Institution, 1979); J McNulty 'Integrating the Income Tax' (1983) 31 Am J Comparative Law 661; Kragen & McNulty, above n 26 at pp 1241-1258; A Warren 'The Relation and Integration of Individual and Corporate Income Taxes', (1981) 94 Harv L Rev 719; A Warren, 'Recent Corporate Restructuring and the Corporate Tax System', 6 February 1989 Tax Notes 715, 719.

distribution 'grossed-up' by the amount of corporate tax paid, and they would be allowed to credit the corporate tax paid against their individual tax liability on 'qualifying dividends', to borrow the Australian term.<sup>28</sup> So the entire corporate earnings, say \$100, would be imputed to the shareholders when the after-tax distribution, say \$66 (\$100 minus \$34 corporate tax), was made. They then could credit the previously-paid corporate tax (\$34) against their individual income tax liability. They would have to pay any balance owing or possibly get a refund if their shareholder credit (eg \$34) exceeded their shareholder tax (eg \$28). Their creditable amount would have to be geared to the amount of corporate tax paid on the earnings out of which the dividend was paid, as with the elegant system of franking debits and credits in Australian law, lest untaxed or tax preference income carry too much credit relief to shareholders. (The system, in a way, would resemble the indirect foreign tax credit given in the United States to a United States' corporate shareholder which receives dividends from a foreign subsidiary out of foreign earnings on which a foreign tax was paid by the subsidiary. See IRC para 902; cf para 960.)

When top individual income tax rates in the United States were 91% or 70%, and corporate tax rates were 52% or 46%, this difference in rates would have discouraged actual dividend distributions by a corporation even if a shareholder imputation and credit system had been in effect, since distribution to relatively high-bracket investors would cause a second tax much higher than the credit allowed for the corporate tax paid earlier.

However, the 1986 Tax Reform Act established a new rate relationship between top (or usual) corporate tax rates and top (or usual) individual rates in the United States, much as the 1986-1987 reduction in individual rates from 78% to 49% and abolition of the Division 7 undistributed profits tax created a new alignment between individual and corporate rates at 49% in Australia. With the United States' top corporate rate (34%) higher than the usual top individual rate (28% or even 33%, with the 5% surtax to phase out exemptions and lower brackets) for the first time in United States' history, a credit for corporate tax would not only usually equal, but would usually exceed the United States' individual tax. So, shareholders would be happy to receive dividends that were taxable at 28% to them but would give them a 34% tax credit, and hence a refund (or excess credit) of \$6. Many of them would actually prefer to invest in corporations that paid out all their profits each year as dividends, or would put pressure on their corporations to distribute all of their after-tax profits.

As a consequence of an imputation credit that often exceeded shareholder tax, the United States' tax law would then become biased against retention of earnings.

One solution to this problem of a tax bias of a shareholder credit system in favour of actual distributions would be to give each corporation a right to elect to allocate, or attribute, its earnings to its shareholders, even if it did not actually distribute them to shareholders, but retained them for expansion or other re-investment. Allocated earnings would be

<sup>28</sup> This system would trace the post-1987 Australian system. See Woellner, Vella & Chippendale, *Australian Taxation Law* (1987) 782-783.

taxable to shareholders as if distributed, even if retained by the corporation and not actually distributed, and such 'allocated' and taxable earnings would entitle the shareholders to whom they were attributed to take a credit for corporate income tax paid.

So long as the corporate tax rate equalled or exceeded the top individual shareholder's tax rate, as it does now in the United States (as in Australia), shareholders would not object to being taxed on corporate earnings that had not actually been distributed to them. This would be true because the taxability to them would entitle them to a tax credit that, assuming the corporate income was fully 'franked', would at least fully offset their individual tax burden and possibly or often exceed it. They would be happy to become eligible to get the excess as a refund, or (as in Australia), only as a credit against tax on their other income. (This voluntary allocation technique was an inventive part of the recommendations of the Carter Commission in Canada in 1966;<sup>29</sup> it only now becomes feasible or easy to adopt in the United States because of the new near parity between top corporate and individual rates created by the 1986 Tax Reform Act.) This plan would leave the corporate income tax in place, for incentive or regulatory uses.

To be sure, there are some difficult problems with either a mandatory or elective shareholder imputation credit approach to integration. They include the problems of corporate tax preferences, foreign shareholders, tax-exempt shareholders, audit adjustments, foreign income and changes in shareholders during the year. Studies in the United States, and experience in Western Europe, Australia, and Asia, show that these problems probably can be solved satisfactorily, or at least tolerated.<sup>30</sup> Admittedly, the solutions add some complexity to the system. A deduction (or split rate of tax, as in Japan) for dividends paid would be simpler—but also less complete and less fair.

American followers of the Australian reforms are particularly impressed with the system of Australian solutions for the problems of untaxed or tax preferred corporate income and dividends paid earlier in the year than corporate earnings or tax (the qualifying dividends account of franking credits and debits), dividends paid to non-residents (exempt from dividend withholding tax, so long as out of taxed company income), intercorporate dividends (exemption by the para 46 rebate and imputation credit passthrough), bonus shares, redeemable preference shares, liquidations, local branches of non-resident companies, excess imputation credits, pre-imputation profits and foreign income with foreign tax credits. We will want to know of the experience with these mechanisms and to gauge whether they would work equally well in the United States. Some, such as the treatment of bonus shares and liquidations would not fit the United States' system without adaptation, or would not be needed. Many others closely resemble ideas suggested in the United States. Some decisions, such as the prospective-only rule for the QDA balance, and

29 See Canada, Royal Commission on Taxation, *Report of the Royal Commission on Taxation* (The Carter Commission Report) 6 Vols (1966).

30 See McNulty, above n 17; Norr, 'The Taxation of Corporations and Shareholders', (Deventer, The Netherlands, Kluwer 1982); Woellner, Vella & Chippendale, *Australian Taxation Law* (1987) 781-793; 'Business Tax Reform: Ending the Double Tax on Company Dividends', Statement of the Treasurer of 10 December 1986, February 1987 Bulletin of the International Bureau of Fiscal Documentation 91.

later assessments or refunds, and the treatment of cooperatives, will require us to re-study our earlier thinking. (We can only envy the abolition of the branch profits tax, since we are just beginning to work with our new one).

### **The real problem: improving the individual income tax**

The fairness and neutrality of the partnership (or S-Corporation) method or the imputation-credit method reveals what is the real problem presented by the separate corporate income tax, in my view. It is not so much a matter of proposing revisions to improve the corporate income tax; there is not much theoretical justification for a separate corporate income tax.

The United States has employed a separate corporate tax mainly to compensate for a fundamental theoretical defect in its individual income tax: its failure to tax shareholders (on an accrual basis) for the increase in their share values each year as they hold the shares. This failure comes from the United States' tax system's 'rule of realisation', which means that gains in share values will not be taxed unless and until the shareholder 'realises' them. He or she 'realises' them only by selling or exchanging them. Not even a gift or bequest of the shares is treated as a realisation. This is a major preference, a tax expenditure, a 'loophole' in United States' individual income tax law. (It applies, by the way, to all assets, not just to corporate shares.) It allows an investor to defer individual income tax for an indefinite period, by causing his corporation to retain its profits and by not selling his shares that have gone up in value as a consequence of retained profits.<sup>31</sup>

When individual income tax rates were much higher than corporate rates, this advantage was very large. Now it is small, occasional, or non-existent, under the new post-1986 United States' rate relationships. But those rates and rate relationships are likely to change again, and individual rates may again rise above the top corporate rate. (Moreover, in the United States deferral can lead to forgiveness due to the fresh-start basis at death rule.)

So it may well be that the United States simply has enacted and retained a separate, unintegrated corporate income tax to compensate and correct for the failure of the individual income tax to reach unrealised gains in share values resulting from undistributed corporate profits. If so, a partnership (or S corporation) transparency system, or an elective or mandatory shareholder imputation credit method would provide the right 'second-best' solution. The result would be right because it would tax shareholders, once, at their individual rates, as determined by their individual circumstances, on their shares of undistributed as well as distributed corporate earnings. It would eliminate the double tax or 'overtaxation' problem of the unintegrated United States' corporate tax. It would be 'second-best' because share value increases may not correspond exactly to corporate earnings such as those taxable at once to a partner or proprietor, or to shareholders under a credit or transparency integration system. And, the partnership method would be problematic because of the liquidity problem.

<sup>31</sup> See L Gabinet & Coffey, 'The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems' (1977) 27 Case West Res L Rev 895.

## An alternative solution

Once it is perceived that the trouble with the United States' classical, unintegrated tax system for taxing corporate sector earnings lies in the failure of the individual income tax to include unrealised appreciation in corporate shares when the gains accrue, other promising solutions can be discerned. Of course, one direct approach would be to try to estimate or determine the annual increase or decrease in share values, and to require inclusion of gains (or deduction of loss) in the shareholder's income each year. The troubles with this approach include the difficulty of determining the changed values without a market transaction in each share, and the supposed liquidity problems for shareholders taxable each year on paper gains when they may not have cash or liquid assets with which to pay the tax. Perhaps both kinds of problems could be overcome by various techniques in an annual accrual method income tax as to some assets, particularly publicly traded stocks.<sup>32</sup>

Another approach, drawn from feasible proposals for the correct taxation of gains on sales of capital assets, and resembling an experimental technique in the United States' international tax area, may be more promising. It would permit repeal of the corporate income tax and its accoutrements, even without an imputation credit, or if a credit could not be currently given at a rate high enough to remove shareholder resistance to taxable distributions or allocations.

This approach involves the proposition that a reasonable approximation of taxing accrued but unrealised gains in corporate shares could be made by taxing the gains only at the time of realisation (sale or exchange) but by imputing the gains evenly to the years of the holding period, and charging interest for the deferral of tax (until the year of realisation). The bunching phenomenon could be cured by an averaging approach that treated the gains as having accrued ratably over the period the asset was held and the actual rates of each of those years, or a single assigned rate could be applied to each year's gain. (While rates remain relatively low and flat, as in the United States since the 1986 Tax Reform Act, the need for such 'averaging' is minimised.)

Taxation of share gains at the time of realisation on the theory that the gains occurred ratably over the years the asset was held, with an interest charge for deferral, would disadvantage shareholders whose gains in fact happened late during the investment period and would undertax those whose gains actually happened earlier. The system would not always correspond to what an actual, accurate annual accrual system would do—either as to gains or deductible losses. Particularly in the case of untraded, closely-held corporations, it might never be ascertainable whether and how much the realisation/proration/interest charge tax differed from an annual accrual without realisation system.

A method of ameliorating the possible injustice to shareholders, or the economic inefficiency, of such a realisation/interest charge system would be to let shareholders choose instead to be subject to a transparency regime, if they preferred it as an alternative. This regime would be one that would tax shareholders each year on their proportions of undistributed corporate earnings in lieu of taxation on share gains upon realisation

32 See D J Shakow, 'Taxation Without Realisation: A Proposal for Accrual Taxation', (1986) 134 U Penn L Rev 1111, 1132-1137; Thuronyi, 'The Taxation of Corporate Income—A Proposal for Reform' (1983) 2 Am J Tax Pol 109; W D Slawson, 'Taxing as Ordinary Income the Appreciation of Publicly-Held Stock' (1967) 76 Yale L J 623; Note, 'Realising Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities' (1982) 34 Stan L Rev 857.



and with interest. In other words, shareholders could elect the partnership, (or S corporation) style of integration (full taxation of undistributed as well as distributed corporate earnings) as an alternative to throw-back tax and interest charge on realisation. Share basis increases upon taxation annually would mechanically adjust the computation of gain or loss on later realisation.

If gain on realisation occurred over and above the adjusted basis (and undistributed earnings taxed to shareholders), it could either be ignored or it could be taxed then as an investment gain that occurred in addition to share market value increases resulting from retained earnings. If taxed, this added gain could be treated either as arising pro-rata over the years (even though the taxpayer had opted out of this system as to gain equalling retained earnings) or as occurring upon realisation, as it is now. If a loss resulted, and were deductible, that would correct for over-taxation in earlier years when retained earnings evidently exceeded the overall increase in share values (or there was an actual decrease). Or, the loss could be ignored and non-deductible (as could gains) as a price or reward for having opted the annual transparency tax alternative.

The election of annual (transparency) taxation on retained corporate earnings would be particularly necessary and feasible for shareholders of small, closely-held companies where annual changes in market value of shares prove difficult to determine. One question is whether such an election would have to be made by the entity itself or by all of its shareholders uniformly, as when the partnership or S corporation form is selected, or whether each shareholder could make his/her/its own choice, a new and relatively untried possibility. In effect, all the undistributed corporate earnings could be allocated to shareholders, or each shareholder could choose individually whether to accept such an allocation and pay tax on it. (Another question would be whether shareholders individually, or acting in concert or through the entity, could change their elections from year to year, and whether a new shareholder could make a fresh choice for newly acquired shares.)

### **An example from international tax**

The United States' Congress has recently (1986) constructed a small regime that consists of just such a choice between realisation with interest or annual transparency treatment in the international field, when it enacted the PFIC (Passive Foreign Investment Company) legislation.<sup>33</sup> The PFIC legislation, IRC para 1291-1298, was conceived as a method to close a loophole, or undesired advantage, enjoyed by United States' persons who put passive investments in foreign corporations, or made portfolio or similar investments through them, such as in foreign mutual funds. The taxpayer object was for the income from the investments to be retained in the foreign corporation subject to (lower) foreign rates of income tax and free from (higher) United States' rates for a period of time. ('His object all divine, he would achieve in time'.) The technique, in other words, *deferred* application of the higher United States tax until distribution, sale or other repatriation, at which time the higher United

33 See J Isenbergh, 'Perspectives on the Deferral of United States Taxation of the Earnings of Foreign Corporations' Dec 1988 Taxes 1062. The predecessor of the PFIC system, para 1246-47 for Foreign Investment Companies, allowed an election of *actual* distribution of 90% of taxable income as an alternative to ordinary income (vs capital gains) treatment on sale of shares of a FIC up to taxable dividend potential. The PFIC election thus is different and much more interesting as a model for corporate tax integration.

States' tax would be borne [preferably with a foreign tax credit for the (lower) foreign taxes paid earlier].

Even though United States' tax were collected later (and not avoided by holding the property until death, when a fresh-start basis under para 1014 could allow tax-free realisation of the profit from the retained investment income), deferring that tax meant larger after-tax profits in the end. The larger profits come from reinvesting each year's full investment profits reduced only by lower foreign tax, and not subtracting an additional amount for the higher United States' tax. And no interest was charged later when this 'deferred' United States' tax was paid. Paying the higher United States' tax later rather than earlier amounted to an 'interest-free loan' of the United States' tax from the United States' Government to the taxpayer. The funds 'loaned' without interest could be reinvested by the taxpayer and he could keep the added profits (less eventual tax on the added profits). The time value of money means that the present value (or cost) of a later payment of the higher United States' tax is less than the present value of paying it earlier.

So the PFIC anti-deferral system, like the FPHC (Foreign Personal Holding Company) and CFC (Controlled Foreign Corporation) and FIC (Foreign Investment Company) systems that preceded it, was designed to counteract the undue deferral of United States' tax on retained profits of a foreign corporation. To do so, this PFIC system takes a dual approach, with a taxpayer election that mirrors the domestic 'integration' system proposed above. The first alternative, under PFIC rules, consists of taxing shareholders of non-electing PFIC's when they realise gains on sales of shares, or on dividend or liquidating distributions (called excess distributions) of earlier profits, by allocating the income ratably to the shareholders' holding period and charging interest to cover the fact that tax on the earlier years' income is not collected until realisation, etc. (See IRC para 1291ff.) As a consequence of this arm of the PFIC system, tax is not imposed until sale or distribution, when the amount of gain is fixed by a market transaction and liquid funds presumably are available to the taxpayer for use in paying this tax. ('Earnings and profits' of the PFIC are not relevant in this regime.)

Probably because ratable attribution of realised gains may over-tax or under-tax the shareholder, the PFIC system allows for another option. If a PFIC elects to become a QEF (Qualified Electing Fund), United States' shareholders are taxed currently (each year) on their pro-rata shares of the PFIC income, including undistributed earnings. This is in lieu of taxing realised gains at the end of the line. It requires that shareholders pay tax on undistributed as well as distributed PFIC earnings. So they must find liquid assets to pay the tax (or demand an annual distribution sufficient to pay the tax on the undistributed and distributed earnings.) This amounts to an election to submit to partnership, S corporation or transparency-type integration. It is voluntary, entity by entity; either the realisation with interest rule applies or, if an election is made for the entire PFIC, it becomes a QEF and all shareholders are taxed currently.

The two arms of the PFIC legislation offer the United States' shareholders their choice of burden to bear to counteract the improper benefit of deferring United States' tax on their income. They may elect to be taxed on accrued gains later at the time of realisation, with interest, or earlier, currently upon undistributed earnings, as they wish. Presumably investors can and will choose which kind of fund to invest in if they cannot control the election of the fund.

The deferral of proper United States' tax on the shareholders which PFIC attempts to correct is analogous to the deferral of proper tax a United States' shareholder in a domestic United States' corporation obtains, albeit at the price of a corporate income tax on undistributed corporate earnings plus a later individual income tax on the shareholder if he receives dividends or gain on the sale of his shares. The PFIC legislation thus suggests an analogous solution to this parallel problem. The corporate income tax could be repealed and all United States' shareholders could be given a choice of current taxation on undistributed profits, or the alternative of taxation later upon realised gains, with interest. [No escape by the fresh-start basis at death rule would be tolerable under this proposed solution. (The PFIC system itself contains a rule requiring carryover basis at death, or fair market value if lower.) And indexing for inflation would be a separate and desirable change to make.]

Two admissions must be made. One is that while corporate and individual tax rates are as similar as they now are in the United States, the deferral of individual tax at the expense of unrelieved corporate tax is not so big a loophole. But there remain the problem of inappropriate taxation of retained earnings and the problem of double taxation or overtaxation of distributed corporate profits, problems that a complete integration system would solve.

Secondly, even if some complete integration system were adopted, there would remain the problem of deferral of individual income tax on unrealised gains in assets other than corporate shares, unless the United States converts from a realisation-style to an accrual-style income tax. The present separate corporate income tax seems to try to compensate for the deferral of tax on undistributed corporate profits and unrealised increases in share values even though no such correction is made as to most other assets. Shareholder imputation and credit would remove this unusual, uncharacteristic and crude 'correction' for corporate earnings and possibly better harmonise their taxation with the taxation of unrealised gains in other investments. So would some of the other proposals made here.

The realisation plus interest approach could be applied to *all* assets, not just shares of stock. If it were not, the question would arise why to treat corporate share gains differently and more disadvantageously than other investments. One answer to the latter question might be that the taxation of each year's accrued but unrealised gain in shares is an approximation of taxing the annual earnings of the corporation that were retained and not distributed. It would be an alternative to the partnership or transparency (or S corporation) method of taxing corporate sector earnings. The latter is usually viewed as a preferable reform of the corporate income tax. The former would be a second-best corporate tax reform, and a good individual income tax reform. It would truly be 'first-best' however, only if extended to all assets.

## OVERVIEW AND SUMMARY

In summary, this article has attempted to describe the main characteristics of the United States' federal income tax law, and to identify and analyse the most important policy issues facing the United States at this time. These included how to improve the base and rate structure of the individual and corporate income taxes, whether to change from an accretion-model income tax to a cash-flow income tax or a consumption

tax, whether to adopt a value added tax, or a retail sales tax, or a personal expenditure tax as a substitute for, or as a supplement to, the income tax, whether to retain, abolish or restructure the wealth transfer (gift and estate) taxes, and whether to repeal the corporate income tax.

It would seem preferable to retain and improve the individual income tax. Many would favour repealing or phasing out some of its 'loopholes', such as the exclusion for interest received from municipal bonds, the fresh-start basis at death, the deduction for home mortgage interest and the deduction for state income and property taxes. In theory, imputed income from home ownership should be taxed in some manner. A few would add gifts and bequests to the income tax base.

The Social Security payroll tax probably should be retained, though possibly made more progressive by an exemption and rate changes, unless a 'negative income tax' system were adopted to combine the income tax and social benefit systems. In that event, perhaps the payroll tax and the Social Security benefit system could be abolished or reduced.

Some would seek to retain low and flat income tax rates, with exemptions or credits to make the income tax system progressive even though the rate were low, flat and uniform.

Gifts and bequests should be taxed as income and the transfer taxes repealed.

It would seem wise to retain the (new) taxation of capital gains at ordinary rates but to add indexation of basis for inflation and/or an interest charge for deferral. A return to optional income averaging should be considered if the tax rates were to become more steeply graduated.

Many analysts would be hesitant to enact a VAT or a personal expenditure tax, except as a supplement to a major and broadened income tax.

There is some inclination to examine further a federal low rate *wealth* tax, along lines suggested by Professor George Cooper, if it were to be constitutional to adopt one at the national level.<sup>34</sup> A modest annual wealth tax would impose a tax burden on the ownership of property or resources, which the United States' income tax largely fails to do. It fails to tax as income the imputed value of owning assets, or using them for personal benefit and consumption. Only a truly comprehensive income tax, with a definition of income that included not only realised gains but accrued (though unrealised) appreciation and imputed income would tax the ownership and benefits of wealth. And, experience teaches, it may be more practical to have several taxes with low rates (such as separate taxes on income, wealth and consumption) than to try to make a high-rate single tax, such as an income tax, cover all 'ability to pay'. Moreover, an annual wealth tax at a low rate, say 1% of value, amounts to a flat tax on income from the property at 8.3%, if the market or imputed income from the wealth is, for example, 12% of its value, or so the tax can be viewed since owners will probably pay the annual wealth tax out of income. (To be sure, another adage says 'old taxes are good taxes',

<sup>34</sup> See G Cooper, 'Taking Wealth Taxation Seriously', The Ninth Mortimer Hess Memorial Lecture, delivered before the Association of the Bar of the City of New York (May 29, 1978), reprinted in (1974) 34 Record of the Association of the Bar of the City of New York 24. But see B Isaacs, 'Do We Want a Wealth Tax in America?' (1977) 32 U Miami L Rev 23.

and one must be cautious about recommending the introduction of any new tax or tax system to improve an old one.)

Finally, there is a new opportunity: to take advantage of the newly-created rate relationship between individual and corporate rates, to enact an optional shareholder imputation credit method of integrating the corporate and individual income tax, with a voluntary 'allocation' aspect along the lines of the Canadian Carter Commission Report. Whether or not earnings were distributed, they could be 'allocated' and taxed to shareholders, most of whom would not object because of the sufficient credit they would be entitled to claim against their individual income tax liability or have refunded. Many shareholders would prefer taxable allocation or distributions because of the refund. In other words, the corporate income tax could and should become a tentative withholding tax to be applied against individual income tax liability. It would provide revenue and would repair the present failures of the individual income tax as to corporate earnings and unrealised shareholder gains. Thus the corporate tax would become mainly the 'handmaiden' or assistant of the individual income tax.

A broader reform, to tax gain on all assets upon realisation with a throwback principle and an interest charge for deferral could moot the question of corporate tax integration and provide a first-best reform of the United States' individual income tax. An election of transparency treatment, as for PFIC's, would allow corporations to step out of the realisation (throwback) interest charge if they preferred.

## **Conclusion**

Rate changes and base broadening of the individual United States' income tax in recent years have not only improved the fairness and efficiency of that tax, but also have set the stage for new reforms. These include repeal of the wealth transfer taxes with inclusion of gifts and bequests in income, and integration of the corporate income tax—with a voluntary 'allocation' and current taxation even of undistributed corporate earnings. Such a corporate income tax structure would be more neutral with respect to corporate distribution policies than other integration plans and is made feasible by the newly instituted relationship between individual and corporate income tax rates and between ordinary income and long-term capital gain rates. The United States should seize the opportunity for these structural reforms now, before the budget deficit or other events overtake the tax reform process and destroy the conditions under which these reforms can be born and can prosper.