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Office Correspondence

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To Mr. Shere, Interdepartmental Tax
Committee

Subject: Integration of Corporate

From Richard A. Musgrave

and Individual Taxation

I have tried to straighten out my thinking on some points discussed in Monday's meeting and this is what I come out with.

To begin with, we should distinguish between two separate issues, namely, (1) coordinating the taxation of dividend income under the personal and the corporation income tax, and (2) adjusting the corporation income tax so as to encourage capital expenditures and to discourage the retention of liquid balances. Some proposals such as the exclusion of reinvested income from the corporate tax base might meet the second point but be of no help or even objectionable with respect to the first. Other proposals such as the exclusion of dividends paid from the corporate tax base would meet the first problem but its contribution to the second would be limited,--it might be helpful on the individual side but harmful on the corporate side. To avoid confusion we should consider these two issues separately and then combine what would seem the best solutions for each.

Coordinating the taxation of dividend income.

While the term double taxation may be misleading in some uses, it is true, nevertheless, that income from corporate equity capital is subject to both the corporate income tax and the individual income tax, while other types of income, say bond interest, is subject to the individual income tax only. If defined in this way, I see no objection to the term "double taxation". The coordination problem, then, falls into two parts:

- (1) To the extent that corporate income is distributed, the question arises whether the resulting combined rate of tax on corporate equity income is too heavy and if so how it should be reduced.
- (2) To the extent that corporate income is retained and the corporate rate falls below the individual rate, tax payment is postponed. How can this be met?

(1) With respect to (1), the problem is not so much whether corporations are discriminated against as such (surely there is no evidence that corporate enterprises suffer from undue disadvantages as compared to other forms of business), but whether the marginal rate of taxation on dividend income is too high, on equity grounds or with respect to risk taking.

If the level of rates is not considered excessive, would it not be better on economic grounds to substitute an increase in the personal income tax schedule for the present double taxation method? This would be simpler and have the advantage of submitting income other than corporate dividends to the same higher rates. But since for political reasons the feasibility of such an approach is very dubious, it may be argued that the "double taxation" technique is desirable as the one feasible way of increasing the degree of progression under the personal income tax.

In fact this point need hardly be answered since there is little doubt that the postwar revenue act will bring some tax reduction for middle and higher income groups. Considering the strong popular appeal of the "double taxation" argument as such, I think that it would be better to meet it (that is, to give some credit to dividend income) and then to insist on maintaining surtax rates at a fairly high level rather than to stand pat on the present treatment of dividends while yielding more on the personal rate schedule. Quite apart from being more feasible politically, I think that the first approach is also more sound economically because it would leave the tax rate on non-equity income at a relatively higher level.

Next there is the question of technique,--should the credit be given on the corporate or the individual side? I would favor the exclusion of dividends paid from the corporate base over the British method, mostly in order to avoid the extensive refund problem which the latter implies if the corporate rate is kept at a reasonably high level,--that is, at a level considerably above the first bracket income tax rate. Given, say a 35 per cent corporate rate on retained income, how much opposition along the lines of the undistributed profits tax controversy would there be to the "exclusion from the corporate base" approach? I doubt that it would be too serious, since what is involved is tax reduction, not a new tax. If reasonably acceptable politically, I would favor this approach. I figure that the resulting loss of yield would not exceed 2 billion dollars.

(2) With respect to (2), we can either force distribution by penalty taxation or find some means of taxing undistributed profits to the shareholder, or at least meet part of the problem by keeping a fairly high corporate rate on undistributed income.

The "penalty approach", designed to force distribution is not feasible. The "taxation to owner" approach is theoretically the only real solution, but it raises many difficulties. Nevertheless, the taxation of undistributed income via the stock dividend or partnership method should be considered carefully. As a minimum, corporations (perhaps below a certain size) might be given the option to be treated as partnerships for tax purposes. If this approach would not seem feasible, we would have to be satisfied at this point with taxing the retained income under the corporate rate; this would be far from satisfactory but if the corporate rate is kept up at a fairly high level, it might not be too bad.

My general conclusion with respect to the coordination problem is thus as follows: (1) exempt dividends from the corporate base; emphasize the resulting production in the combined rate on individual incomes and limit cuts in the surtax rates correspondingly; (2) keep a corporate rate of 35 per cent (30 per cent being a minimum) on the retained part of corporate income; (3) investigate the possibility of making retained income taxable to the individual, if not for all corporations, then at least for those which can use the partnership method (probably optionally).

Adjusting the corporation tax to provide investment incentives.

Assuming that dividends paid are excluded from the corporate base and that the corporate rate is kept at 35 per cent, what further changes in the corporate tax should be made to provide investment incentives?

Main emphasis should be placed on improving the definition of corporate net income. This includes the treatment of losses, the treatment of depreciation and the treatment of certain other expenditure items such as research. With respect to depreciation, I think that liberalization of the timing schedule should be considered but I am not sure that it would be desirable to permit 100% depreciation at the time a new investment is made. (This is the essence of Mr. Colm's scheme of including depreciation plus profits in the tax base, and making new investment outlays deductible. I understand that he would not apply his scheme to the present type of corporation tax, but to an additional tax.

applied to "public corporations" as such. This raises the problem whether there should be an additional and substantial per se tax on public corporations. For various reasons I believe not.) However, our program should go as far as reasonably possible toward improving the net income definition; thereby the most important incentive measures, possible on the corporate tax level, are taken.

There remains the question what additional incentives to investment may be given. Whatever can be done will, most likely, have to be done by allowing additional, not by disallowing present deductions. (Disallowing depreciation unless matched by expenditures would not be compatible with a reasonable definition of net income under which the investor would seem entitled to charge his depreciation against the net income from his investment without having to commit himself to a continued and permanent reinvestment of his funds.) The other approach mentioned at the last meeting--that is, Mr. Salant's scheme under which all new investment would be exempt from the corporate tax, in addition to present depreciation allowances--goes too far in reducing the corporate tax base. Under this scheme a very large part of corporate income would remain entirely untaxed. To the extent that corporate investment would occur even without the special incentive of tax credit, the only result would be a loss of yield equal to the corporate tax on the amount invested. To the extent that the plan would produce additional investment, this would constitute a net gain to be set off against the loss of yield on the tax side. On the whole I believe that the complete exemption of invested funds under the regular corporation income tax would be too radical a concession to the incentive argument.

The principle of giving some tax credit for investment may, however, be applied in a more moderate form, Gordon Keith's suggestion, for instance, that a credit be given (possibly at varying percentage rates) for new investment (that is to say, investment in excess of reinvestment of depreciation allowances) seems quite promising. This kind of credit would suffice to meet the argument that the exemption of dividends from the corporate base would be a deterrent to expansion, particularly for small corporations.

The matter of equity as against fixed debt financing remains to be considered. The relative disadvantage of fixed debt financing would be reduced considerably by the exemption of dividends from the corporate base and the crediting of net investment

expenditures, but some tax penalty on equity financing would still remain. However, I do not see how this problem can be solved entirely as long as the corporation tax is retained. Disallowing interest charges as a deduction would be a possibility but does not seem feasible or desirable.

Conclusion

In conclusion these steps are recommended as the most feasible solution to the coordination and incentive problem:

- (1) Exempt dividends from the corporate base, keeping individual surtax rates relatively high.
- (2) Lower the corporate rate to 35 per cent.
- (3) Liberalized treatment of losses, depreciation and certain other expense items under corporate tax.
- (4) Consider tax credits for net expansion under corporate tax.

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These notes were written prior to receipt of the Colm-Salant recommendation which, if I understand it correctly, proposes (1) to reduce the rate of the present corporation tax to 33% and permit full depreciation to be charged at the time of investment (in place of depreciation over time) and (2) to add a new 30% tax on net additions to corporate balances. However, the preceding discussion indicates my reaction to this plan: (1) I do not think that it meets the problem of tax treatment of dividends,--a problem which I think should be met; (2) I do not think it feasible, for purposes of the postwar Revenue Act to propose a tax on hoarding which would be a net addition to the existing corporation income tax, even though it may be technically feasible and economically sound. Such incentives as can be provided will have to be granted via well chosen reductions in present taxes, rather than via the imposition of a new penalty tax, particularly one as complex as the hoarding tax would have to be if proper assurances for averaging is given.