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National Bureau of Economic Research

Volume Title: The Income Tax Burden on Stockholders

Volume Author/Editor: Daniel M. Holland

Volume Publisher: Princeton University Press

Volume URL: <http://www.nber.org/books/holl58-1>

Publication Date: 1958

Chapter Title: Front matter, The Income-tax Burden on Stockholders

Chapter Author: Daniel M. Holland

Chapter URL: <http://www.nber.org/chapters/c2604>

Chapter pages in book: (p. -26 - 0)

THE INCOME-TAX BURDEN
ON STOCKHOLDERS

NATIONAL BUREAU OF ECONOMIC RESEARCH

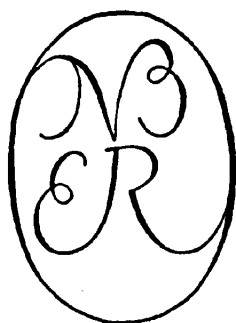
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The Income-Tax Burden on Stockholders

DANIEL M. HOLLAND

NEW YORK UNIVERSITY



A STUDY BY THE
NATIONAL BUREAU OF ECONOMIC RESEARCH, NEW YORK

PUBLISHED BY
PRINCETON UNIVERSITY PRESS, PRINCETON

1958

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Printed in the United States of America
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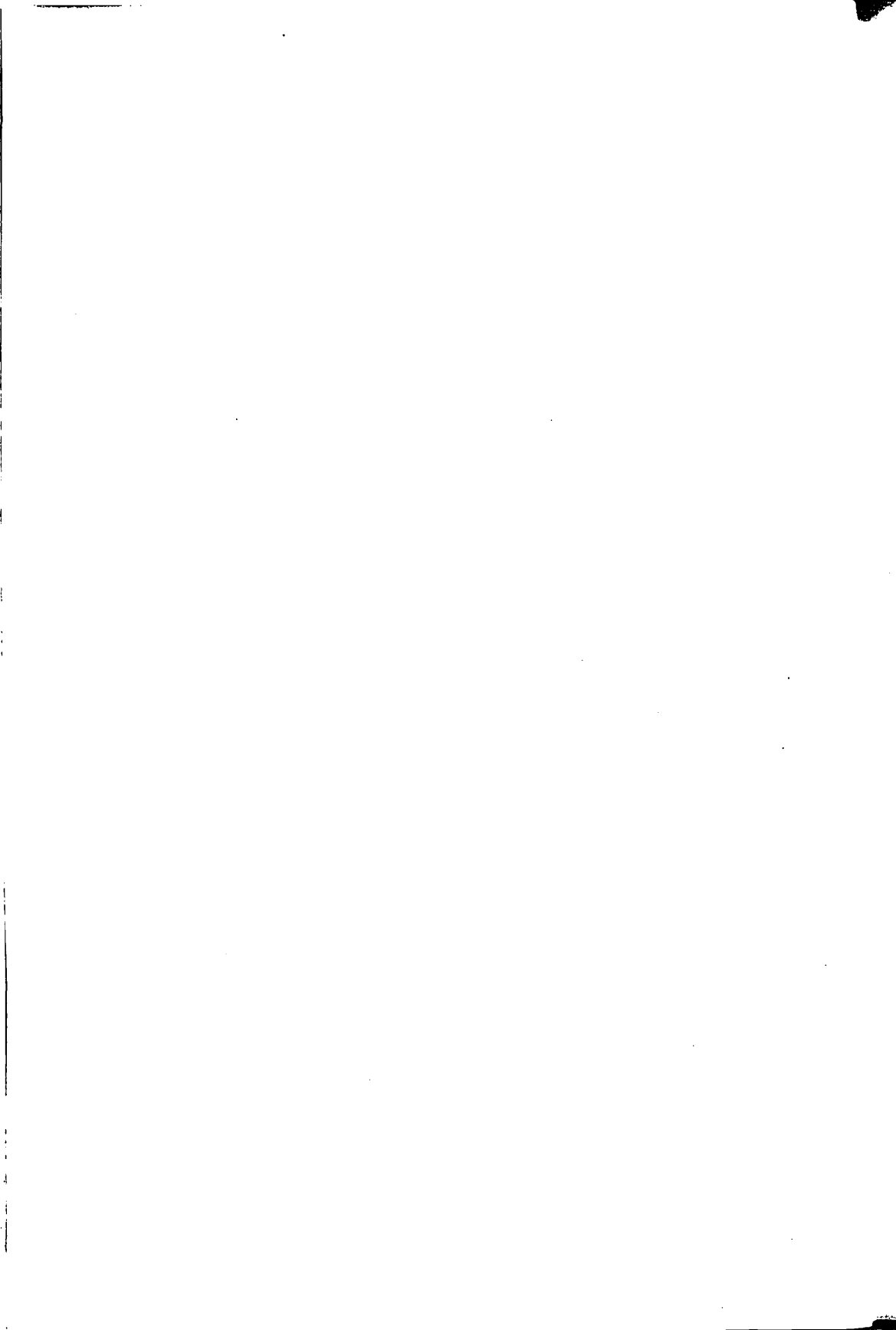
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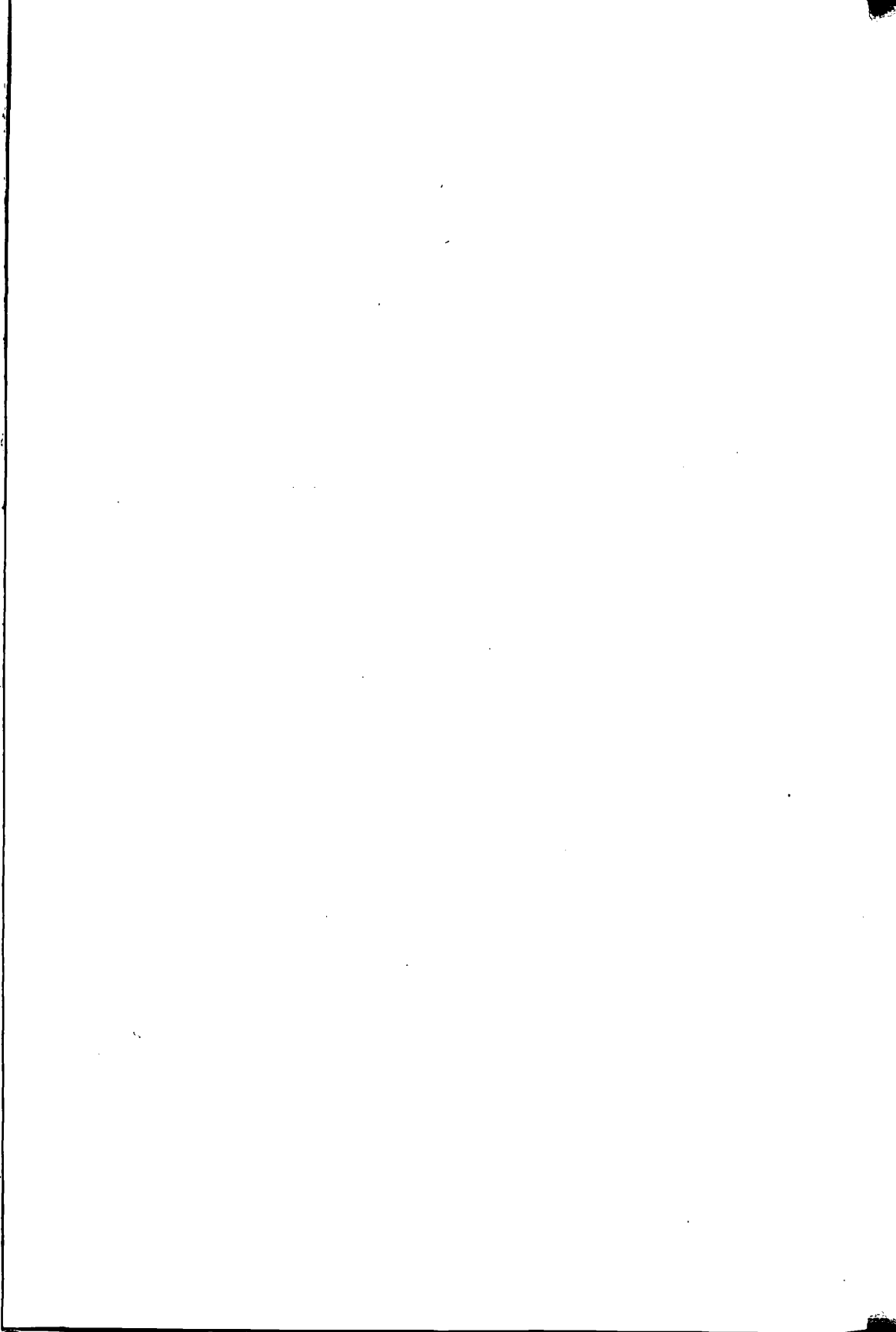
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TO MY MOTHER AND FATHER



Preface

THE existence of two income taxes on corporate earnings—a tax at the corporate level and another at the personal level when earnings are distributed—has long been a sore spot in our income tax structure. It is generally agreed that this leads to a rate of taxation for stockholders different from the rate for other income recipients.

But the extent of difference and even its direction—whether “overtaxation” or “undertaxation”—have been matters of controversy. By pointing to the distributed segment of corporate earnings it is a simple matter to demonstrate overtaxation.¹ By considering only the undistributed portion, undertaxation can be shown.

What is the net result when both distributed and undistributed corporate earnings are considered? This is our problem.

The attempt was made to measure the differential taxation of stockholders for 1940-1952 (excluding 1942 and 1943 because the necessary data are lacking). Most of the principles relevant to this problem have been developed by other investigators. The main concern here has been to provide quantitative evidence consistent with these principles, in order to show how heavy this overtaxation or undertaxation was, what factors determined its magnitude, and how much of a net difference it made to federal revenues in the years studied. The answers are not always entirely satisfactory, for the results are only as valid as the assumptions used in their derivation. One could, indeed, say that a major contribution of this study is to show the kinds of assumptions that must be made to solve the problem, and the quantitative effect of the choice of one set of assumptions rather than another. In particular, while most of these findings are based on the assumption that the corporation income tax rests on profits, others have been developed to show what happens to the estimates when it is assumed that half the tax is shifted, i.e. not borne by stockholders. Another test analyzes the effect of modifying the tax law definition of net income to take account of current costs of replacing inventory and depreciable assets. These are only two of a number of tests and alternative calculations that were made. But the results rest on many other assumptions which are spelled out in the body of the report. The reader should keep them in mind.

¹ Some words used repeatedly in the text are heavily laden with inferences which are highly controversial. “Overtaxation,” “undertaxation,” and related words are written with quotes only occasionally to remind the reader that they express allegations and not the views or opinions of the author. The reader is asked to “see” these terms in quotes when the marks are omitted in favor of appearance and readability.

PREFACE

The conclusions are, therefore, tentative at best. Certainly all questions are not answered, and the answers provided are subject to qualification. Yet headway has been made with the problem. The results should be useful to anyone who must grapple with the complexities of our tax system and is concerned with its effects and with distributive justice.

The findings are summarized in Chapter 8. It is desirable at the outset, however, to provide a general idea of what the reader may expect to find in the study. Here, then, are examples of conclusions that the reader will encounter below in more elaborate and quantitatively buttressed form.

1. Not all stockholders were overtaxed. Despite the double taxation to which they were subject, some stockholders were undertaxed. If their pro rata share of corporate earnings had been taxed promptly and in full as part of personal income, their tax liability would have been larger than it was under both the corporation and personal income taxes. This is because a sizable proportion of corporate earnings are not distributed, and for some stockholders the personal tax rate on such earnings if distributed would have exceeded the rate of corporation income tax.

Overtaxation was at its heaviest at the bottom of the income scale, dwindled as stockholder income rose, and turned into undertaxation at the top of the income range. The income level at which the change from overtaxation to undertaxation occurred varied from year to year, influenced by significant yearly variations in a number of factors. Among these are the height and progressivity of the personal income tax, the rate of corporate tax, the amount of corporate earnings, and the allocation of corporate earnings between dividends and retentions.

2. The revenue that would be yielded if all corporate earnings were taxed as part of personal income (an assumption treating stockholders as "partners" in corporate enterprise) has been compared with the combined yield from the existing corporation tax and the personal income tax on stockholders. The difference between the two proved to be surprisingly small. As of 1955, for example, the current net revenue contribution of the corporation income tax came to a sum that could also have been obtained from a 3 percentage point hike in the personal income tax rate (with stockholders' pro rata share of corporate earnings included in income). In another year, 1947, no increase in personal income tax rates would have been necessary to maintain federal revenues, for either tax structure—the existing two taxes on corporate earnings or the hypothetical taxation of all corporate earnings under the personal income tax alone—would have brought approximately

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the same amount of revenue. (See Chapter 6 for a qualification of these revenue estimates.)

3. If the corporate tax is actually shifted in whole or in part, the observations on over- and undertaxation need to be modified, not in general pattern but in magnitude. Overtaxation would be a less severe problem, undertaxation would be more important.

4. On the other hand, if corporate earnings were measured with reference to the current rather than the historical costs of maintaining inventory and replacing depreciable assets, then overtaxation is more severe than our usual method would indicate, and undertaxation is not as widespread.

5. Much has been made of the progressivity effect of the corporation income tax, since, if it is not shifted, its weight falls on a source of income highly concentrated in its distribution. But the analysis indicates this effect is uneven and indiscriminate at best. Stockholders with essentially similar taxable incomes were found subject to widely varying effective rates of tax because some had invested heavily and others lightly in corporate stocks. But even for "average" stockholders in each income class, the progressivity effect of the corporate tax is equivocal. The findings are to some degree dependent on the definition of progressivity used. Under one definition stockholders in lower income brackets were taxed more progressively because of the corporate levy. Under two other definitions, less progressive taxation of stockholders was the general rule.

6. Only a slight degree of relief is afforded most stockholders by the dividend exclusion and tax credit incorporated in the Internal Revenue Code of 1954. These provisions are designed to reduce somewhat the double taxation of distributed earnings. The extent to which such earnings are overtaxed varies inversely with the stockholder's income level, but the relief provisions are not directly geared to this relation. Therefore, considered in relation to the condition they are designed to alleviate, the credit and exclusion operate in somewhat capricious fashion.

The numerous qualifications to which this study's findings are subject are noted in the text. Some general omissions or noteworthy features of the study's approach should be mentioned here.

The investigation was limited to double taxation, without taking account of the possibility of triple taxation because of inclusion of 15 per cent of dividends received by corporations in the corporate income tax base. This omission, however, is not serious. Our basic measures would be changed very slightly by an adjustment on this score.

The study adopts one point of view. There are, of course, others.

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Double taxation, under- or overtaxation pose no problem for those who believe that the corporation as such is a proper subject for taxation.² (But even proponents of this point of view would probably recognize the problem raised by deliberate use of the corporation to avoid personal taxation.)

In general, the published statistics and the categories under which various items reported on tax forms are tabulated have been accepted. Except for a test calculation (see Chapter 4) no adjustments are made for underreporting of dividends or other sources of income. Moreover, no allowance is made for the fact that in some closely held corporations income tends to be paid out as officers' compensation, rather than as dividends, and therefore, free of corporate tax.

The note of caution sounded earlier bears repeating. The conclusions should not be accepted uncritically. The conceptual framework and statistical procedures, set forth in the first chapter and developed in concrete detail in the next two chapters, were selected from a number of possibilities. This must be considered in evaluating the findings and in using them properly.

Acknowledgments

THIS study was initiated while I was a Carnegie Research Associate at the National Bureau of Economic Research. Of the many people who have generously provided help and critical advice in the course of the work I am particularly indebted to: the late Robert Murray Haig for his aid and encouragement in the early stages of the investigation; Lawrence H. Seltzer for his continuing interest and suggestions from start to finish of the project; Arthur F. Burns who spelled out for me in a searching reading of an earlier draft what is involved in economic research; Richard B. Goode and W. Leonard Crum, for both the guidance and insights provided by their published work and the comments they made in critically reviewing an earlier draft of the manuscript.

In addition, at one stage of its development or another, I have benefited from a careful reading of the manuscript by Solomon Fabricant, Harold M. Groves, Clarence Heer, Thor Hultgren, Geoffrey H. Moore, Beardsley Ruml, Carl S. Shoup, and Richard Slitor. Helpful comments and suggestions were made by Percival F. Brundage, Gerhard Colm, Marius Farioletti, Michael Gort, C. Lowell Harris, A. G. Hart, C. Harry Kahn, Simon S. Kuznets, Eugene Lerner, George Lent, Maurice E. Peloubet, Marshall Robinson, Dan T. Smith, William S. Vickrey,

² See, for example, Gerhard Colm, "The Corporation and the Corporate Income Tax in the American Economy," *American Economic Review*, May, 1954, pp. 486-503.

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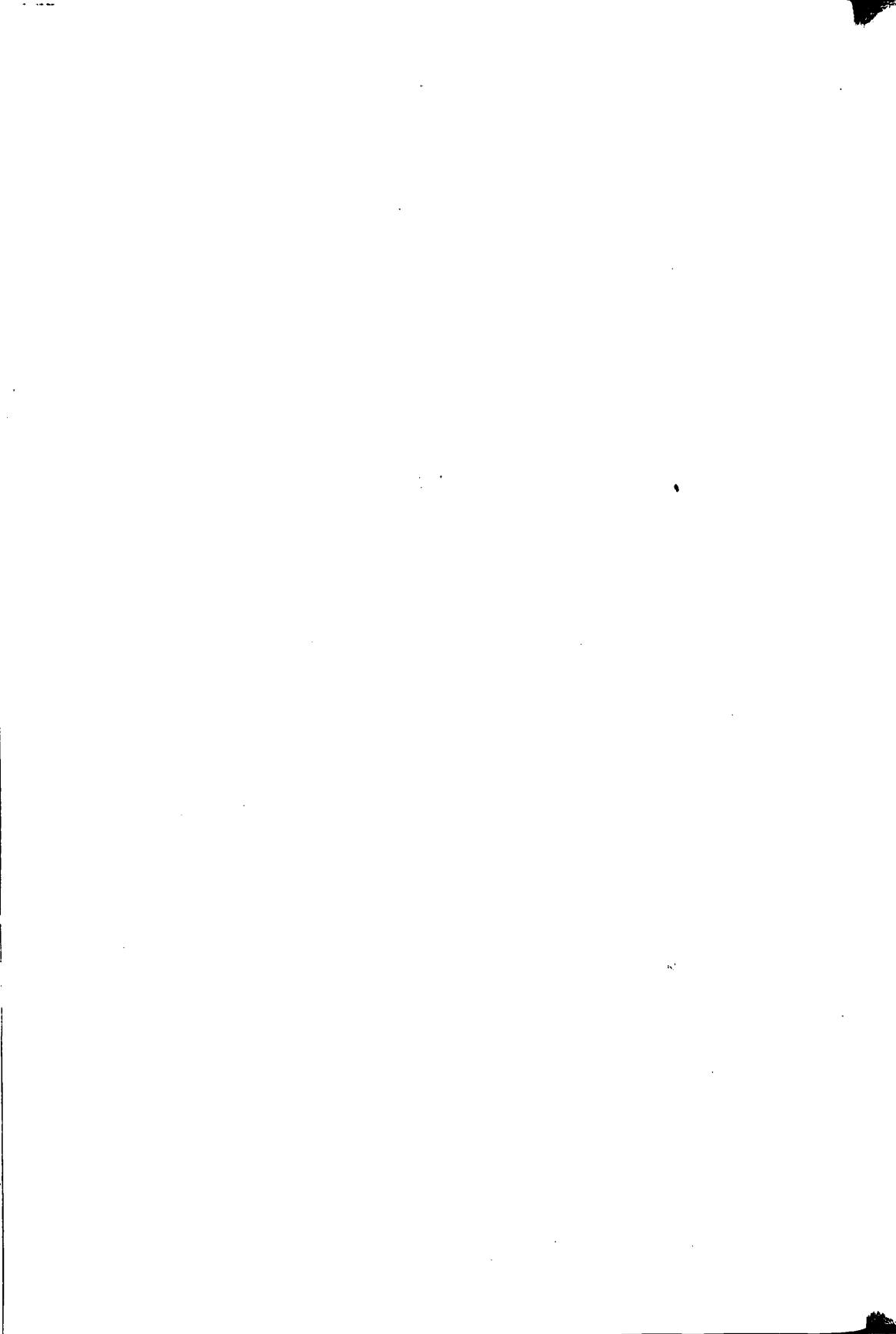
and Leo Wolman. I wish to thank Thomas R. Atkinson of the Federal Reserve Board of Atlanta who made unpublished materials available to me.

In the early stage of the project, Bella Kobocow helped me with the intricacies of *Statistics of Income*, and Gloria Moskowitz and Fred Stuart rendered computational assistance. Doris Eiseman and Mary Anne Crossot were responsible for most of the heavy burden of statistical work and helped me clarify a number of conceptual problems. Near the completion of the project Juanita Johnson with great ability and diligence took the data in hand, checked all the computations, and generally helped to put the pieces together. In this difficult task, her "strength was as the strength of ten."

Louise Cooper improved the language of an earlier draft. To Margaret T. Edgar who painstakingly edited a later version and whipped the manuscript into final shape, I am particularly grateful. H. Irving Forman, with characteristic skill, drew the charts. Dorothy Chesterton and her typing staff met the challenge of my handwriting with dignity and perseverance.

While all those cited helped to shape the study, this does not mean that they are to be identified with either its point of view or its procedures. Quite the contrary is true in a number of cases. For the study's conclusions and errors I alone am responsible.

DANIEL M. HOLLAND



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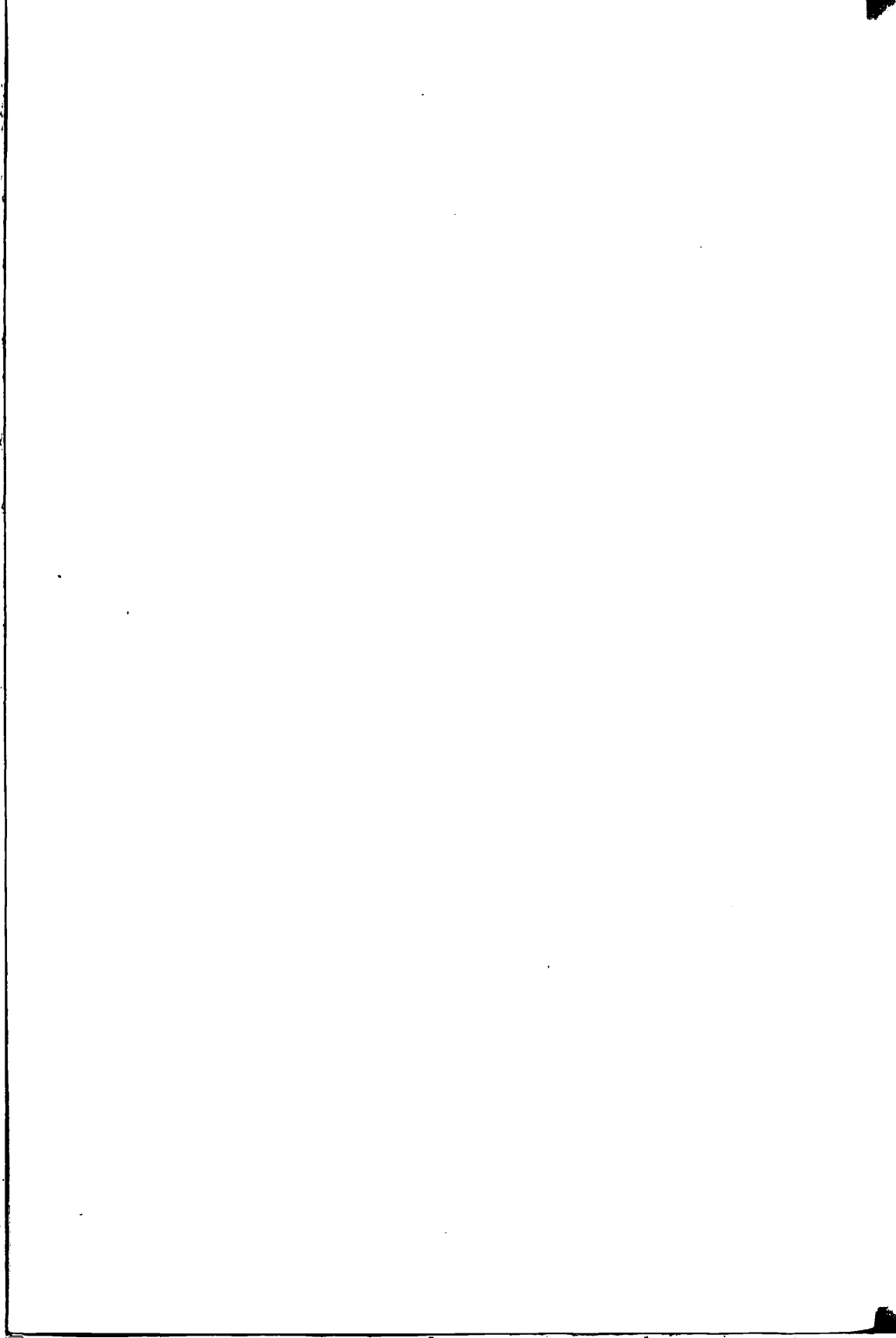
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