FINAL REPORT

"TAX LAW EFFECTS ON BUSINESS CONCENTRATION"

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Introduction

Business concentration is measured in terms of market concentration (the share of a market controlled by a given number or percentage of firms) and by aggregate concentration (the percentage of total assets, receipts or value added provided by a given number or percentage of firms in our economy). Increases in market concentration are regulated primarily by the antitrust laws but such laws only have peripheral impact on increases in aggregate concentration. Increases in aggregate concentration of business can however have profound impact on our social, political and economic status. The purpose of this paper is to study how the tax laws may discriminate against small and medium size businesses and in favor of large businesses, thereby increasing aggregate concentration or decreasing business concentration less than would occur with a neutral tax system.

Aggregate Concentration Trends

Aggregate concentration can be measured by a number of yardsticks, e.g., assets, business receipts, value-added. Also, it is possible to utilize various standards of reference, i.e., absolute number of firms; absolute asset size, business receipts size or value-added size; percentage of firms. Use of any one of these yardsticks or standards of reference has its shortcomings, but greater reliability and different meaning can be attached to consistent results obtained from use of a number of such concentration measures.
As the following table illustrates most of the business receipts were earned by corporations and most of the concentration of business receipts in firms with over $10 million in receipts resulted from corporate receipts.

Table 1
Percent of Total Business Receipts by Form of Business and Size of Receipts

<table>
<thead>
<tr>
<th>Size of Business Receipts</th>
<th>Under 100,000</th>
<th>100,000- 500,000</th>
<th>500,000- 1,000,000</th>
<th>1,000,000- 10,000,000</th>
<th>Over 10,000,000</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorships</td>
<td>4.09</td>
<td>3.57</td>
<td>.72</td>
<td>.76</td>
<td>.08</td>
<td>9.22</td>
</tr>
<tr>
<td>Partnerships</td>
<td>.51</td>
<td>1.19</td>
<td>.47</td>
<td>1.11</td>
<td>.68</td>
<td>3.96</td>
</tr>
<tr>
<td>Corporations</td>
<td>.86</td>
<td>4.45</td>
<td>3.58</td>
<td>16.78</td>
<td>61.15</td>
<td>86.82</td>
</tr>
<tr>
<td></td>
<td>5.46</td>
<td>9.21</td>
<td>4.77</td>
<td>18.65</td>
<td>61.91</td>
<td>100.00</td>
</tr>
</tbody>
</table>

For purposes of comparison, Table 2 is included below to illustrate the make-up of business by size of receipts in 1965.

Table 2
Percent of Total Business Receipts by Form of Business and Size of Receipts

<table>
<thead>
<tr>
<th>Size of Business Receipts</th>
<th>Under 100,000</th>
<th>100,000- 500,000</th>
<th>500,000- 1,000,000</th>
<th>1,000,000- 10,000,000</th>
<th>Over 10,000,000</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorships</td>
<td>8.15</td>
<td>4.47</td>
<td>.87</td>
<td>.82</td>
<td>-</td>
<td>14.31</td>
</tr>
<tr>
<td>Partnerships</td>
<td>1.25</td>
<td>2.04</td>
<td>1.99</td>
<td>-</td>
<td>-</td>
<td>5.28</td>
</tr>
<tr>
<td>Corporations</td>
<td>1.39</td>
<td>6.44</td>
<td>5.25</td>
<td>20.16</td>
<td>47.17</td>
<td>80.41</td>
</tr>
<tr>
<td></td>
<td>10.79</td>
<td>12.95</td>
<td>8.11</td>
<td>20.98</td>
<td>47.17</td>
<td>100.00</td>
</tr>
</tbody>
</table>

The changes in percentage of business receipts between 1965 and 1975 reflect in part the effects of inflation and growth of existing firms into larger size categories. Substantial reductions in the percentage business receipts of small and medium size firms (receipts under $10 million) sug-
gests that other factors also might have had a significant effect on increasing business concentration, e.g., the closing of many small grocery stores, their market being now served by large chain groceries, the merger of small businesses into larger ones.

Since corporations have such a large proportionate share of total business (86.8% in 1975), it is informative to see in more detail how aggregate concentration has changed in corporate business.

Table 3
Percent of Assets by Asset Size for Different Years
All Active Corporations

<table>
<thead>
<tr>
<th>Year</th>
<th>Under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-50 million</th>
<th>50-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>1.82</td>
<td>4.35</td>
<td>2.82</td>
<td>10.85</td>
<td>6.25</td>
<td>14.80</td>
<td>6.76</td>
<td>52.36</td>
</tr>
<tr>
<td>1964</td>
<td>1.76</td>
<td>5.27</td>
<td>2.92</td>
<td>9.55</td>
<td>5.49</td>
<td>14.44</td>
<td>6.90</td>
<td>53.67</td>
</tr>
<tr>
<td>1974</td>
<td>1.73</td>
<td>5.60</td>
<td>2.92</td>
<td>7.75</td>
<td>4.30</td>
<td>12.88</td>
<td>6.34</td>
<td>58.48</td>
</tr>
<tr>
<td>1974</td>
<td>.90</td>
<td>3.22</td>
<td>2.04</td>
<td>4.96</td>
<td>2.66</td>
<td>9.28</td>
<td>5.00</td>
<td>71.94</td>
</tr>
</tbody>
</table>

It might be expected that natural growth and inflation would have had a more even-handed impact on business size than is illustrated in Table 3, even taking into account the fact that the over $100 million assets size group is a closed end which will grow by growth of firms in that category and by the addition of new firms to that category and decrease by firms which get smaller and move to a lower group. (Asset size groups under $100 million grow by new additions to their groups but decrease by firms whose growth moves them into the next higher group) or whose losses move them into the next lower
group.) To gain further insight into the closed end effect we can compare percentage of total assets owned by an absolute number of largest firms and by a percentage of total firms with the over $100 million asset size group.

Table 4
Percent of Assets Owned by Largest 4000 and .2% of Firms and Firms with Over $100 million in Assets
All Active Corporations

<table>
<thead>
<tr>
<th>Year</th>
<th>Top .2 Percent</th>
<th>Largest 4000</th>
<th>Over $100 million assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Firms</td>
<td>Assets</td>
<td>Number of Firms</td>
</tr>
<tr>
<td>1945</td>
<td>842 57.11%</td>
<td>73.15%</td>
<td>542 52.36</td>
</tr>
<tr>
<td>1954</td>
<td>1610 59.56%</td>
<td>68.44%</td>
<td>932 53.67</td>
</tr>
<tr>
<td>1964</td>
<td>2747 62.80%</td>
<td>66.53%</td>
<td>1758 58.48</td>
</tr>
<tr>
<td>1974</td>
<td>3932 72.25%</td>
<td>72.37%</td>
<td>3755 71.94</td>
</tr>
</tbody>
</table>

The top .2% and top 4000 were chosen because they represent approximately the same number of firms as had over $100 million in assets in 1974. Examination of the percentage of assets owned by the largest 4000 firms in 1945 and 1974 shows no significant change in concentration of asset ownership, the largest 4000 owning 73.15% of total corporate assets in 1945 and 72.37% in 1974. Between 1945 and 1974 the total new investment in all corporations (financed by new stock issues, increases in retained earnings and increased borrowing) "appears to have been" made by the top 4000 and all others in proportion to their asset ownership in 1945. The term "appears to have been" was used because of the possibility that some of the growth of the top 4000 was attributable to mergers. Growth through merger, rather than consisting of additions to the total of corporate investment, merely combines the existing corporate investment of two or more firms. The merger im-
pact becomes a more likely explanation of growth when the 1964-1974 period (a period of very high merger activity) is compared with the 1945-1964 period. During the 1945-1964 period the top .2 percent of corporations in asset size experienced moderate increases in their percentage ownership of total corporate assets and the largest 4000 experienced a decline in their percentage ownership of total corporate assets. During the period 1965-1974 the number and dollar value of large acquisitions (over $10 million) was substantially greater than for the 1945-1964 period. It was during this time period between 1965 and 1974 that the large corporations experienced their greatest growth in percentage ownership of total corporate assets. The hypothesis that mergers were a substantial cause of increased aggregate concentration is buttressed by data showing that on the average, very large non-financial corporations have substantially smaller percentage increases in retained earnings than small and medium size corporations and have lower debt to equity ratios than small and medium size corporations. See discussion infra, Corporations-Retained Earnings. Since adequate historical data on merger activity of all active corporations or all non-financial corporations is not available further analysis is limited to mergers in mining and manufacturing.
Table 5

Mining and Manufacturing Corporations (with Balance Sheets)
Percentage of Asset Ownership by Asset Size Group

<table>
<thead>
<tr>
<th>Year</th>
<th>Under 25 million</th>
<th>25-100 million</th>
<th>100-250 million</th>
<th>Over 250 million</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954 Number</td>
<td>634</td>
<td>138</td>
<td>95</td>
<td></td>
<td>193,782</td>
</tr>
<tr>
<td>Assets</td>
<td>30,007</td>
<td>20,935</td>
<td>76,268</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percent of Total</td>
<td>15.5%</td>
<td>10.8%</td>
<td>37.8%</td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>1974 Number of Firms</th>
<th>1,358</th>
<th>415</th>
<th>469</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>65,763</td>
<td>64,073</td>
<td>662,232</td>
<td></td>
</tr>
<tr>
<td>Percent of Total</td>
<td>71.0%</td>
<td></td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>
minimize the total growth in asset ownership attributable to mergers and without a doubt understate growth attributable to mergers, but is necessary absent more detailed data. Based on these assumptions over 31% of the increase in percentage asset ownership of the largest 469 firms between 1954 and 1974 (4/12.8) was attributable to mergers between firms in the largest 469 category.

A more accurate measure of concentration attributable to mergers could be constructed by using more detailed data on individual firms and taking into account additional factors such as 1) acquisitions by the largest 469 firms of smaller firms in mining and manufacturing, 2) acquisitions by the largest 469 firms outside the mining and manufacturing industries and 3) acquisitions of mining and manufacturing firms by firms in other industries. However, the preliminary analysis above provides ample support for the thesis that measures of aggregate concentration by comparison of asset ownership of the largest 100, 200, 500 or 4000 will understate aggregate concentration unless adjustments are made for additions to the number of firms in the group attributable to mergers. The above analysis also supports the hypothesis that mergers are a substantial cause of increased aggregate concentration or at least, constitute a substantial hinderance to deconcentration from natural market forces.
II. Tax Policy at the Individual Taxpayer Level

Our present Federal Income tax system does not include within the definition of income all economic gains and losses, but only those which are "realized." Unrealized appreciation in the value of property owned by a taxpayer is not taxed as income, nor is the taxpayer allowed a deduction for unrealized losses. Arguably the economists' definition of income as all increases in wealth would provide a better tax base than "realized income," creating greater horizontal and vertical equity amongst taxpayers and eliminating tax deterrents to the free movement of capital. One reason we are unlikely to witness abandonment of the realization concept and adoption of an economic income tax base is that such a change would require annual valuations of each taxpayer's assets and liabilities, an enormous administrative task. Another reason for not adopting an economic income tax base is the possible detrimental effect on capital investment.

More recent proposals to reduce the unfairness, economic inefficiency and complexity of the realization income tax have turned to consumption-expenditures taxes, the two most important being the Value Added Tax (VAT) and the progressive consumption expenditures tax. Because the VAT is a proportional rather than a graduated tax, VAT proponents have not suggested complete repeal of the tax on realized income but merely some rate reductions in the tax on realized income. Thus the VAT if enacted would not eliminate but would merely reduce the size of the realization
problem. A progressive consumption expenditure tax, if based on cash flow treatment of investment assets and loans (92 Harvard L. Rev. at 1610) and if coupled with repeal of the corporate income tax (Id. at 1637), could eliminate "realization" problems. However, practical problems of implementing a progressive consumption expenditures tax appear to be very substantial and the likelihood of enactment of such a tax is small. See generally, Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979). Thus, the realization problem is likely to be a continuing one under our tax system, although its importance might be reduced somewhat by the enactment of a value added tax and reduction in tax rates on income.

Because the tax base for our income tax is "realized income" it is difficult to discuss tax policies such as fairness and economic efficiency. The issue with respect to any particular tax law provision will be fairness or economic efficiency compared with what alternative? For example, should fairness (horizontal and vertical equity) and impact on allocation of resources of a preferential tax provision be tested by consumption expenditures or a tax on realized income? If the proper comparison is with a tax on all "realized income" than any deviation from that concept would be unfair and create misallocations of resources. But the realization concept itself is arguably "unfair" and causes misallocations of resources; the preferential provision at issue was probably enacted in the first place to reduce such "unfairness" and "misallocation of resources." Thus
preferential treatment of long-term capital gains are defended on grounds of fairness (bunching of income, gain represents impact of inflation and not gain in real dollar economic power) and economic efficiency (less deterrent to free movement of capital). Non-recognition of gain or loss on incorporation of a going concern is justified by fairness (lack of change in substance of underlying investment) and economic efficiency (promote movement of capital between alternative forms of doing business). When in fact most of the tax code's provisions are there to create and then to limit exceptions to the realization concept, it is arguable that our tax base is not realized income, but rather is more like a consumption expenditure tax base.

Evaluating Impact on Allocation of Resources

Given the numerous and substantial deviations from a realized income base for our income tax system, economic impact of a particular tax provision on the allocation of resources must be determined by comparison with two hypothetical alternatives: 1) economic impact if only this particular tax law provision were changed, and 2) economic impact if there were no income tax law. Assume that the particular provision produced result X, elimination of that particular provision would produce result Y and no income tax would produce result Z. If X is further from Z than Y, one could conclude that the particular tax law provision has caused misallocations of resources under the assumption that the market place would have determined the most efficient allocation of resources at point Z. The problem is, of course, to estimate points Y and Z, a difficult if not im-
possible task given the complexity of our tax system, the unique and changing situations of individual taxpayers and the interaction of that complex system on those unique and changing situations.

Evaluating Fairness

Fairness of a particular tax law provision can only be determined by comparing economic effects of that provision with two alternative hypothetical situations: 1) economic effect if this particular provision were eliminated or changed, and 2) economic effects of a fair tax system. Obviously a different commentators will have different views as to what is a fair tax system, many probably correlating fairness with an economic income tax base, some correlating fairness with a consumption expenditure tax base, others with a realized income tax base.

Conflict Between Fairness and Economic Goals

In terms of fairness it is arguable that economic income is the best base because it will result in taxation of all increases in wealth. However, an economic base for income will result in a tax bias against saving and in favor of consumption since income used for consumption is taxed only once but income used for savings is taxed twice—once when earned and again when those savings earn income. The double tax on savings can be comprehended by comparing consequences of savings in a system without taxes with consequences of savings under an income tax.

If there were no taxes and Taxpayer earned $1000, he could choose between immediate consumption or savings (deferred consumption).
If the savings could be expected to generate a 6% return in the future, the choice for Taxpayer would be between immediate consumption of $1000 now or deferred consumption of $1000 plus about $60 per year in the future, e.g., $2012.21 at the end of 12 years (assuming the income stream is also invested at 6%). If a 50% tax is applied to all income (under either an economic income base or a realized income base) the choice for Taxpayer would be between immediate consumption of $500 or deferred consumption of $500 plus about $15 per year in the future, e.g., $712.87 at the end of 12 years (assuming the net income stream is also invested at 6%). In the no tax situation the choice is between $1 of current consumption or $2.12 of consumption 12 years later; in the tax situation the choice is between $1.00 of current consumption of $1.43 of consumption 12 years later. In order to maintain the $1.00 to $2.01 ratio for the choice between current and deferred consumption either the initial amount of earnings which were saved ($1000) or the stream of income produced by the initial savings must not be taxed. See The Effects of Tax Policy on Capital Formation, 60-61 (Financial Executives Research Foundation, 1977). To the extent our current tax system defers taxation of unrealized gains, provides exclusions for certain types of dividend income and taxes long-term capital gains at preferential rates our current system ameliorates the bias in favor of consumption (although it may cause misallocation of capital).
The bias against deferred consumption (saving) can be defended by changing our reference point for ascertaining fairness i.e., by comparing economic consequences of income taxes on salary income with consequences of income taxes on investment income. If all income in the above hypothetical were from wages, the wage earner would have only $712.87 of net spendable income at the end of 12 years. Can we say there is a bias against deferred consumption when the taxpayer with investment income is taxed no more heavily than the wage earner? On the other hand might it be argued that the above hypotheticals understate the negative impact of taxes on savings since savings with no taxes would have been $2012 but with taxes were only $712?

The extent to which double taxation of deferred consumption will cause the rate of return on capital investments to increase or will cause less capital investment is not known. To the extent the increases in the rate of return on capital investment offset the tax on earnings from capital, the tax will be shifted from savers to consumers and/or labor. To the extent such double taxation reduces investment and increases consumption, wealth increases of savers are minimized but the economy as a whole may suffer from the lower amount of investment. Thus, the fairness of taxing all increases in wealth as income may be more apparent than real and to the extent such tax burden is really born by the saver, may have damaging effects on the economy as a whole.
A somewhat similar problem of tension between fairness (in terms of wealth) and economic impact on savings exists due to progressive tax rates. Since most savings come from the wealthiest taxpayers, progressive rates will tend to reduce savings more than would a flat tax rate. This impact on savings produced by progressive income tax rates is substantially mitigated under our current tax law by income tax "loopholes" and by other regressive taxes such as Social Security taxes, state and local sales taxes, etc. Progressive rates with "loopholes" reflect Congressional response to the competing values of "fairness" and perceived needs for increased savings to promote economic growth. See generally, Boris Bittker, Income Tax "Loopholes" and Political Rhetoric, 71 Mich. L. Rev. 1099 (1973).

Recommended Policy Choices

Although the primary thrust of this paper is to deal with the effects of the tax laws on the size structure of business entities, tax effects of proposed reforms on individual taxpayer fairness, the distribution of wealth among individuals, savings and investment cannot be ignored. In general, this author favors those modifications of the income tax law which would make it more like a progressive consumption expenditures tax, e.g., by providing tax preferences for savings and reinvestment of business earnings. As long as capital is concentrated in the hands of the wealthy, most attempts at wealth redistribution through the tax system will result in decreasing capital available for
investment (by taking money away from the wealthy) and increasing consumption expenditures (by transfer payments to the poor and the provision of governmental services). As previously noted, our progressive income tax scheme is substantially negated by the realization concept, non-recognition of income provisions, preferential tax rates applicable to long-term capital gains, allowable deductions in excess of economic cost and tax credits for specific types of investments. These tax preferences are, in general, justified by the need for the tax system to not deter and, in some cases, to provide incentive for new capital investment. Almost all of these tax "loopholes" are available primarily to the wealthy, i.e., those who own most of the capital. True wealth redistribution can occur only if the tax laws encourage savings and wealth accumulation by less wealthy taxpayers. Examples of such wealth redistribution tax law provisions are discussed throughout this report, e.g., pension plans, ESOP's and proposed legislation to encourage savings.

Tax Shifting

Effective tax burdens on business income might be shifted to consumers, employees or others so that the burden of increased taxes and the benefits of decreased taxes on business would not impact on business owners, but such burdens and benefits would flow to consumers, employees and others. For example, the benefits of oil depletion allowances, it has been argued, have resulted in lower gasoline prices for consumers and not in larger profits for oil companies. One study conducted by Krzyzariak and
Musgrave, The Shifting of the Corporate Income Tax (1963) concluded that the tax is completely shifted in the short run. W. Klein, The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics, 1965 Wisconsin L. Rev. 576, The general consensus however, appears to be that we just do not know whether or the extent to which the corporate income tax is shifted, see Klein, id. at . Neither deductive logic nor empirical studies have been able to conclusively unravel the mysteries of tax shifting and tax incidence.

In general, the analyses in this paper are based on the assumption that tax burdens and benefits are not shifted, or if they are shifted, they are shifted to consumers. Compare, S. Shurrey, Value-Added Tax: The Case Against, 48 Harvard Business Review 86, 90 (Nov. - Dec. 1970) where it is predicted that most economists would advise lawmakers to assume that there was no shifting for policymaking progress. Adoption of this assumption that business taxes are not shifted is not unreasonable for the purposes of this study to determine discriminatory impacts of various tax law provisions on small and large businesses. To the extent the burdens and benefits of such discriminatory tax laws are shifted to consumers or employees, the comparative size and viability of large in relation to small business are affected in much the same way they would be affected if the burdens and benefits accrued directly to the business owners. For example, assume a tax law provision which reduces the effective tax rate on large business income which is not available to small businesses.
Further assume that large businesses shift this entire tax benefit to their employees (in the form of higher wages) and customers (in the form of lower prices). The shifting may occur because the large business is more interested in growth than profit maximization (compare John Kenneth Galbraith, the New Industrial State), is in competitive markets which force the price reductions, is faced by strong unions which will demand higher worker pay as profits rise or for other reasons. To the extent the tax benefits are not shifted to employees or to small business (e.g. in the form of higher prices paid small business for raw materials and supplies, lower prices on goods sold to small business) the tax benefits will probably result in the growth of large business in comparison with small business.

Although the rate of return on investment to large businesses does not increase, the total amount invested in large business and total returns to large business owners will grow as a result of expanded sales induced by price reductions.

Obviously, because of complexity of the market system and aberrations thereof in our economy, the incidence of business tax benefits and burdens is not subject to simple solution. The conclusion that tax preferences for large businesses result in the growth of large businesses vis-a-vis small business is based on the assumption that such tax preferences increase the rate of return to large corporate owners in the short run and increase investment in large business in the long run or that such tax preferences result in increased sales by large business induced by price reductions which again results in large business growth. These assumptions, although not accurate in all cases, are probably
sufficiently accurate to merit their use. Further justification for use of these assumptions can be posited on the rationale that public policy implications of business concentration in large firms warrants the use of "worst possible" assumptions about economic effects when economic effects cannot be accurately ascertained.

Tax Policy at the Business Enterprise Level

A. Tax Structure for Business

Four basic forms of business are recognized for tax purposes: Sole proprietorships, partnerships, Subchapter S corporations and corporations. Sole proprietorships, partnerships and Sub S corporations do not pay tax at the business entity level, instead income or loss from such businesses flow through to the individual owners and are netted with other income and losses of such owners. The earnings of corporations are subjected to double taxation in the sense that such earnings are taxed to the corporation when earned under the corporate income tax and the net after corporate tax is taxed as income to the shareholders when distributed as dividends.

Business Losses

Corporate losses do not currently flow through to the individual shareholders, such losses being realized only upon disposition of investment in the corporation by the shareholder. Losses of partnerships and Sub-S corporations flow through as incurred to owners to the extent of their basis in their partnership or Subchapter-S interest. Beginning in 1979 losses of part-
nerships and Sub-S corporations as well as losses of sole proprietorships flow through to the individual owners only to the extent of the owners "at risk" investment in the business. I.R.C. § 465. Although the at risk limitations restrict the flow of business losses to individual owners of sole proprietorships, partnerships and Sub-S corporations such business forms still have a loss pass through advantage in comparison with corporations since they can still pass through current operating losses as offsets against ordinary income of the business owners whereas corporate losses usually will be recognized by shareholders as capital losses only upon sale of their shares or liquidation of the corporation.

The preferential treatment of sole proprietor, partnership and Sub-S losses appears justifiable at least during the early years in the business life, as an incentive to new business formation. Most new businesses are formed as sole proprietorships, partnerships or Sub-S corporations. Arguably the new business formation justification suggests that similar loss flow through treatment be accorded new corporations as well as these other business forms. In fact, I.R.C. section 1244 does extend the benefit of ordinary loss treatment to individual shareholders in corporations on the first $1,000,000 of stock issued, however, such ordinary loss cannot be recognized until there is a sale or other disposition of the stock by the individual shareholder.
Another justification for such preferential loss pass through is the encouragement of small business, almost all sole proprietorship, partnerships and Sub-S corporations being small businesses

Table 6

BUSINESSES BY TYPE AND SIZE OF RECEIPTS

<table>
<thead>
<tr>
<th>Number of Businesses</th>
<th>Percent of Total Receipts by Size and Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Under 100,000</td>
</tr>
<tr>
<td>Sole Proprietorships</td>
<td>10,881,969</td>
</tr>
<tr>
<td>Partnerships</td>
<td>1,072,790</td>
</tr>
<tr>
<td>Sub-S Corporations</td>
<td>358,413</td>
</tr>
<tr>
<td>Corporations</td>
<td>1,665,234</td>
</tr>
</tbody>
</table>

* Statistics of Income, 1975 does not separate out Sub-S corporations from regular corporations by size of business receipts but only by size of assets. Since relatively few Sub-S corporations fall into large asset size groups in comparison with all active corporations, it is suspected that Sub-S corporations' receipts would fall predominantly in the receipts size groups under $1,000,000.

Finally, current deduction of losses by sole proprietors and owners of partnerships and Sub-S corporations may be defended as the corollary of taxing business earnings currently to such owners. Owners of regular corporations are not taxed currently at the individual level if the earnings are retained in the corporation.

**Business Earnings**

Corporate income and individual income are taxed at different rates. Following is a rough comparison of marginal and effective tax rates for individuals and corporations:
Table 7

<table>
<thead>
<tr>
<th>Taxable Income Size</th>
<th>Approximate Marginal Rate</th>
<th>Approximate Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individual</td>
<td>Corporation</td>
</tr>
<tr>
<td>$10,000</td>
<td>18%</td>
<td>17%</td>
</tr>
<tr>
<td>25,000</td>
<td>32%</td>
<td>17%</td>
</tr>
<tr>
<td>50,000</td>
<td>49%</td>
<td>20%</td>
</tr>
<tr>
<td>75,000</td>
<td>54%</td>
<td>30%</td>
</tr>
<tr>
<td>100,000</td>
<td>59%</td>
<td>40%</td>
</tr>
<tr>
<td>500,000</td>
<td>70%</td>
<td>46%</td>
</tr>
<tr>
<td>1,000,000</td>
<td>70%</td>
<td>46%</td>
</tr>
<tr>
<td>10,000,000</td>
<td>70%</td>
<td>46%</td>
</tr>
</tbody>
</table>

Tax policy literature is replete with references to the unfairness and economic inefficiency attributable to the double taxation of corporate earnings (once at the corporate level and again at the shareholder level) in comparison with the taxation of income from sole proprietorships, partnerships and Sub-S corporations only at the individual level.

Unfairness of the corporate tax can be illustrated by comparing tax consequences of corporate investments by high bracket and low bracket individuals. Assume Low Bracket taxpayer earns $25,000 of taxable income (putting him in an effective tax bracket of 18%) and High bracket investor earns $500,000 of income (putting him in an effective tax bracket of 64%). Each invests $1,000 in corporation X which is in a 46% effective tax rate bracket and which earns a 10% return on these shareholders' investments ($100 earnings on each $1,000).
Regardless whether corporate earnings are retained or distributed the burden of the corporate income tax falls more heavily on the low bracket than the high bracket investor. For High Bracket investor the corporate income tax may result in tax savings rather than a tax burden where corporate earnings are retained. These retained earnings might escape income tax completely at the shareholder level if the shareholders hold these stocks until death, giving their heirs a stepped-up basis in the stock which could be sold without generating taxable gain. Sale of the stocks by the shareholder during their lifetime would presumably generate long-term capital gain, 40% of which would be included in their income. The preferential treatment of long-term capital gains combined with the deferral of taxation on such gains would make such deferred long-term capital gains tax equivalent to an extremely low current tax rate. See A. Harberger and M. Bailey, The Taxation of Income from Capital (The Brookings Institution 1969) at p. 11 where it is estimated that such deferrals are sufficiently long to convert a 25 percent capital gains rate into the equivalent of a 7% current tax rate.
Economic inefficiency may be attributed to the corporate tax because of the excess tax burden on corporate source earnings and the "lock in" effect on retention of earnings to avoid tax at the shareholder level. A rough approximation of the excess tax burden caused by the double taxation of corporate earnings computed by George Break and Joseph A. Peckman indicates that for 1976 such double taxation produced $19.4 billion of revenues more than would have been produced by eliminating the corporate income tax and imputing all corporate earnings to shareholders. Of the $19.4 billion excess burden, about $12.5 billion was borne by tax-exempt organizations owning corporate shares and $6.9 billion was borne by individual investors. Break and Peckman, Relationship Between the Corporate and Individual Income Taxes, 28 Nat'l. Tax J. 341, 349 (1975). No approximations of the lock-in effect on retained earnings are available, nor is it likely that such an approximation could be made. Although we might predict that the double taxation of distributed corporate earnings has some impact on resource allocation, it is impossible to estimate such impact without more precise knowledge than is currently available regarding the incidence of the corporate income tax and the impact of the lock-in effect on corporate earnings in the context of our tax system, replete with loopholes and tax preferences. For example, the excess burden of the corporate income tax is relatively small, the tax burden on corporate source income estimated to be $61 billion rather than $41.6 billion if corporate earnings were imputed to shareholders and taxed only at the share-
holder level. Furthermore, it is arguable that the excess burden is really only $6.9 billion because $12.5 billion of the excess burden is attributable to the fact that 24% of corporate stock is owned by tax-exempt organizations. Such tax exempt status arguably creates countervailing resource misallocations since such organizations are induced to invest in corporations by the fact that their tax-exemption in general applies to passive investment income but not to unrelated business income. Furthermore, the lock in effect on retained earnings may increase corporate investment of profitable corporations by more than any decrease in corporate investment caused by the $6.9 billion excess burden on corporate source earnings. The net impact of the double tax on corporate source income on resource allocations is further complicated by the possibilities of shifting of the corporate income tax and myriad tax preferences for specific industries resulting in widely varying effective corporate tax rates for different industries.

B. Impact of Business Tax Structure on Business Size

Sole proprietorships, partnerships and Sub-S corporations

Initially it is necessary to observe that the impact of the tax laws on resource allocations can affect economic efficiency and the size structure of business. Although it will often be possible to estimate the impact of a change in a specific tax law on resource allocations, it will normally be impossible to determine whether that change in resource allocations promotes or detracts from economic efficiency since
other tax law provisions may have offsetting resource allocation effects. Thus, although the impact of elimination of the excess corporate tax burden on resource allocations among different size businesses (and perhaps even among different industries) might be estimated, determination of whether those new resource allocations promote or detract from economic efficiency could only be made by taking into consideration the impact of all other tax laws (and all other laws, institutions, practices etc. which tend to distort resource allocation from what it would be in a hypothetical free market economy).

On the other hand, knowledge of the impact of a particular tax law provision on resource allocations will often allow estimation of the impact on the size structure of business. Of course, we cannot determine how the particular tax law provision changed the size structure of business from what it would have been in a perfectly competitive market economy with neutral tax laws because we do not know what the size structure of business would be in this hypothetical economy that never was. We can, however, estimate whether the particular tax law provision will cause greater or lesser business concentration than already exists in our real but imperfect economy.

As illustrated in the following table, most small businesses are conducted as sole proprietorships, partnerships or Sub-S corporations.
Table 9
Number of Small Businesses by Types with Gross Receipts Under $1 million and over $1 million.

<table>
<thead>
<tr>
<th>Size of Gross Receipts</th>
<th>Under $1 million</th>
<th>Over $1 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorships</td>
<td>10,866,844</td>
<td>15,125</td>
</tr>
<tr>
<td>Partnerships</td>
<td>1,054,492</td>
<td>18,602</td>
</tr>
<tr>
<td>Corporations</td>
<td>1,774,171*</td>
<td>249,476</td>
</tr>
</tbody>
</table>

*Approximately 300,000 of these corporations with gross receipts under $1 million are probably Sub-S Corporations.

Arguably the excess tax burden on corporate source earnings is beneficial to small business. Most small businesses are conducted as sole proprietorships, partnerships or Sub-S Corporations as Table 9, supra, illustrates. Reduction of the double tax burden on regular corporations, whether in the form of full or partial integration of corporate income taxes, would arguably cause a reallocation of resources from non-corporate (including Sub-S corporations) to corporate business forms. Such reallocation would occur by increasing the after-tax rate of return on corporate investment (assuming the corporate income tax is not shifted) or by making corporations more competitive than they are currently vis-a-vis non-corporate business forms (assuming the corporate income tax is shifted). To the extent the excess tax burden on corporate source income allows small businesses to effectively compete with medium and large size corporations, elimination of that excess tax burden threatens the survival of small, non-corporate businesses.
Corporations - Progressive Rates

Reduction of the double tax burden on regular corporations might also threaten the survival of small regular corporations by eliminating the tax advantage of progressive corporate income tax rates on the first $100,000 of corporate income. As can be seen in Table 7, supra, the lower rates of tax on the first $100,000 of corporate income results in meaningful reductions in effective corporate tax rates for corporations with up to $500,000 of taxable income. Although corporations with taxable income in excess of $500,000 get the same dollar benefit from the lower rates on the first $100,000 of income, this benefit is less significant in terms of its impact on after-tax rate of return on investment.

It should also be noted that the above effects of progressive corporate tax rates must be viewed in light of the fact that other tax preferences will alter the effective tax rates of different corporations. To the extent the dispersion of these preferences is not uniform among different size classes of corporations, actual effective tax rates differ from the predicted effective tax rates in Table 7. Table 9 below shows the difference between estimated effective tax rates and actual effective tax rates for corporations by selected size groups of net income for the year 1975.
Table 9
Active Corporations with net income subject to normal tax
(other than Sub-S corporations and Discs) - 1975

<table>
<thead>
<tr>
<th>SIZE OF NET INCOME</th>
<th>0-50,000</th>
<th>51,000-100,000</th>
<th>100,000-500,000</th>
<th>500,000-1,000,000</th>
<th>1-10 million</th>
<th>10-100 million</th>
<th>100 million or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Number of firms</td>
<td>744,033</td>
<td>57,382</td>
<td>52,938</td>
<td>7,352</td>
<td>7,060</td>
<td>1,043</td>
<td>135</td>
</tr>
<tr>
<td>2) Tax after Investment &amp; Win Credit</td>
<td>1,707</td>
<td>1,082</td>
<td>4,431</td>
<td>2,266</td>
<td>8,256</td>
<td>12,374</td>
<td>29,357</td>
</tr>
<tr>
<td>3) Net Income</td>
<td>10,006</td>
<td>4,265</td>
<td>11,934</td>
<td>5,439</td>
<td>19,984</td>
<td>31,367</td>
<td>68,700</td>
</tr>
<tr>
<td>4) Actual effective tax rate</td>
<td>17.1%</td>
<td>25.4%</td>
<td>37.1%</td>
<td>41.7%</td>
<td>41.3%</td>
<td>39.5%</td>
<td>42.7%</td>
</tr>
<tr>
<td>5) Estimated effective rate - 1975</td>
<td>20.0%</td>
<td>30%</td>
<td>42.0%</td>
<td>46.2%</td>
<td>47.5%</td>
<td>48%</td>
<td>48%</td>
</tr>
<tr>
<td>6) Actual less Estimated Rates</td>
<td>2.9</td>
<td>4.6</td>
<td>4.9</td>
<td>4.5</td>
<td>5.2</td>
<td>8.5</td>
<td>5.3</td>
</tr>
</tbody>
</table>

1. Foreign tax credits were not deducted from Tax since net income includes foreign income. If actual effective returns were computed using tax after all credits including foreign tax credits, the actual effective rate of tax on corporation with $100 million or more of net income is less than 17%.

2. Net income includes foreign source income but does not include tax-exempt interest income.

3. Line 2 divided by line 3.

4. Estimates based on average income per firm using rates in effect for 1975: 20% on first $25,000 of income, 22% on next $25,000 and 48% on excess over $50,000.

5. Actual rates below estimated rates due primarily to investment credits, preferential treatment of long-term capital gains, net operating loss deductions, Western Hemisphere Trade Corporation deductions.
Projecting the difference between actual and estimated effective tax rates for 1975 to 1980 we get the following estimate of real effective tax rates for 1980:

Table 10
Estimate of Real Effective Tax Rates by Size of Income-1980

<table>
<thead>
<tr>
<th>SIZE OF NET INCOME (in thousands)</th>
<th>50</th>
<th>100</th>
<th>500</th>
<th>1,000</th>
<th>25,000</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective rate based on tables</td>
<td>18.5%</td>
<td>26.8</td>
<td>42.1%</td>
<td>44.1%</td>
<td>45.9%</td>
<td>46.0%</td>
</tr>
<tr>
<td>Less: Actual rates difference-1975</td>
<td>2.9</td>
<td>4.6</td>
<td>4.8</td>
<td>4.9</td>
<td>8.5</td>
<td>5.3</td>
</tr>
<tr>
<td>Estimate of real effective tax rates</td>
<td>15.6%</td>
<td>22.2%</td>
<td>37.3%</td>
<td>39.2%</td>
<td>37.4%</td>
<td>40.7%</td>
</tr>
</tbody>
</table>

The above estimates of real effective tax rates may not accurately reflect comparative tax burdens for several reasons. First, the concept of net income is itself subject to substantial manipulation and variation. For example, net income of small corporations is probably understated because of deduction of unreasonable salaries, net income of the largest corporations is probably understated because of shifting of income to foreign low-tax subsidiaries. Depreciation deductions, inventory valuation methods, dividends received deductions, etc. may have different impacts on income of different size firms. Second, the comparative burden above assumes earnings are retained in the corporation. To compare total
tax burdens, at corporate and individual levels, on corporate source earnings we would have to know more about the distribution of corporate ownership, i.e., stock ownership by different tax bracket taxpayers in different size corporations. For example, if, as may be the case, most stock in large corporations is held by tax-exempt organizations, pension plans, low bracket individuals and trusts, but most stock in small corporations is owned by high bracket individuals, then, in fact, the effective tax burden on small corporation distributed earnings will likely exceed the effective tax burden on large corporation distributed earnings. Assume that the average shareholder in small corporations is in a 50% tax bracket and the average shareholder in the largest corporation is in a 10% tax bracket.

<table>
<thead>
<tr>
<th></th>
<th>Small Corp.</th>
<th>Large Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Corporate Tax Rate</td>
<td>20%</td>
<td>40%</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>$20</td>
<td>$40</td>
</tr>
<tr>
<td>Dividend to Shareholder</td>
<td>$80</td>
<td>$60</td>
</tr>
<tr>
<td>Tax to Shareholder</td>
<td>$40</td>
<td>$6</td>
</tr>
<tr>
<td>Total Tax</td>
<td>$60</td>
<td>$46</td>
</tr>
</tbody>
</table>

It will be noted that elimination of the corporate income tax or reduction in the corporate tax rate differentials will place an even greater comparative tax burden on small corporations' earnings than the present system.
All proposed corporate tax integration schemes do not have the same impact on the corporate progressive rate structure. Under a full integration scheme which imputes corporate earnings directly to shareholders, all benefits to small corporations or corporate progressive rates would be eliminated. Under a Grossed Up Dividend Tax Credit approach the benefits of progressive corporate tax rates would be preserved to the extent corporations retain their earnings but would be reduced to the extent the tax burden on distributed earnings is reduced. Analysis of the impact of particular integration approaches on small business does not appear to be necessary at this time because there are substantial other problems with all current proposals which make their enactment unlikely. See generally, articles in 28 National Tax J. 255-381 (1975). If any particular integration proposal were to receive serious congressional consideration, it is imperative that the implications of such proposals for small business also be analyzed and considered.

**Corporations - Retained Earnings**

Large Corporations have a higher ratio of net worth to total assets than small corporations as the following table indicates:
Table 11

Ratio of Net Worth to Total Assets - 1975

<table>
<thead>
<tr>
<th>Asset Size Categories - Active Corporations 1975</th>
<th>$1 under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) All Active Crops.</td>
<td>27.4%</td>
<td>56.6%</td>
<td>34.8%</td>
<td>33.7%</td>
<td>28.2%</td>
<td>22.2%</td>
<td>24.8%</td>
</tr>
<tr>
<td>2) Less Financial Corps.</td>
<td>26.4%</td>
<td>37.7%</td>
<td>35.5%</td>
<td>36.1%</td>
<td>37.5%</td>
<td>42.3%</td>
<td>44.1%</td>
</tr>
<tr>
<td>3) Less Sub-S Corps.</td>
<td>28.9%</td>
<td>38.4%</td>
<td>35.6%</td>
<td>34.4%</td>
<td>28.4%</td>
<td>22.2%</td>
<td>24.8%</td>
</tr>
<tr>
<td>4) Less Financial &amp; Sub-S</td>
<td>27.2%</td>
<td>38.2%</td>
<td>36.0%</td>
<td>37.2%</td>
<td>38.2%</td>
<td>42.4%</td>
<td>44.1%</td>
</tr>
</tbody>
</table>

Financial corporations must be excluded for comparative purposes (see lines 2 and 4 above) since banks and other such institutions record deposits as liabilities. Sub-S corporations may also be excluded (see line 4) because the possibilities of a "lock-in" of undistributed previously taxed income gives them special incentive to distribute rather than retain their earnings. The data on lines 2 and 4 reflect the higher ratio of equity financed ownership of assets by large corporations (assets over $10 million).

Further insight into the financing of asset ownership by different size corporations can be gained by a comparison of the ratios of capital stock/net worth and retained earnings/net worth for various size corporations. The data source, Statistics of Income, does not allow segregation of financial corporations for this purpose but such segregation is not essential since
the peculiarities of the financing business will inflate liabilities but should not distort the composition of net worth.

### Composition of Net Worth - 1975

<table>
<thead>
<tr>
<th>Asset Size Categories</th>
<th>$1 under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Active Corps:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stock/Net Worth</td>
<td>107%</td>
<td>44.9%</td>
<td>39.2%</td>
<td>37.6%</td>
<td>43.4%</td>
<td>49.8%</td>
<td>48.9%</td>
</tr>
<tr>
<td>Retained Earn/Net Worth</td>
<td>(7%)*</td>
<td>55.1%</td>
<td>60.8%</td>
<td>62.4%</td>
<td>56.6%</td>
<td>50.2%</td>
<td>51.1%</td>
</tr>
<tr>
<td>All less Sub-S Corps:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stock/Net Worth</td>
<td>99.9%</td>
<td>42.8%</td>
<td>37.8%</td>
<td>37.3%</td>
<td>43.4%</td>
<td>50.0%</td>
<td>48.9%</td>
</tr>
<tr>
<td>Retained Earnings/ Net Worth</td>
<td>0.1%</td>
<td>57.2%</td>
<td>62.2%</td>
<td>62.7%</td>
<td>56.6%</td>
<td>50.0%</td>
<td>51.1%</td>
</tr>
</tbody>
</table>

Based on the above table it appears fair to conclude that very small corporations (under $100,000 in assets) have no retained earnings, all of their assets are financed by borrowing or capital stock. This is not surprising in light of the fact that about one-third of these very small corporations are in service businesses and a great number of the remainder are probably fairly new enterprises. It is surprising to find that corporations with $100,000 to $10 million in assets have a higher ratio of retained earnings to net worth than do large corporations with assets over $10 million, especially since such large corporations have a higher ratio of net worth to total assets and such large corporations are suspected of being older than the medium sized corporations.
The explanation of the lower retained earnings of large corporations may be found, in part, in differences in after tax profitability, as the following tables illustrate.

Table 12
Profitability of Different Size Corporations - 1975 Active Corporations with Net Income (Other Than Financial & Sub-S Corps.) Net Income as percent of Net Worth of such Corporations with Net Income or Net Loss

<table>
<thead>
<tr>
<th>Asset Size Categories</th>
<th>$1 under 100,000</th>
<th>100,000- 500,000</th>
<th>500,000- 1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Net Worth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before Tax</td>
<td>35.9%</td>
<td>21.7%</td>
<td>22.2%</td>
<td>23.5%</td>
<td>24.2%</td>
<td>27.0%</td>
<td>16.0%</td>
</tr>
<tr>
<td>After Tax*</td>
<td>30.8%</td>
<td>17.4%</td>
<td>16.1%</td>
<td>15.2%</td>
<td>15.3%</td>
<td>13.1%</td>
<td>9.6%</td>
</tr>
</tbody>
</table>

*Taxes before reduction by Foreign Tax Credit.

As the next table shows, the higher profitability of profitable small businesses is offset by the higher risk of losses.

Table 13
Profitability of Different Size Corporations - 1975 Active Corporations With Net Income or Net Loss (Other Than Financial & Sub-S Corps.)

<table>
<thead>
<tr>
<th>Asset Size Categories</th>
<th>$1 under 100,000</th>
<th>100,000- 500,000</th>
<th>500,000- 1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Net Worth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before Tax</td>
<td>0.3%</td>
<td>13.4%</td>
<td>16.5%</td>
<td>18.7%</td>
<td>19.4%</td>
<td>17.5%</td>
<td>15.3%</td>
</tr>
<tr>
<td>After Tax*</td>
<td>(4.7%)</td>
<td>9.0%</td>
<td>10.4%</td>
<td>10.4%</td>
<td>10.5%</td>
<td>9.7%</td>
<td>8.9%</td>
</tr>
</tbody>
</table>

*Taxes before reduction for Foreign Tax Credits

More important to the explanation of the smaller retained earnings/net worth ratios of the largest corporations are the
dividend policies of different size corporations. As the following table illustrates, the largest corporations distribute a substantially higher proportion of their after-tax earnings than do small and medium size corporations.

Table 14

Distributions to Shareholders as a Percent of After Tax Earnings*
Active Corporations with Net Income
(Other Than Financial Corporations and Sub-S Corporations)

<table>
<thead>
<tr>
<th>Asset Size Categories</th>
<th>$1 under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-5 million</th>
<th>5-10 million</th>
<th>10-100 million</th>
<th>Over 100 million</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6.1%</td>
<td>7.0%</td>
<td>10.7%</td>
<td>13.0%</td>
<td>17.5%</td>
<td>23.4%</td>
<td>51.2%</td>
</tr>
</tbody>
</table>

*After tax earnings not increased by foreign tax credit, i.e., foreign tax credit not deducted from total taxes in computing after tax net income.

Prof. Alan L. Feld, in his report on "Tax Policy and Competition" suggests several reasons why larger corporations distribute more and retain less of their earnings than smaller corporations, i.e., many shareholders in large corporations are in zero or low tax brackets, large corporations have better access to capital markets in terms of new stock issues and borrowing, and many shareholders in smaller corporations can extract needed funds from corporate solution by paying themselves larger salaries, etc. Additional hypotheses that may help to explain the greater earnings retention by smaller corporations are 1) smaller corporations are in growth sectors of the economy, and 2) very small corporations are predominantly "younger" corporations which have not had time to accumulate sufficient earnings to raise their ratio of net worth/total assets to respectable levels.
Although the above analysis shows that the retained earnings of small and medium size firms is growing at a faster rate than the retained earnings of large size firms (because of higher profitability and lower dividend pay out rates of small and medium size corporations), it must be remembered that these conclusions are based on averages for many industries for one given year. Within our economy different industries might have different profitability and dividend pay out rate structures in different years. Comparison of Wholesale and Retail Trade Industry statistics with Mining and Manufacturing statistics for 1974 illustrate some of these differences.

Table 15
Comparison - Wholesale and Retail Trade with Mining and Manufacturing Corporations
1974 Corporations with Net Income or Net Loss

<table>
<thead>
<tr>
<th>After tax Return on</th>
<th>Asset Size Categories</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Worth (1)</td>
<td>$1 under 100,000 100,000-500,000 500,000-1 million 1-10 million 10-100 million 100-250 million over 250 million</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>2.8 14.0 15.1 16.1 16.8 13.5 5.3</td>
</tr>
<tr>
<td>Mining &amp; Manufacturing</td>
<td>(26.3) 10.7 10.8 10.6 8.8 8.9 14.4</td>
</tr>
<tr>
<td>Dividends/After Tax earnings</td>
<td>214.9 20.4 19.1 19.9 29.9 34.2 64.6</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>30.6(2) 23.2 22.8 20.3 32.9 39.0 51.7</td>
</tr>
<tr>
<td>Increase in Retained Earnings/Total Assets</td>
<td>1.0 4.5 4.7 4.7 4.5 3.4 2.7</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>(5.8) 3.1 3.5 3.9 2.9 2.7 3.2</td>
</tr>
</tbody>
</table>

(1) Foreign tax credits not used to reduce total taxes.

(2) Distributions of $46.5 million on net loss of $152 million.

(3) Increase in retained earnings of all mining and manufacturing corporations with assets of $250 million or less as a percent of total assets of all mining and manufacturing corporations with assets of $250 million or less.
The above data illustrate some important differences between industries in terms of profitability, dividend policy and growth through retention of earnings. It also illustrates differences among different asset size firms in different industries, especially among the very largest (over $250 million in assets) and the very smallest ($100,000 or under in assets), e.g., although the very largest wholesale and retail trade firms are substantially less profitable than smaller firms, the very largest mining and manufacturing firms are substantially more profitable than smaller firms. Because of higher dividend pay out ratios for the very largest firms, however, growth through retained earnings is less for the largest firms in wholesale and retail trade than for others and growth of the largest mining and manufacturing firms is about the same (3.2%) as it is for smaller mining and manufacturing firms (3.1%). These statistics on growth through retained earnings are roughly comparable to the findings of other researchers over longer time periods. See Feld study and Lintner and Butters study.

One interesting aspect of this data is that it suggests that the trend toward increasing concentration of assets in mining and manufacturing, see discussion of "Aggregate Concentration Trends", supra, is not the result of growth through retention of earnings.
Corporations - Foreign Source Income

Foreign source income of foreign subsidiaries of U.S. corporations is, in general, not taxed by the United States until remitted as dividends to the U.S. parent company. (Subchapter F of the Internal Revenue Code does require inclusion of imputed dividend income to U.S. shareholders of a "Controlled Foreign Corporation (CFC) when the CFC has certain types of tax haven tainted income or when the CFC invests in certain types of "U.S. property.") Upon receipt of dividends by the U.S. parent company, the U.S. parent company must include dividends received (grossed up to include foreign taxes paid) in income, but can elect to take a credit against its U.S. tax liability on such income in the amount of the foreign taxes paid.

Most dividends received from foreign corporations are received by the very largest U.S. corporations. For 1975 corporations with over $250 million in assets received over 91% of dividends received from foreign corporations and claimed over 97% of the total foreign tax credits claimed by corporations. In general, for purposes of this report, total U.S. taxes were determined without reduction for foreign tax credits since the gross income of the U.S. corporation included the actual dividends received plus the foreign taxes paid on the earnings representing the dividend. To reduce total taxes by the foreign tax credits allowed would overstate after tax income of U.S. corporations by the amount of the foreign tax credits claimed. Although beyond the
scope of this report, this author believes the foreign tax credit system does not give the largest U.S. corporations unfair advantage vis-à-vis smaller U.S. corporations. The advantage that the largest U.S. corporations have in the area of foreign source income of foreign subsidiaries is the deferral of tax on foreign source income of foreign subsidiaries not remitted to the U.S. parent, not the foreign tax credit on remitted earnings.

The deferral of U.S. tax on retained earnings of foreign subsidiaries allows U.S. corporations to retain earnings in low tax foreign jurisdictions. Smaller corporations will often lack the finances and expertise to enter foreign markets through foreign subsidiaries and thus are less likely than large corporations to benefit from such deferral. Such deferral probably results in understatement of the actual growth in asset concentration in the hands of the largest corporations (assuming the largest corporations own most of the foreign subsidiaries) but does not help to explain the increasing aggregate concentration reflected in Statistics of Income since those statistics do not include growth in assets of foreign subsidiaries by reason of retention of earnings. U.S. corporations cannot file consolidated returns with their foreign subsidiaries (with the exception of some Canadian and Mexican subsidiaries) and thus ownership of foreign subsidiaries is reflected in tax statistics at historical cost.

Deferral of tax on foreign source income of foreign subsidiaries, although arguably often necessary to allow U.S. corporations to compete with foreigners on equal terms in foreign
markets, disadvantages smaller U.S. corporations vis-a-vis the largest U.S. corporations in foreign markets in those situations where U.S. exports would be competitive with foreign competitors. To the extent the largest corporations establish foreign subsidiaries, not to meet foreign competition or even to take advantage of lower foreign costs of production but solely to reduce taxes, the deferral concept favors large U.S. corporations with the finances and expertise to utilize foreign subsidiaries. Unfortunately, the decision to enter foreign markets by way of a foreign subsidiary is based on an inseparable mixture of financial, political and economic motives.

The deferral concept may also discriminate against small and medium size business firms by making it possible for large corporations with foreign subsidiaries to earn a lower rate of return on their U.S. operations. The lower rate of return on U.S. operations would be offset by substantially higher after-tax rates of return on foreign subsidiary operations for financial reporting (other than tax) purposes. The cure for this possible defect is to require recognition of contingent U.S. tax liability for financial reporting purposes, i.e., to require the reduction of foreign income retained by the foreign subsidiary by the amount of U.S. tax which would have been payable had those earnings been repatriated. Recognition of such contingent liability would be consistent with economic realities (U.S. shareholders will realize the foreign income only net of payment of U.S. tax)
and would alleviate possible problems of domestic competitive advantages accruing to corporations with foreign subsidiaries operating in low tax foreign jurisdictions.

Abuses of the deferral concept, for example, shifting of income to foreign, low-tax subsidiaries by unreasonable cost and pricing allocations, exacerbate the problems of book versus tax income. Although I.R.C. section 482 gives the I.R.S. considerable latitude in reallocating income and deductions between related firms, it is suspected that substantial income shifting goes undetected because of the tremendous administrative burden in attempting to test the reasonableness of all transactions with and among foreign subsidiaries. Furthermore, the special tax status of Puerto Rico would appear to encourage transfer of patents and other property to Puerto Rican subsidiaries for manufacture of goods for export around the world. The cost of development of the patent might be deducted from U.S. source income by the U.S. parent company, the transfer of property to the Puerto Rican subsidiary tax-free under I.R.C. section 351 and earnings of the Puerto Rican subsidiary from exports around the world exempt from U.S. taxation and subject only to the "tax holiday" rates available in Puerto Rico. (Puerto Rican subsidiaries are exempt from subchapter F taxation of Controlled Foreign Corporations.) Such income shifting from the U.S. parent to its low tax foreign subsidiary has the effect of lowering U.S. and total current tax liabilities, allowing
the U.S. parent to understate income for U.S. tax purposes and to overstate income from worldwide operations for financial accounting purposes.

Domestic International Sales Corporations (DISCs) are U.S. corporations engaged primarily in the export of U.S. made goods, often the exported goods being produced by the parent corporation of the DISC. Corporations that use a DISC for their exports can defer for long time periods U.S. income tax on a portion of the DISC export profits. One objective of the DISC legislation was "to remove the disadvantage to companies that export goods from the United States compared with companies that manufacture abroad through foreign corporations."

J. Bischel & R. Feinschreiber, Fundamentals of International Taxation, 108-109 (P.L.I., N.Y. 1977), citing S. Rep. No. 437, 92nd Cong., 1st Sess. 90, at I, § E (1971). Because of the complexity of the DISC provisions, the lack of technical expertise in arranging export sales and the lack of foreign contacts by small and medium size businesses, it is suspected that DISCs are utilized primarily by the same giant corporations which have foreign subsidiary operations. More research is needed to ascertain the availability of data which would confirm or repudiate the suspicion that DISCs, like the deferral of tax on foreign source income of foreign subsidiaries, discriminates in operation in favor of the largest corporations to the detriment of small and medium size U.S. businesses.
NONTAXABLE ACQUISITIVE MERGERS - INTRODUCTION

The Internal Revenue Code provides for non-recognition of gain or loss on exchanges of stock or securities in certain types of separate reorganizations as defined in Code section 368. Basically these reorganizations fall into the following categories:

A) statutory merger or consolidation
B) stock for stock exchange
C) stock for assets exchange
D) divisive reorganizations
E) recapitalizations
F) mere change in identity, form or place of organization.

The first three types above (A, B and C type reorganizations are frequently called "acquisitive reorganizations" since they result in the acquisition by one company (the acquiring company) of control of the stock or assets of another company (the acquired company). Shareholders of the acquired corporation who receive stock or securities in the acquiring corporation in exchange for their stock in the acquired corporation do not recognize gain or loss on such exchanges pursuant to a "reorganization."

Nonrecognition of gains or losses on acquisitive reorganizations provides a tax incentive for merger. The tax incentive to merger is provided not to the acquiring company but rather to the shareholders of the acquired company. From the perspective of the acquiring company the choice is often between tax free internal growth and tax free acquisition. See Peter Steiner, Mer-
But it takes two to tango i.e., it generally requires the consent of shareholders of the acquired company as well as the acquiring company to consummate a tax free merger. From the perspective of the shareholders of the acquired company, they have a choice between a taxable sale of their shares or a tax free merger. The taxable sale might be to individuals, another small corporation or to a large publicly traded corporation. The taxable sale may result in disappearance of the acquired corporation as a small business or may not, depending on the identity of the purchasers. The tax free sale will by definition result in the combination of the acquired company into another enterprise, i.e., a merger, consolidation or operation of the acquired company as a subsidiary of the acquiring corporation. Thus the tax laws provide tax incentive to shareholders of the acquired corporation to merge rather than to sell their shares. Because of the tax laws, stock of a corporation proposing a tax free acquisition becomes more valuable than an equivalent amount of cash to shareholders of the acquired corporation since the stock may be received tax free but the cash will be reduced by taxes.

Furthermore, it should be noted that the tax free merger acquisition technique is available as a growth mechanism primarily by large, publicly traded corporations and not by smaller, closely held corporations. FTC data for the year 1977 show that
80.8% of the acquiring companies in tax free mergers had over $10 million in assets and 49.2% had over $100 million. FTC Statistical Report on Mergers and Acquisitions, Table 9 (1978). This is not surprising in light of the fact that shareholders of acquired corporations will generally not be willing to accept a minority shareholder position in a small, closely held corporations are not willing to give up substantial voting control to outsiders.

Whether such tax encouragement of mergers of corporations into large publicly held corporations constitutes an unwarranted tax loophole can only be answered by examination of the policies for and against such tax treatment in the context of the taxing scheme of the Internal Revenue Code.

NONTAXABLE ACQUISITIVE MERGERS-POLICY ANALYSIS

From its inception our taxing scheme did not tax all increases in wealth (economic income) but only taxed "realized" gains and income. The income tax was not applied to increases in the value of property owned by taxpayer unless the taxpayer sold, exchanged or disposed of his property. At an early stage in the development of our tax system the courts decided that certain exchanges which did not alter the underlying basic nature of the taxpayer's investment were not taxable events under the realization concept. See Eisner v. Macomber, 252 U.S. 189 (1920); Weiss v. Stern, 265 U.S. 242 (192). However, changes in the nature or extent of taxpayer's investment were taxable events. See Stratton's Independence and other cases cited infra, Appendix B.
It should be noted that our current "realization" tax scheme creates deterrents to the free movement of capital. Since appreciation in value of investments is not taxed until the investment property is sold or exchanged, the tax laws provide disincentive to sales or exchanges of investment property. Thus under our "realization" tax scheme a taxpayer who sells or exchanges his 1000 shares of IBM stock will have to recognize his gain or loss on that investment even if he reinvests the proceeds in farm-land, a small business or RCA stock. Nonrecognition of gain or loss on acquisitive reorganizations is inconsistent with the general realization principles of our existing tax law.

One way in which our tax system attempts to ameliorate the deterrent effect of taxes on capital movements is by preferential treatment of long-term capital gains. Arguably, greater freedom of movement of capital would exist if we had a tax system which annually taxed all increases in economic wealth whether or not realized, or if we had a system which taxed only consumption expenditures. One problem with the taxation of all increases in economic wealth, whether or not realized, is that such a scheme would require annual valuations of each taxpayer's assets and liabilities, thereby creating administrative problems of enormous magnitude. Problems with the consumption expenditures tax scheme are that implementation would be complex, enforcement difficult because of the small base on which the tax is levied and enactment politically unlikely. See Graetz, Implementing a Progressive Consumption Tax, 92 Harvard L. Rev. 1575 (1979).
At an early date in the history of our income tax law Congress began creating exceptions to the realization concept. These exceptions were based on public policies supporting deferral of recognition of gains or losses on the occurrence of certain events, such events not constituting an appropriate time to recognize gain or loss because of the overriding public policy. Policies used to support non-recognition of gain or loss include:

1) to prevent taxing gain on exchanges which have not resulted in substantial changes in the nature of taxpayer's investment.

2) to prevent taxpayers from voluntarily recognizing paper losses when they have not substantially changed the nature of their investment.

3) the event did not generate cash needed to pay tax,

4) administrative difficulty in computing the amount of gain or loss,

5) to accomplish economic goals, e.g., incentive to new business formation, facilitate mobility of labor, provide flexibility in form of business organization.

1. No substantial change in the nature of taxpayer's investment

A change in the nature taxpayer's investment would, according to the Courts, not include mere changes in the pieces of paper representing the same underlying investment, nor changes which reflect a decreased ability to enjoy the increased value of the property, e.g., capitalization of earnings to accompany
a stock dividend. Eisner v. Macomber supra. In most cases, however, courts have tended to view as a realization any change in the nature of the underlying investment, including reincorporation in another state. See Appendix B, infra.

Congress, at least in the area of corporate reorganizations, has taken a very liberal view of what constitutes a change in the nature of taxpayer's investment. The legislative history of the corporate reorganization provisions evidences Congressional conceptualization of such events as "purely paper transactions," and as "merely changes in form and not changes in substance." Leg. History, supra.

Clearly Congress has been in error in characterizing all corporate reorganizations as merely changes in form and not as changes in the nature of taxpayer's investment will depend on many variables but the merger of a small, closely held corporation into General Motors for GM stock would appear to reasonable persons to constitute a substantial change in the nature of the original small corporation shareholders' investment, i.e., changes in the "underlying corporate assets, the nature and diversification of products, the size of the business, the business' earnings and growth possibilities, management, and financing abilities ... relationships of stockholders to management ... control over policies, election of directors, selection of personnel, expansion of the business, financial and dividend policies ... evaluation in the securities markets ... traded on an exchange ... readily convertible into
cash." Hellerstein, Mergers, Taxes and Realism, 71 Harvard L. Rev. 254, 267 (1957). Obviously, not all corporate reorganizations involve so substantial a change in the nature of taxpayer's investment. Whether a particular reorganization will result in a "substantial" change in the nature of taxpayers investments must depend on all the facts and circumstances, including the type of reorganization, as well as the meaning attributed to the term "substantial." Granting non-recognition treatment to all corporate reorganizations on the grounds that some may not result in substantial changes in the nature of taxpayer-shareholder's investment is not warranted nor necessary.

2. Prevent taxpayers from deducting "paper" losses.

The objective of preventing taxpayers from deducting paper losses on reorganizations which do not substantially change the nature of taxpayer's investment can be accomplished by changing the statute to not recognize gains or losses unless the change is substantial or merely by not recognizing losses (but recognizing gains) on any reorganizations. Opposition of the Treasury in 1934 to complete elimination of the non taxable reorganization provisions is understandable in light of the then prevailing economic conditions; their failure to propose tax law changes to prevent this potential abuse and at the same time close the non taxable reorganization gains loophole can be explained perhaps by a political climate opposed to tax increases in a depression or lack of imagination or lack of awareness of the business structural implications of such reorganizations. However, although non-recognition of gains or
losses is mandatory for transactions fitting the reorganization forms, taxpayers can recognize their losses by slight deviation from the reorganization forms. Thus the reorganization provisions do not in fact prevent taxpayer's from deducting losses on transactions which are in substance the equivalent of reorganizations.

3. Defer taxation on transaction not producing cash to pay tax.

In general, exchanges of property for services (§ 83) or for other property, are taxable events. Congress has created numerous statutory exceptions to the concept that gains and losses realized by property exchanges must be recognized based in part on the idea that it would be unduly harsh to collect taxes in cash from a taxpayer who has entered into a transaction which does not produce cash. For example, I.R.C. section 1031 allows deferral of recognition of gains on like kind exchanges of certain types of property held for investment or the production of income. Thus the exchange of a ranch for an apartment building or the trade-in of an old tractor on a new tractor are not taxable events under § 1031.

It should be noted first that policies other than the prevention of undue harshness to the taxpayer, perhaps forcing him to sell property to obtain cash to pay his tax liability, also support the section 1031 concept. For example, like kind requirements puts some limits on the nature of the change in taxpayer's investment, the fact that application of section 1031 is mandatory puts some limits on deduction of "paper" losses (although taxpayers can usually deduct losses by merely
changing the form of their transactions), and administrative
difficulties in computing the amount of gain or loss, are ad-
dditional policies supporting section 1031.

Second, it should also be noted that section 1031 does
not apply to exchanges of inventory, stock or securities. If
a taxpayer were to exchange his Ford Motor Company stock for
a ranch or for stock in General Motors, the exchange would be
a taxable event, the taxpayer would be required to sell property,
borrow cash or use available funds to pay his tax liability.
The transaction would result in a taxable event for taxpayer
even if he exchanged his Ford Motor Company stock for a con-
trolling interest in a small business, a not uncommon type
of transaction for an employee who has worked for years,
saving and investing his earnings so that one day he could
purchase or start up his own business.

Based upon an analysis of the policies underlying sec-
tion 1031, it is fair to generalize that the deferral of gains
under that provision is not justifiable solely on the grounds
of harshness to the taxpayer in taxing non-cash producing ex-
changes. In general, taxpayers must recognize gain or loss on
property exchanges even if the taxable transaction leaves them
with no cash to pay their tax. Statutory exceptions to the
general rule are based on more than just the possible harsh-
ness to the taxpayer, e.g., involuntary nature of the conver-
sion (§ 1033) unexpected, and involuntary conversions (§ 109
and history as response to decision in Helvering v. Bruan), no substantial change in the nature of the property exchanged and encourage labor mobility (§ 1034).

The policy of preventing taxation in non-cash producing exchanges is particularly inappropriate to the situation where taxpayer receives stock of a publicly traded company in exchange for stock or assets in his business. Such publicly traded stock is divisible and usually has a readily ascertainable market value. If need be, part of it could be sold or pledged on a loan to secure funds to pay the tax. See generally Hellerstein article, supra.

Even if the stock received by the taxpayer in the acquisitive merger is not publicly traded, it is reasonable to collect tax on the exchange assuming there has been a substantial change in the nature of taxpayer's investments and other policies do not compel non-recognition. Harshness to the taxpayer will depend on his overall financial situation. Harshness to the taxpayer in this situation is no more onerous than harshness to the taxpayer who owns G. M. stock which he wishes to use to purchase or start up a small business. Why should we be more concerned about the ability to pay of a shareholder who voluntarily merges his business into a substantially different (substantially larger) enterprise than we are about the individual who seeks to convert his G. M. stock into an investment in small business? Unless it is our policy to encourage business concentration and discourage business deconcentration and the start up of new ventures, both transactions should produce the
same tax consequences or the tax laws should favor the decon-
centration transactions. Harshness to the taxpayer is no great-
er in one than the other of the above transactions.

4) Administrative difficulty in computing gain or loss

In order to compute the taxpayers gain or loss on an
acquisitive merger it is necessary to ascertain the value of what
he received or, in the alternative, the value of what he has
surrendered. Philadelphia Park Amusement Co. v. United States,
130 Ct. Cl. 166, 126 F. Supp. 184 (Ct. Claims, 1954). Since such
information is necessary to compute gain or loss on all taxable
exchanges, whether exchanges of property for services or for
other property, the question arises whether the nature of the
consideration received tax-free in an acquisitive merger (stocks
and securities of the acquiring company) is such that it is
inherently more difficult to value than in other taxable
transactions.

If the consideration received is stock or securities
regularly traded on an established market, e.g., G. M. stock,
valuation problems are minimal. Adjustments in value could
be made based upon control and blockage factors as is current-
ly done for gift and estate tax purposes. See I.R.C. Reg.
20.2031.

If the consideration received in the acquisitive merger
is not regularly traded on an established market, e.g., stock
in a closely held company, valuation problems would be more
difficult, but not insurmountable. Such valuation is currently
required under the Gift and Estate tax laws and the valuation
methods there used could be used in the income tax laws. An informed judgment as to the amount of gain or loss is better than the one answer most likely to be wrong, i.e., no gain or loss. To insure against valuation uncertainties hindering business deals it may be possible to devise valuation methods which are more specific than those in the Gift and Estate tax regulations and/or provide a procedure for advance rulings on such valuations. Furthermore, for purposes of determining gain a discount of say 10% might be given off the ascertained valuation in the case of stock or securities not regularly traded on an established exchange in order to insure against creation of income through over valuation of consideration received. Again, some estimate of the gain is better than no estimate at all.

The Internal Revenue service has considerable experience in valuing the type of consideration received in tax-free acquisitive mergers, under the Gift and Estate tax laws, when stock or securities are used to pay compensation to employees directly or indirectly through retirement plans, in some taxable sales where part of the consideration is stock or securities of the buyer, etc. The volume of tax-free mergers is not so great as to place an insurmountable burden on the I.R.S., possibly 2000 tax free mergers occurring each year. Furthermore, the costs to the I.R.S. of valuing consideration in such transactions might not be significantly more (and might even be less than the costs to the I.R.S. of reviewing transactions to determine whether they qualify under existing law for tax-free merger treatment.)
5) Economic Justifications for Tax-Free Acquisitive Mergers

Insight into the consequences of acquisitive mergers can be obtained by consideration of the motivations for such transactions. Among the motives of acquiring companies in mergers are the following:

ACQUIRING COMPANIES MOTIVES FOR MERGERS AND ACQUISITIONS

I. At the company level

A. Operating efficiencies

1. economics of scale in production and research
2. economics of scale in marketing and distribution
3. economics of scale in advertising
4. acquire key personnel
5. acquire needed technology
6. assure sources of supply as to availability, continuity
7. assure market outlets for more control over sales efforts, to avoid fluctuations in sales and to provide better customer relations

B. Obtain monopololy or oligopoly power

C. Financial Advantages

1. Diversify out of depressed and unfavorable markets
2. Obtain additional capital needed in the business
3. Exploit excess debt capacity of acquired firms
4. Increase average earnings per share through acquisition of firms with high earnings per share
5. Reduce fluctuations in earnings per share
II. At the management level (power and security of management)

A. Increase business profitability

B. Increase the appearance of business success

1. Larger assets, sales and employee size provide managers with increased power, prestige and earning capacity

2. More diversified shareholdings may provide additional security for managers of publicly held corporations

3. Pooling of interest accounting may inflate book profits

4. Consolidated returns and failure to report divisional profits may better hide management errors in specific product lines

C. Provide executive level jobs for promotion of deserving employees of acquiring company.

III. At the shareholder level

A) Increase return on investment

B) Diversification of risk

C) Control over larger enterprise

Among the motives of owners of acquired companies for merger are:

ACQUIRED COMPANY MOTIVES FOR MERGER

I. At the company level

A. Operating efficiencies

1. economies of scale in production and research

2. economies of scale in marketing and distribution
3. economies of scale in advertising
4. acquire key personnel
5. acquire needed technology
6. assure sources of supply
7. assure market outlets

B. Obtain monopoly or oligopoly power

C. Financial advantages
   1. Diversification of risk
   2. Obtain additional capital needed in the business
   3. Supply needed capital to acquiring firm
   4. Make use of tax losses of acquired or acquiring firm

II. At the management level
   1. Retire from active business management
   2. Obtain employment with larger business enterprise

(Note - managers of acquired firms will probably usually find merger threatening to their job security - the managerial level benefits of retirement or employment in the larger firm are most often shareholder-manager benefits and not seen as benefits by non-shareholder managers.)

III. At the shareholder level
   1. Sale of business at a "premium" price
   2. Increase return on investment
   3. Diversification of risk
   4. Obtain readily marketable shares
5. Provide for business continuity after death or retirement

6. Estate planning objectives, *e.g.*, minimize valuation problems, provide estate liquidity, provide heirs with passive investments.

Combinations of motivations for individual acquisitive mergers are unique and would probably include some of the motives from the above lists. Although the above lists of motives are not exhaustive, they are informative because they suggest the possibility that mergers may be prompted by motives which do not justify their encouragement through preferential tax-treatment, *e.g.*, power, security and status of acquiring firms' managers, tax-benefits for owners of acquired firms.

The importance of various combinations of motives are likely to change with changing exogenous tax, legal and economic conditions. Cf. P. Staines, mergers at pp. 206-217.

Economic justifications for a more liberal governmental merger policy are usually based on claimed economic efficiency (*i.e.*, operating efficiencies and reduction of tax impediments to capital movements.) The extent of economic efficiency attained through mergers is a complex issue. Empirical studies are woefully inadequate to measure operating efficiency before and after merger, primarily because of lack of per unit cost of production and distribution data. Even if such data were available, substantial problems of nullifying the effects of other variables would still exist. Use of substitute measures
of economic efficiency, e.g., before tax profits, return on invested capital, changes in market value of shares, are also unsatisfactory tests of efficiency as explained below.

Existing studies which utilize firm profits or earnings per share or market values show no statistically significant increase in profitability of the merged firm over the per-merger firms. See studies cited 40 Ohio State L. J. 876 n. 32; studies cited on pp. 16-17, Hearings on Mergers and Economic Concentration, pt. II. One would expect that attainment of economic efficiencies (like the attainment of greater market power) would result in greater post-merger profitability for the acquiring firm. On the other hand it has been argued that the maintenance of pre-merger profitability rates after mergers is evidence of increased economic efficiency in light of the 15 to 20 percent premium paid to the shareholders of the acquired firm. See statement of William F. Baxter, Hearings, Mergers and Economic Concentration 1979 at p. 25. However, there are a number of weaknesses in this theory that constant profits after payment of an acquisition premium is evidence of economic efficiency.

First, the constant profits could possibly merely reflect greater market power of the firms post-merger.

Second, the constant profits may merely reflect the fact that the premium, although large from the perspective of shareholders of the acquired firm, was small in comparison with the profits of the acquiring firm.
Third, the constant profits might merely reflect pre-merger imperfect competition, i.e., either the acquired, the acquiring or both firms did not seek profit maximization pre-merger.

Fourth, the "premium" was not in fact a premium but merely reflected market undervaluation of the acquired firm prior to announcement of the proposed merger due to the fact that controlling shareholders of the acquired firm were siphoning out profits as compensation to avoid corporate income taxes.

Fifth, the "premium" was paid in stock of the acquiring company, not cash, so that total assets of the merged firm after merger was the same as the total assets of each of the firms prior to merger. Profits should remain constant in such acquisitions for stock unless the merger produced inefficiencies. Earnings per share of the merged firm might very well increase substantially over earnings per share of the acquiring firm on the usual tax-free merger assuming that "pooling accounting" is used and that the P.E. ratio of the acquired corporation was lower than that of the acquiring corporation. See Appendix A

Sixth, increased profitability may be due to increased use of debt financing. The increased profits were due to increased risk taking by increased debt financing. Existing data suggests that conglomerates, in general, have higher debt-equity ratios than average non-conglomerates.
If stock market success is used to measure profitability (as many economic studies attempt, Weston and Mansinghka; Lev and Mandelker; Samuel Reid; Thomas Hogarty, all cited at pp. 190-192 of P. Steiner, Mergers) to the acquirers a problem in addition to those listed above is encountered, i.e., was the "premium" paid to the sellers merely a reflection of market undervaluation of the acquired firm's shares prior to merger. Such undervaluation might be caused by the fact that the market price only reflected valuation of a minority interest or that the acquired firm had a low dividend paying policy or that general economic conditions caused undervaluation. See Joseph F. Bradley, Limiting Conglomerate Mergers: The Need for Legislation, 40 Ohio State Law J. 867, 877 n. 4 (1979); Hay & Morris at pp. 496-497.

A more serious problem with use of market valuations of shares to ascertain profitability is that market valuations may be subject to the "PE Game." If acquiring companies have higher PE ratios than the companies they acquire and the stock market continues to value the acquiring company after merger at its pre-merger PE ratio (two conditions which were met at least during the merger wave of 1965-68), the market price of the company's stock would increase substantially in many mergers. See excellent discussion of this topic in P. Steiner, Mergers, pp. 96-127 (U. Mich. 1975).

Existing economic data thus fails to establish that increased economic efficiency is either a dominant motivation for or a result of mergers in general. As noted by others it
is not surprising that conglomerate type mergers would not produce significant synergy efficiencies. Most importantly, economic studies of pre-merger and post-merger economic efficiency cannot tell us what would have occurred had the merger not been consumated, i.e., would greater efficiency have occurred by internal growth, debt financing or sale of the business to other individuals. In view of the absence of convincing evidence that mergers promote economic efficiency not otherwise attainable, economic efficiency is not a sound justification for encouragement of tax-free mergers as opposed to taxable sales of businesses.

Removal of tax impediments to capital flows is also not a sound justification for preferential tax treatment of acquisitive mergers. Merger transactions should not be given tax preferred treatment over sales transactions since the inevitable result of the merger transaction is the combination of two or more businesses into a single entity whereas sales transactions may or may not result in such business concentration depending on the identity of the buyer. If market forces warrant such business combination, then such business combination will likely result even without the tax preference for mergers.

**TAX FREE ACQUISITIVE MERGERS - PROPOSED STATUTORY CHANGES**

The receipt of publicly traded stock or securities in an A, B or C type acquisitive reorganization should be treated as boot received by the sellers for purposes of I.R.C. section
356. These changes are basically the same as those proposed by Professor Hellerstein. Reasons for this change are as follows:

1) Change in the nature of taxpayer's investment

Receipt of publicly traded stock or securities in an acquisitive reorganization represents a change in the nature of the recipient's investment. This is clearly true where the recipient exchanges stock or securities in a closely held corporation for publicly traded stock or securities. In such exchanges the recipients of the publicly held stock have converted their difficult to sell assets into readily marketable assets, saleable in whole or in part. In an exchange for publicly traded stock in another corporation, shareholders of the acquired corporation have changed their investment in the same manner as an investor who exchanges his IBM stock for RCA stock - both types of transactions should represent taxable events.

It will be noted that this proposal does not make acquisitive reorganizations taxable where the consideration received by the sellers is not publicly traded stock or securities even if the reorganization results in a substantial change in the nature of taxpayer's investment. By not changing the tax free status of such receipt of non-publicly traded stock or securities in acquisitive reorganizations, problems of ability to pay...
tax and valuation are minimized. See discussion infra.
Furthermore, restriction of taxability to receipt of publicly traded stock or securities is warranted by the need to eliminate the acquisition advantage of publicly traded corporations.

In general, publicly traded corporations are large corporations and non-publicly traded corporations are small. Only publicly held corporations can offer the advantage, under current law, of tax free receipt of readily marketable assets to sellers. Non-publicly traded corporations, by definition, could not, under current law, offer to sellers the receipt of readily marketable stock. The consequences of this discrimination under current law is that practically all tax free acquisitive reorganizations are consumated by large, publicly traded corporations. Most acquisitions by small, non-publicly traded corporations have been taxable, the shareholders in the acquired firm being unwilling to accept or the acquiring firm being unwilling to give up, equity participation in the acquiring firm. In those situations where the sellers do accept non-publicly traded stock in the acquiring firm, the sellers are likely to obtain a substantial equity interest in the merged enterprise and take an active role in management.

2. Valuation

When publicly traded stock is received in an acquisitive merger, it can be valued by reference to market quotations on the date of acquisition. A discount might be allowable from market value under the "blockage rule" if the sellers received such a large block of stock in the acquiring firm that it would
be impossible to sell it quickly without depressing the market price. Although it is arguable that such valuation is not precise, it is clearly more accurate than no estimate at all. See Mergers & Economic Concentration, Hearings before Subcommittee on Antitrust, Sec. 96-26 pt. 2, statistics on p. 16 showing that acquired firm stockholder's receive large premium over market value for their shares.

3. Ability to pay tax

The proposal is consistent with the ability to pay tax concept because, if need be, the sellers can obtain cash to pay their taxes by selling some of the publicly traded stock they receive or using it as security for a loan. Such sellers are in no worse position than the taxpayer who sells his RCA stock so that he can invest the proceeds in IBM stock or in a small business. The transaction was not an involuntary conversion (except for possibly some minority shareholders of the selling corporation who, by accepting the position of minority shareholder, have voluntarily surrendered control over timing of dividends and other corporate distributions) so that deferral of taxation is not warranted by the involuntary nature of the exchange. Compare I.R.C. § 1034. Nor is the asset received indivisible as is often the case in § 1031 like-kind exchanges.
Section 351 Incorporating Transfers

Certain incorporating transfers meeting the requirements of I.R.C. section 351 are non-taxable exchanges. The purpose of section 351 is to promote new business formation and flexibility in form of business organization. Tax-free incorporations like tax-free mergers promote flexibility in form of business organization. Both types of transactions allow shifting of factors of production such as needed capital, technology and managerial skills so as to allow for increased efficiency and business viability. However, there are differences between tax-free incorporations and tax-free acquisitive mergers in terms of impact on industrial structure and economic effects. Incorporating transfers are usually a first step in starting a new business or changing the form of a business from sole proprietorship or partnership to a corporate form. Tax free acquisitive mergers usually represent the joining together of separate existing corporate businesses and are accompanied by a transfer of control and ownership to another. Most incorporating transfers result in the creation of new, small businesses, most acquisitive mergers result in the disappearance of a small business and the increase in size of a large business. An exception to the general rule of recognition of gain and loss on sales or exchanges for business creating exchanges is justifiable in terms of economic policy. An exception to the general recognition rule is also justifiable for mere changes in form from sole proprietorship or
partnership to corporate form on grounds of making an existing business more viable by increasing financing capability, limiting liability, providing for business continuity and allowing for a structured form of centralized management. Such rationales do not justify nonrecognition treatment for acquisitive mergers of two or more existing businesses already operating in corporate form which ordinarily results in continuation of the separate businesses under a centralized management.

Some incorporating transfers can be imagined which would be like mergers e.g., where two separate operating businesses are combined in section 351 incorporating transfers. To make the problem even clearer assume 1000 small corner sole proprietor grocers incorporate in a single corporation or assume A & P and a small corner grocer transfer their businesses to form a new corporation. Although these latter transactions would come within the literal language of section 351 as non-taxable incorporating transfers, at least one commentator has doubts that such transactions (other than the transfer by A & P) would come within section 351. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, p. 3-6 (Student ed., 4th ed., 1979). In view of the fact that Congress specially provided that certain investment diversification incorporations are not tax-free by enacting section 351(d) in 1966, it is however arguable that the courts would not make taxable incorporating transfers like the 1000 small grocers without specific statutory authorization.
Should section 351 tax-free incorporation treatment be limited to make taxable the incorporation of two separate sole proprietorships or the 1000 small grocers incorporations? The amalgamation of two separate businesses into a single corporation tax-free is apparently difficult to justify since arguably the creation of new business ventures is not encouraged and there has been a change in the substance as well as the form of the investments of the transferors. However, such tax-free amalgamation of separate sole proprietorship or partnerships may be defended on the ground that the investors have a substantial continuity of interest in their old assets, assuming each transferor group receives a substantial proprietary interest (i.e., 20% or greater) in the newly formed corporation. If the two business transferors do not receive a substantial proprietary interest in the new corporation, presumably other transferors have contributed substantially more valuable property, thereby causing such a dramatic change in the scope of the businesses as to invoke the new business creation justification for non-taxability.

In the case of the 1000 small grocers, the incorporating transfers should arguably be taxable for the reason that the transferors have altered the substance of their investment, having exchanged business property for less than a 1% interest in a corporation. However, it is arguable that section 351 need not be amended to make this type of transaction taxable since it is highly unlikely to ever occur, i.e., it is unlikely that 1000 or even 100 small grocers would be willing to form such
a corporation to operate many separate small businesses. There is a much greater likelihood of incorporation of 2 or perhaps even 5 sole proprietorships or partnerships but in such incorporations there would likely be substantial continuity of proprietary interest in the sense that each of the previous small business owners would obtain a substantial, i.e., 20% or greater, proprietary interest in the new enterprise or a substantial likelihood of creation of a new business. Section 351 could be explicitly amended to make taxable incorporations in which the owners of small businesses receive less than a 20% proprietary interest in the new venture but such amendment would not have great impact, would raise difficult questions of what is a "business" and might impede some creations of new businesses out of the assets of existing businesses. In any event the likely result of such mergers of sole proprietorships or partnerships is not the creation of a large corporation.

If A & P and a small corner grocer should transfer their business assets to a new corporation in incorporating transfers, the small corner grocer should have a taxable transaction because the substance of these transfers is a sale of the small corner grocer to A & P. As to A & P there is substantial continuity of proprietary interest by A & P in its transferred assets but no such substantial continuity exists with respect to the small corner grocer who will probably receive less than 1% of the stock in the new corporation and no new business is created. However, since the likelihood of such a transaction
is improbable, A & P not likely to go to the expense of establishing a new corporate form in order to acquire a small grocer, and since the impact on business concentration would not be great, most sole proprietorships and partnerships being smaller businesses, it appears that section 351 need not be amended to make taxable the merger of a sole proprietorship or partnership into a corporation in section 351 incorporating transfers. Recommended Amendments to IRC § 351.

Section 351 does need to be amended, to exclude from tax-free treatment certain types of incorporating transfers. The purposes of section 351 (tax-free incorporation of existing businesses and tax-free formation of new businesses) are not furthered by giving such tax-free treatment to transfers of stock and securities. By limiting application of section 351 to assets other than stock or securities some of the overlap between section 351 and the reorganization provisions would be eliminated.

Incorporating transfers of assets by two or more corporations which have the substantial effect of a merger or consolidation should also be excluded from tax-free treatment under IRC section 351. This rule would be needed to prevent circumvention of the taxable merger route through consolidating transfers where the transferor corporations do not distribute the stock they receive in exchange for their assets. For example, if A Corp. and B Corp. each contribute all of their assets to newly formed C Corp. in exchange for C Corp. stock, the
effects of the transactions are substantially the same as a consolidation of A and B Corps. even if the C Corp. stock is not distributed to the shareholders of A Corp. and B Corp. It should be noted that this type of transaction is a realistic possibility, see Rev. Rul. 68-357, 1968-2 C.B. 144; Rev. Rul. 76-123, 1976-1 C.B. 94. Furthermore, such transfers may have a substantial impact on concentration of business because there is greater probability that the corporate businesses so joined will be substantial in size. Difficulties can be imagined in determining when the substance of a transaction is that of a merger or consolidation but as a rule of thumb it is proposed that the transfer of more than 50% of the assets of each of two or more corporations to a new corporation is in substance a merger or consolidation of those existing corporate businesses. Such incorporating transfers which are in substance mergers or consolidations of two or more companies should be taxable events for any corporate transferor which receives 50% or less of the voting stock of the new corporation, i.e., section 351 should apply to only such transferor corporations which receive more than 50% of the voting stock of the newly formed corporation.

**Securities in § 351 Transactions**

A separate and distinct issue arising in section 351 incorporating transfers is whether the receipt of "securities" by the transferors should continue to qualify for tax-free treatment. Securities for this purpose are defined as debt...
with a maturity date, in general, in excess of ten years. (F., Camp Walters Enterprises, Inc. v. CIR, 22Tc 737, 750-751 (1954), aff'd 230 F.2d 555 (5th Cir.), cert. denied 352 U.S. 826 (1956). Since securities give the incorporating transferor substantially less of a continuing proprietary interest in the transferred property than does stock, it is arguable that securities received should be treated as "boot" for purposes of section 351.

From a policy perspective, according tax-free treatment to the receipt of securities in section 351 transactions has mixed effects on the viability of small business. On the one hand, such tax-free treatment could encourage larger capitalization of small business by giving the incorporators and outside investors a specific timetable as to when their investment may be reclaimed. While invested in the corporation, these funds represented by securities may be generating income in excess of the interest rate charged the corporation, and such excess generated income may be taxed at lower corporate rates than if taxed to the security holder. On the other hand, the issuance of securities by the new corporation can aggravate capital needs of the business because of the need to pay interest at a fixed rate on the debt and eventually, the need to repay the debt. In the absence of clearer evidence as to the effects of tax-free receipt of securities in incorporating transfers on the viability of small business, no change is recommended in existing law. Since the transferor-
security holders will recognize their gain or loss on transferred property when the securities are redeemed, it is arguable that such deferral of taxation is warranted by the same policies which justify nonrecognition treatment for transferors who receive stock.

Depreciation

Large corporations are more capital intensive than small corporations in the sense that they have higher ratios of total assets and depreciable assets to business receipts than do smaller businesses.

### Active Manufacturing Corporations - 1975

**Measures of Capital Intensity**

<table>
<thead>
<tr>
<th>Asset Size Category</th>
<th>$1 under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-10 million</th>
<th>10-100 million</th>
<th>100-250 million</th>
<th>over 250 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets/Total Receipts</td>
<td>31.7</td>
<td>40.6</td>
<td>41.0</td>
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<td>61.7</td>
<td>69.8</td>
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<td>Depreciable Assets/ Bus. Receipts</td>
<td>21.6</td>
<td>24.0</td>
<td>22.2</td>
<td>24.2</td>
<td>30.7</td>
<td>36.4</td>
<td>41.8</td>
</tr>
</tbody>
</table>

### Active Wholesale and Retail Trade Corporations - 1975

**Measures of Capital Intensity**

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<th>Asset Size Category</th>
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<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-10 million</th>
<th>10-100 million</th>
<th>100-250 million</th>
<th>over 250 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets/Total Receipts</td>
<td>23.7</td>
<td>30.4</td>
<td>31.0</td>
<td>31.8</td>
<td>35.5</td>
<td>32.5</td>
<td>45.6</td>
</tr>
<tr>
<td>Depreciable Assets/ Bus. Receipts</td>
<td>10.5</td>
<td>10.2</td>
<td>8.9</td>
<td>8.4</td>
<td>9.4</td>
<td>10.8</td>
<td>12.9</td>
</tr>
</tbody>
</table>

It is not surprising in light of the capital intensive nature of very large corporations, that depreciation would provide greater tax benefits to large corporations than to small and medium size...
corporations. (Some of the greater savings to large corporations can be attributed to the fact that depreciation deductions, like any other deductions, save more taxes for a high bracket than a low bracket taxpayer. This effect is inherent in a progressive tax on net income.) As the next table illustrates, large corporations do in fact offset proportionately more gross income with depreciation deductions than do smaller corporations.

Active Manufacturing Corporations and Trade Corporations - 1975
Ratio of Depreciation Deductions to Total Receipts

<table>
<thead>
<tr>
<th>Asset Size Categories</th>
<th>$1 under 100,000</th>
<th>100,000-500,000</th>
<th>500,000-1 million</th>
<th>1-10 million</th>
<th>10-100 million</th>
<th>100-250 million</th>
<th>Over 250 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>2.3</td>
<td>2.2</td>
<td>1.9</td>
<td>1.9</td>
<td>2.2</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>1.2</td>
<td>1.0</td>
<td>.8</td>
<td>.8</td>
<td>.8</td>
<td>.8</td>
<td>.9</td>
</tr>
<tr>
<td>Totals for Manufacturing</td>
<td>2.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td>Totals for Wholesale &amp; Retail</td>
<td>.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>.9</td>
<td></td>
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</tbody>
</table>

Whether the proportionately greater depreciation deductions claimed by large corporations unfairly discriminates against small and medium size corporations depends upon whether 1) allowable depreciation rates are economically justifiable, and 2) all sizes of corporations have similar opportunities to use the same depreciation rates. If current depreciation rates exceed economically justifiable rates, than the tax law depreciation provisions unfairly discriminate in favor of larger, more capital intensive businesses. If some methods of accelerated depreciation are only in reality available to large corporations, e.g., the ADR system, the tax law discriminates unfairly in favor of those large corporations.
Economically justifiable depreciation

What constitutes fair depreciation for capital expenditures would arguably not be a difficult concept if our economy were neither inflationary or deflationary. Assuming away inflation and deflation, the allocation of capital costs to the revenues they produce would appear equitable under our tax system, the allocation based on the annual decline in value of property used in trade or business or held for investment resulting from wear, tear or obsolescence. See I.R.C. § 167. Accelerated depreciation methods would be fair to the extent they merely represent more rapid decline in an asset's value during its earlier years' of use. Such depreciation deductions would generate a tax-free cash flow equal to replacement costs for the assets depreciated.

Inflation makes total depreciation deductions less than the cost of replacement, such excess costs having to be made up by the on-going business obtaining additional outside investment or by higher after-tax rates of return on internally generated funds. If depreciation does not take inflation into account, part of the taxable business profits would merely reflect keeping up with inflation rather than taxation of net increases in wealth. Arguably the unfairness to businessmen is no greater than the unfairness to any investor who must pay tax on gains which merely represent the impact of inflation. However, it is possible to distinguish inflationary impact on business assets subject to wear, tear and
absolescence from inflationary impact on personal assets or business assets not subject to wear, tear and absolescence, e.g., raw land owned by a business or a personal residence. Assets subject to wear, tear and absolescence will someday become worthless. Regardless of inflation these assets will be used up in the production process. The "benefits" of inflation will be enjoyed by the owners of such depreciable property only to the extent that its salvage value, if any, is increased and higher returns on the asset are produced. Economic pressures would be generated by inflation to raise the rate of return on invested, depreciable assets so as to generate after-tax cash profits to allow for replacement of the depreciated assets at inflated prices, but competition, to the extent it determines its supply curve on the basis of historical rather than inflation indexed costs, would limit the rate of return on these depreciable assets. Assets not subject to wear, tear and obsolescence presumably would increase in value in response to inflation. The owner of the non-depreciable asset winds up with no increase or decrease in wealth in the economic sense, but may have to pay a capital gains tax if he sells or exchanges the assets. The owner of the depreciable asset winds up with a practically worthless assets which during its useful life produced tax deductions equal to its historical cost and generated income consistent with its historical cost. To the extent the depreciating asset generated excess income due to inflation (e.g., impact of inflation on the demand curve, competitors acquired new equipment, etc.) such excess income was taxed as ordinary income and not as capital gain.
Thus the argument for inflation indexing of depreciable assets can be made.

Assuming that inflation adjustments for depreciation can be justified on fairness or policy grounds, there are a variety of methods which can be used to make these adjustments. One method is to allow accelerated depreciation in excess of economic depreciation and/or tax credits for new capital additions as our current tax law allows. The main problem with this approach is that the benefits will vary with the rate of inflation and may be less than or more than is necessary to adjust for inflation. For example, Professor Jorgenson concludes that the effective tax rate under our current tax system (depreciation and investment credits) on construction machinery income is 6% if the inflation rate is 6% and 34% if the inflation rate is 12%. Hearings on Tax Restructuring Act of 1979 at p. 71. The effective tax rate on construction machinery income under these conditions is substantially less than the statutory tax rate on corporate income in excess of $100,000 (46%), and thus the tax benefits generated are arguably more than can be justified as an inflation adjustment. Proposals to liberalize depreciation such as the Conable-Jones 10-5-3 proposal would further lower these effective tax rates, producing a negative effective tax rate on construction machinery investment assuming a 6% inflation rate.
A different approach to making inflation adjustments for depreciation deductions is taken by Smith and Sullivan, *The Taxation of "Real Profit": Towards a Laissez-Faire Revenue Code*, 51 Nebraska L. Rev. 258 (1971). They would index basis in assets for inflation and allow depreciation deductions on an increasing (during inflationary periods) basis which should result in total depreciation deductions more nearly approximating replacement costs. Such increased depreciation deductions would allow generation of a tax free cash flow sufficient to replace used up assets.

To correct the inflation problem Prof. Dale W. Jorgenson, (Hearings, Ways & Means Comm. on Tax Restructuring Act of 1979, 96th Cong. 1st Sess. p. 62, Serial 96-50 (Nov. 1979) proposes a First Year Capital Recovery System which would allow deduction of the cost of an assets in the year of acquisition, discounted down to present value. The discount is necessary because "economic depreciation actually occurs in the years after the asset is originally acquired. Future economic depreciation must be discounted back to the present to arrive at a present value of economic depreciation." Jorgenson, supra at p. 67.

There are several problems with the Jorgenson proposal. First, what rate is to be used in establishing this discount? Second, the proposal might not benefit newly established businesses and other businesses which do not have sufficient earnings to utilize the entire deduction in the first year. Third, because of progressive tax rates the tax savings resulting from
current deduction may be less than the tax savings from a pro-rated deduction. Perhaps the second and third problems raised above are not substantial in many situations because of income averaging and less carryovers. As for the first problem, establishing a real discount rate, it may be possible to justify an extremely low discount rate to encourage investment in depreciable assets.

Assuming that inflation adjustments should be made for depreciable assets, can even greater benefits for depreciable asset investment be justified? For example, does the need for increased investment in our economy justify even greater tax benefits for investments in depreciable property?

One problem with granting special tax benefits to capital investments is that it might cause economic inefficiency due to misallocation of resources, i.e., more capital is invested in fixed tangible assets qualifying for the benefits and less invested in other forms such as research and development, education, intangible assets, advertising, inventories, etc. The misallocation problem is especially acute for the investment tax credit which grants benefits basically for equipment acquisitions but not for investments in new plants or commercial buildings. Of course, the ultimate impact of the taxation on allocation of resources could only be determined after correlation with the impact of other tax law burdens and benefits, e.g., payroll taxes, corporate income taxes, recapture of depreciation, like-kind exchange non-recognition, expensing of R & D expenditures, capital gains treatment, percentage depletion for minerals, etc. Even
the investment tax credit might be justified if, for example, it can be shown that current depreciation of commercial, industrial and rental buildings is based on unreasonably short estimates of useful life and/or unreasonably low estimates of salvage value. Thus it is possible for some to conclude that the tax laws encourage overinvestment in equipment (Cf. Jorgenson) and others to conclude that the current tax laws encourage overinvestment in buildings. Since most manufacturing operations are conducted by corporations subject to corporate income tax but many rental residential buildings are owned by individuals, the corporate income tax may cause a misallocation of resources from manufacturing to housing. (Cf., statement of Mr. Shoven, Hearings on Tax Restructuring Act of 1979 at p. 112.)

In short, resource misallocation effects of specific tax law provisions could be accurately discussed and predicted if we had a simpler tax system, i.e., if we assume away all the other special provisions in the current tax law which impact on resource allocation. Perhaps we would also have to assume away all other causes of misallocation resources, e.g., Regulation Q, tariffs and quotas, government subsidies, etc., in order to determine whether a particular tax law provision causes resource allocations different than would occur in a hypothetical market economy that never was.

Greater tax benefits for investment in depreciable business property can be justified as part of a scheme to increase total business investments in our economy. By granting special tax benefits to a larger variety of business investments, e.g.,
R & D expenditures, business organization costs, increased inventory costs, etc., hopefully investment resources will not be grossly misallocated and benefits somewhat similar to those achieved by a lower tax on reinvested business earnings is achievable. Such an item by item approach would make the benefits of reinvested earnings available to large and small businesses, to corporations, sole proprietorships and partnerships. The item by item approach would not be as good as lower taxes on retained business earnings in general (e.g., SBE proposal, infra) since it may be impossible under the item by item approach to grant tax benefits for earnings retained in the business for working capital. But the item by item approach would involve less dramatic changes in our tax laws than the SBE proposal and might therefore be more politically feasible.

In conclusion it may be said that depreciation deductions in excess of real declines in value of fixed assets may be justified by the impact of inflation on replacement costs. Allowance of the use of accelerated depreciation represents one method of taking inflationary impacts into account; its fairness depends on the rate of inflation and the existence of other tax law provisions which may ameliorate the proportionately greater tax benefits it bestows on capital intensive businesses.

Availability of accelerated depreciation methods by different size businesses

In a strict legal sense the Internal Revenue Code does not limit use of any particular depreciation method to any
particular size of business. There are, however, at least three depreciation provisions which have differing impact on different size businesses: 1) Additional First-Year Depreciation, 2) Class Life Asset Depreciation Range (ADR) depreciation, and 3) limitation of accelerated depreciation to new property.

Additional first year depreciation of 20% of the cost of certain business property is allowed to both General Motors and the small corner grocery store. However, since the total Additional first year depreciation deduction is limited to $2,000 ($4,000 on a joint return) the benefit of such depreciation is proportionately greater (as a percent of total tax liability) for the small corner grocer than for G.M. For G.M. additional first year depreciation is an insignificant tax benefit. Additional first year depreciation is also probably of insignificant benefit to most medium size firms. Such disproportionate benefits can be justified on grounds that 1) all businesses receive the same dollar benefit, 2) the need for incentives for very small and start-up businesses and 3) the low cost in lost revenues.

It is alleged that the ADR depreciation system allows the fastest depreciation of assets and that the ADR system, because of its complexity, is in reality only available for use by the largest corporations. According to the White House Commission on Small Business, "Internal Revenue Service figures show that 94% of the biggest companies use ADR, but only 1/2 of 1% of companies with less than $15 million in as-
sets use it." At p. 27, citing 1974 ADR Data, Office of Industrial Economics, U.S. Department of Treasury. It appears that the disproportionate benefits of ADR cannot be justified on the grounds which justify Additional first year depreciation. Corrective legislation could provide a simplified ADR method for small business or replace the ADR system with another accelerated depreciation method such as the Jones-Conable 10-5-3 proposal or the Jorgenson proposal. If a substitute for the ADR system is the chosen route to elimination of the disproportionate benefits of ADR, care must be taken to assume that such substitute does not provide overly generous benefits to capital intensive businesses, taking into account the impact of inflation on replacement costs and other tax burdens and benefits accruing to non-capital intensive businesses.

I.R.C. section 167(c), as interpreted by Reg. § 1.167(c)-1, limits the use of certain accelerated depreciation methods (double declining balance and sum of the years-digits methods) essentially to new property. To the extent investment by small businesses in used equipment is greater than investment by large businesses in used equipment, the limitation on the use of accelerated depreciation for used property arguably discriminates against small business.
Investment Credits

Large corporations claim proportionately greater investment credits than small and medium sized corporations in relation to Business Receipts. On the other hand, investment credits confer greater percentage tax liability reductions on small (under $1 million in asset size) corporations and large corporations (over $100 million in asset size) than on medium size corporations ($10-100 million in asset size).

Investment Credits as a Percent of Business Receipts, Net Income, Corporate Income Tax Liability and Depreciable Assets
Active Manufacturing Corporations - 1975

<table>
<thead>
<tr>
<th>Asset Size</th>
<th>Investment Credits as Percent of:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1 under 100,000</td>
</tr>
<tr>
<td>Business Receipts</td>
<td>.086</td>
</tr>
<tr>
<td>Net Income</td>
<td>2.91</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>24.52</td>
</tr>
<tr>
<td>Depreciable Assets</td>
<td>.399</td>
</tr>
</tbody>
</table>

Investment tax credits may represent "unfair" discrimination in the sense that, unlike depreciation deductions which represent a mere timing of capital recovery costs problem, investment credits represent a subsidy to investors in qualifying assets. Taxpayers claiming investment tax credits do not reduce their basis in property on which the credit is claimed by reason of claiming the credit, i.e., they receive full capital cost recovery through depreciation in addition to the investment credit subsidy. Thus, economic justification for investment tax credits is more difficult than economic justification of accelerated depreciation.
Assuming that economic justification for investment tax credits could be made, e.g., as an offset to inadequate deprecation allowances during inflationary periods, questions would still remain regarding possible discriminatory effects of the current investment tax credit system among businesses of differing asset size. (Economic justification would presumably justify discriminatory impact of investment credits on service and other non-capital intensive industries.)

The investment credit can be used to offset the first $25,000 of tax liability and 70% (increased to 90% by 1982) of the tax liability in excess of $25,000. I.R.C. § 46(a)(3). Excess credits are carried back 3 years and forward 7 years. Limiting the credit by the amount of tax liability can result in loss of the credit to firms lacking adequate taxable income within the 10 year period. Since small and medium size business profitability is more volatile than large firm profitability, it can be anticipated that a greater percentage of small and medium sized firms would have losses and inadequate earnings to utilize their investment credits. Statistical data supports this hypothesis:

<table>
<thead>
<tr>
<th>Investment Credit Size</th>
<th>Number of Returns</th>
<th>% of Unused Credit</th>
<th>Unused Credit/Tentative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 50,000</td>
<td>16,099</td>
<td>205</td>
<td>19.2%</td>
</tr>
<tr>
<td>50,000-100,000</td>
<td>148</td>
<td>59</td>
<td>28.8%</td>
</tr>
<tr>
<td>100,000-250,000</td>
<td>75</td>
<td>201</td>
<td>67.1%</td>
</tr>
<tr>
<td>250,000-500,000</td>
<td>37</td>
<td>97</td>
<td>43.9%</td>
</tr>
<tr>
<td>500,000-1 million</td>
<td>18</td>
<td>85</td>
<td>27.8%</td>
</tr>
<tr>
<td>1-10 million</td>
<td>36</td>
<td>434</td>
<td>22.5%</td>
</tr>
<tr>
<td>Over 10 million</td>
<td>5</td>
<td>91</td>
<td>3.22%</td>
</tr>
</tbody>
</table>
(1) Number of returns with unused investment credit.

(2) Unused investment credits for 1975 as a percent of tentative investment credit on investment qualified for credit. Table 15, Statistics of Income.

It would appear that the investment credit limitations may make the credit most available where it is least justified (large, profitable corporations with normal capital replacement) and least available where it is most needed (small and medium size high risk corporations with substantial new investment).

E) Inventory valuation methods

Two basic methods of computing inventory costs are the FIFO and LIFO methods. Use of the FIFO method during inflationary periods results in lower cost of goods sold deductions than use of the LIFO method. The LIFO method, however, is much more complex than the FIFO method and requires sophisticated tax and accounting procedures to implement. See Reg. § 1. Most large businesses use the LIFO method of accounting for inventories and most small businesses use the FIFO method. Also, smaller businesses, in general, have a larger percentage of their total investment in inventories than do larger companies. See Statement of Hon. Frederic W. Hickman, Assistant Secretary of the Treasury for Tax Policy, id. at 247. The chamberlain bill, see Small Business Tax Needs, Hearings Feb., 1975, at p. 9 proposed a simplified LIFO method for small business. The IRS had a simplified LIFO procedure in process.
in February, 1975 (see statement of Hon. Frederic W. Hickman, id. at p. 272. However, it is questionable whether the LIFO method could be sufficiently simplified to make it usable by most small businesses.

It is suspected that inventory turnover rates for small businesses are much higher than for large businesses, thus limiting the importance of LIFO accounting for small businesses. Perhaps inventory turnover rates of small and large businesses must be compared on an industry by industry basis since most large firms are in manufacturing and most small firms are in services and retail sales. Only by making such industry comparisons can the extent of the LIFO discrimination in favor of large businesses under current tax law be determined.

Even if LIFO inventory valuation does not discriminate against small business, the fact that investments in tangible assets get preferential tax treatment (accelerated depreciation and investment credits) works to discriminate against small businesses. For increasing its tangible assets investment firms obtain a tax savings but for increasing investment in inventories (due to increases in the size of inventory) businesses get no tax savings. If small businesses are inventory intensive, tax benefits for equipment investments should be offset by tax incentives for inventory investments. Such tax benefits for inventory investments could be created by allowing deduction for all inventory purchases without adjustment for inventory changes. By equating inventory purchases
with cost of goods sold, businessmen could get a deduction for earnings reinvested in the business inventory. Of course, this accounting would fail to match costs with revenues, but so do accelerated depreciation methods and tax credits for investments in new equipment.

A significant problem with allowing deduction of inventory purchases as cost of goods sold is that it might open the doors to tax avoidance. These tax avoidance possibilities are similar in nature to the tax avoidance possibilities with respect to investment in tangible assets, i.e., tax deferral and conversion of ordinary income into capital gain. However, the tax avoidance possibilities with investment in inventory appear greater than those with investment in equipment and real estate for a number of reasons. First, investment in business inventory is easier than investment in equipment, requiring less of a long-term commitment to business profitability. Secondly, the deduction for inventory increases would be 100% of the increased inventory investment under the above proposal, but accelerated depreciation results in deduction of only some percent of the fixed asset investment and only that portion in excess of straight-line depreciation can be considered to be a tax bounty. Third, in many cases inventory is more readily saleable than is business equipment and business structures. To make the tax treatment of inventory investment and fixed asset investment similar it is necessary to give similar deductions for both, e.g., allow deduction of 10% of total increased investment in either. Because of the much faster turnover rates for inven-
tory than for fixed assets it does not appear feasible to grant investment credits on inventory purchases. Of course, this problem with investment credits for inventory illustrates a major weakness of investment credits for fixed asset purchases—allowing credits for investments which may be turned over every 3 to 7 years, most of which investments would have been made even if there were no investment credit.

F) Employment Taxes—Social Security, Unemployment Insurance & Workmen's Compensation

Since small business is more labor intensive than large business, taxes on wages such as social security taxes and Unemployment Insurance taxes arguably place a heavier burden on small businesses than large businesses. Do the tax laws have a neutral impact on the balance between capital and labor factors of production? Do social security, workmen's compensation and unemployment insurance costs reflect the true cost of labor or do they reflect societal costs necessitated by policies of assing the financial plight of retired and unemployed workers? In other words, are these true labor costs or are they a form of social welfare cost? If they are a form of social welfare costs than such costs should be paid out of the general revenues and not allocated to the labor factor of production.

Social security contributions were at one time viewed as a kind of forced savings, i.e., employees would have to set aside a portion of their wages to provide for their own retirement or disability. The fact that the employer could deduct the entire social security cost but the employee only had to include one-
half such cost in income could be justified as a compromise be-
tween taxing and not taxing as income to the employee that por-
tion of his wages involuntarily set beyond his immediate reach
to provide for his disability or retirement. However, there is
little relationship between an individual employees FICA tax
and the value of benefits that employee will get. If benefits
were correlated with the individuals contributions, FICA taxes
could still be viewed as true labor costs. Such costs could
be viewed as true labor costs when the social security system
was adopted because we did not have at that time a general
social welfare system which provided for the needs of the non-
employed and the under-employed. In light of the adoption of
more generalized welfare schemes, social security unemployment
compensation and workmen's compensation have become partial
substitutes for payments out of the general welfare fund. Thus,
at least to the extent that social security, unemployment and
workmen's compensation are a substitute for welfare, they should
be considered societal rather than labor costs. Since society
has established these minimum standards of welfare for all per-
sons, the costs of providing such minimum standards of welfare
should be allocated to general revenues and not to one specific
factor of production, i.e., labor. In order to have a more
neutral tax system, i.e., to prevent misallocations amongst
the factors of production, the costs of social security, unem-
ployment and workmen's compensation should be funded out of
general revenues to the extent such costs reflect a substitute
for general welfare costs.
Because of the complex interrelationships between social security, unemployment, workmens' compensation and general welfare plans, because benefits have only a rough correlation with contributions and because of the fact that current social security tax collections on employees are used to pay current benefits to retired workers, it would be difficult if not impossible to ascertain accurate allocations of such costs between societal and labor costs. Nevertheless, it is justifiable to conclude that some portion of such costs should be borne by the general revenues rather than being borne solely by labor.

At this time the main proposal to reduce employment taxes is contained in the VAT proposal. If VAT is not enacted, new legislation should be proposed to reduce employment taxes.

In addition to reducing the rates of employment taxes, legislation should also be enacted to defer taxation of the employees one-half of the FICA tax until retirement benefits are received.

G) Tax credits for new jobs

Jobs credits are available for the employment of welfare recipients (WIN Jobs Credit, I.R.C. § 50B) or for the employment of handicapped individuals, young persons and Viet-Nam Vets from disadvantaged families, welfare recipients, young persons who participate in qualified cooperative education programs, and ex-convicts (Targeted Jobs Credit, I.R.C. § 44B). The amount of the credit is 50% of the first $6,000 wages paid each such new employee in the first year and 25% of the first $6000 wages paid each such employee in the second year. (See I.R.C. § 50A, WIN Jobs Credit;
I.R.C. § 51, Targeted Jobs Credit.) These job credits are available for 1979 and 1980, the Secretaries of Labor and Treasury to report to the Senate Finance Committee and the House Ways and Means Committee on the effectiveness of such credits by June 30, 1981.

The purposes of these job credits are to induce businesses to find jobs for those groups which have higher than average unemployment and to reduce welfare expenditures. It might be questioned whether conferring a tax benefit on the employer is an appropriate means to accomplish these purposes. Furthermore, it might be questioned whether these job credits will have a discriminatory impact on large and small business employers. However, such tax benefits to employers, whether large or small businesses, can be justified on the grounds that they encourage employment of the hard-core unemployed, who are unemployed or underemployed because of lack of skills, poor work habits, lack of training, etc. and whose employment, if not subsidized, would be uneconomical. Obviously, not all employees in qualifying groups are underproductive. Some might be more subject to discrimination, e.g., handicapped, minorities, ex-convicts, and job credits justifiable as a means of reducing such discriminatory effects on employment. Although these job credits may somewhat distort the capital-labor balance in favor of labor, some employers may get "windfalls" in terms of finding highly productive employees from amongst the qualified groups and the jobs credits may provide unequal benefits to large and small businesses, these job credits appear a justifiable means to accomplish necessary non-economic as well as economic goals. Classification of groups
eligible to qualify as job credit employees will need continuing
review and refinement to minimize employer "windfalls" not justified
by public policy.

Also, small businessmen and their accountants need to be much
better informed about the WIN and Targeted Jobs Credits. The statutes
need to be simplified, if possible, and concise explanations of these
tax credits and how to utilize them (e.g., how to advertise or seek
out such employees, forms to determine whether an employee qualifies)
distributed to small businesses and their accountants. It is
suspected by this author that most small businessmen and their
accountants are not aware of the availability of such credits.

J) Investment Credit for Energy Saving Devices

These credits are likely to have effects similar to credits for
investment in equipment in terms of small and large businesses. Even
if these credits discriminate in favor of large business they are
defensible as an attempt to deal with the energy crises. Some econo-
mists might argue that we should let market forces resolve the energy
crisis; that use of energy credits will cause a less than optimum
response to the energy crisis. The nature of energy credits enacted
whether for energy saving or energy conversion and the types of
energy conversion preferred, will likely impact on the nature and
extent of our response to the energy crisis. Without energy credits
the energy crisis might cause different changes in industry structure,
e.g., greater shifts to labor rather than capital intensive business,
greater shifts to energy saving processes and equipment, reduction
in operating hours, etc. Energy credits can be viewed as a form
of subsidy to energy users. They are justifiable as short-term measures to assist businesses and individuals to cope with recent dramatic increases in the cost of oil and smooth the transition to other energy forms and greater energy savings.

On a longer term basis energy credits for conservation of non-renewable resources are defensible on "non-economic" grounds, to preserve some of these resources for future generations. Under "perfect competition" prices are determined by the laws of supply and demand, supply curves determined by marginal costs and demand curves determined by marginal utility. But for the OPEC monopoly on oil production, imperfect though it is, oil prices would be much lower, approaching the very low costs of production of oil. Supply curves would represent a function of current production costs. Even though oil producers might recognize the future potential scarcity of oil, oil prices in perfect competition would be determined primarily by current supply and demand curves which would be determined by current marginal utility and current marginal costs. Only by intervention with the market system, e.g., collusive agreement of oil producers to cut production or set "artificially" high prices will oil producers get a price for their product which reflects the non-renewable nature of their product. This "defect" of the market system to reflect potential future scarcities in non-renewable resources could be termed the "Now defect in non-renewable resource pricing."

Individual oil producers might seek to withhold current production and save some of their oil reserves for future sale but there are political and economic limitations. Politically there
are fears of nationalization of oil reserves brought about by withholding domestic supplies, foreign intervention to gain control of needed supplies or humanitarian concerns for oil consumers. Economically there can be fears of future development of oil substitutes, an inability to forgo current revenues, or dependence on the oil consumers. Furthermore, the "chain is no stronger than its weakest link" so that withholding of supplies by a few producers who can afford to save their oil would be offset by increased production by others who could not afford to forgo current consumption.

By inducing energy conservation and greater use of renewable energy sources government can help to preserve non-renewable energy sources for future generations. Such interference with the market system, although it may reduce current" economic efficiency" is justifiable if we are to take into consideration the welfare of future generations.

PENSION PLANS

Pension plans are of two basic types; defined contribution plans and defined benefit plans. Because of administrative problems with defined benefit plans (created by ERSIA in response to many failures of defined benefit plans), these plans are in disfavor amongst business today. This study will examine only defined contribution plans.

Defined contribution plans can be divided into different types on various bases. Qualified plans allow the employer to deduct his contributions to the plan when made, but the employee (recipient) does not report income until plan benefits are dis-
tributed, usually at retirement. To be a qualified plan it must provide non-discriminatory coverage for all employees. Under a non-qualified plan the employee has taxable income, in general, when the employer contributions are made to the plan and the employer gets a deduction when the employee has income. See I.R.C. section 83. Pension plans can also be distinguished on the basis of the form of the employer's contribution, e.g., cash, employee's securities, and on the basis by which the employer's contribution is computed, e.g., employee wages, employer profits.

Pension plan benefits paid in cash by the employer, whether qualified or non-qualified, based on wages or profits, do not provide financing aid to the employer. It is suspected that most small business pension plans are of this type. Pension plan benefits paid in employer's securities can be viewed as a financing technique by the employer, i.e., the employer satisfies his pension plan expense without any cash expenditure. The employer who pays pension plan benefits in cash has his funds depleted by 54% of the benefit paid, assuming he is a 46% tax bracket; the employer who pays pension plan benefits in his own securities has his funds increased by 46% of the benefit paid, assuming he is in a 46% tax bracket and that equivalent benefits would have been paid in cash if employer stock was not used to fund the pension benefits.

That publicly traded corporations with widely held stockholdings are the primary beneficiaries of this financing technique is arguably inherent in the nature of such corporations, i.e., because they are large, often diversified, publicly traded
corporations, employees are willing to accept employer stock instead of cash. Such employers are willing to contribute employer stock because, assuming they are widely held, there are fewer problems of shifting control and less noticeable dilution of owner's equity. (In fact, control of such corporations is frequently in a management group who own little stock but retain control through proxies.) As an alternative to contributing newly issued stock to the pension fund, such widely held, publicly traded companies could accomplish about the same results by selling newly issued shares on the open market and contributing the cash proceeds to the pension fund. Thus, it is arguably not the pension law which discriminates against small business, it is the fact that widely held and publicly traded corporations have a financing option not available to small, closely held businesses. The problem of pension plans increasing funding capacity of large corporations while not helping the funding capacity of small businesses is further accentuated by patterns of investment of pension plan funds. It is suspected that most pension plan funds including small business plans, are invested in large corporate enterprises.

ESOP'S AND TRASOPS

ESOP's (Employees Stock Ownership Plans) are like defined contribution pension plans in which the funds are invested in employer's securities. The principal difference between ESOPs and such pension plans are the ERISA allows an ESOT (1) to borrow money, repayment of which is guaranteed by
the employer and, 2) to buy stock on an installment basis from a shareholder. (ERSIA section 406(a)(1)(B) and section 408(b) (3). Thus ESOP's have potential as a corporate finance technique and as an estate planning technique.

The ESOP financing technique works in the following manner: 1) Employer adopts ESOP and establishes ESOT, 2) ESOT borrows money from bank, pledging as collateral employer's stock to be acquired with loan proceeds and employer's guaranty of loan payment, 3) ESOT pays employer for stock, 4) Employer makes annual contributions to ESOT (tax deductible) to pay off bank loan. The net effect of ESOP employer financing is roughly approximate to direct borrowing by the employer of the needed cash followed by annual contributions of employer's stock to a qualified pension plan for employees. Compare Table B with Table C, J. Kaplan, "ESOP's Fable," Taxes (Dec. 1976) at pp. 466-468, Hearings Before the Select Committee on Small Business, 5.388, The Small Business Employee Ownership Act, U.S. Sen., 96th Cong., 1st Sess. (Feb. 27, 1979). (Note, if you wish to compare apples with oranges, see ESOP's, An Analytical Report, prepared by Hewitt Associates for the Profit Sharing Council of America, 399, 424-437, where ESOP financing is compared with three alternative financing methods growth through retained earnings, debt financing and equity financing. Unfortunately the comparisons are of limited value since they compare consequences of ESOT (employer financing plus payment of employee benefits) with three pure financing techniques without payment of any employee benefits. As could be expected, per share return on shareholders' stock
is lowest with use of an ESOP since the ESOP combines borrowing with increase in shares and involves payment of pension benefits which the other alternatives do not. The ESOP financing technique can be compared with direct borrowing by the employer and employer stock contributions to a qualified plan or employer sale of stock for cash (equity financing) which cash is then contributed to a qualified pension plan for employees. ESOP financing should produce similar consequences to these other alternative financing methods assuming contributions to a qualified employee pension plan. In some situations the alternatives (debt financing with qualified pension funded with employer stock or equity financing with qualified pension funded with cash or stock) may be preferable to use of an ESOP to accomplish similar goals. See Kaplan, ESOP's Fable, supra.

The primary advantage of ESOP's over qualified plans is that the ESOT can purchase shares directly from existing shareholders and thus can be utilized to sell a business or a division of a business to employees using pre-tax earnings to pay the purchase price. Willingness on the part of existing shareholders to transfers of equity ownership and voting rights is essential to the ESOP concept. Although the ESOP regulations allow existing business owners to indirectly control the voting of stock held by an ESOP (see P.H., the Final ESOP Regulations, "Voting Rights" (1978) at p. 498 of Hearings on 5.388.), eventually such stock may be distributed to individual employees. The employer and/or the ESOT may retain a right of first refusal and employees must be given a "put option" with respect to...
distributed ESOP stock, but the employer cannot regain stock which the employee is unwilling to sell. (Id. at 504-505). Thus the employer must be willing to incur some dilution in equity if an ESOP is to be used. Furthermore, if the ESOP is to provide permanent capital increases for the employer, the employee must be willing to hold employer stock, otherwise the employee may exercise his put option when the stock is distributed to him. For small, closely held, non-publicly traded stock, these conditions i.e., employer willingness to incur equity dilution and employee willingness to hold employer stock, will probably most often be met in the case of a sale of the business to employees.

In a sale of a business through an ESOP, the following transactions take place: 1) Employer establishes ESOP, 2) ESOP borrows funds, often from local government or from bank with Small Business Administration guarantees, 3) ESOP purchases stock from existing shareholders, 4) existing shareholders pay capital gains taxes on stock sales, 5) business, now owned by ESOT, makes tax deductible contributions to ESOT to pay interest and principal on bank loan, 6) when stock is distributed from other qualified plans, i.e., if a lump sum distribution is made, the value of the securities (I.R.C. § 402(e)(4)(D)) is taxed as ordinary income subject to special 10 year averaging. (I.R.C. §402(e)). The business need not generate as much profits to make these transactions viable as would be needed if after-tax business earnings were required to purchase the business. In this manner ESOP's can serve as a
financing vehicle for the sale of small business to employees, often saving the business from sale to a large corporation, merger with a large corporation or closing.

ESOP's effectively add to the potential for a sale of a business to employees. In general, employees do not have the cash for a down payment on the purchase price of the sellers shares and it would be a more onerous burden on them to have to pay installments out of after-tax business earnings. Use of a leaveraged ESOP allows the existing shareholders to obtain faster payoff of the purchase price since the ESOP borrows the funds, using subsequent business pre-tax earnings to pay off the principle and interest on the loan. The alternative of company or shareholder debt financing in combination with qualified stock bonus plans is not a viable alternative because the qualified stock bonus trust could not purchase stock from the shareholder and sales of stock by the shareholder to the corporation might be taxed as ordinary income under IRC section 302 stock redemption rules. The ESOP employee buy out technique represents a sound method for providing incentive to the continuity of small business as small business. Such incentives should help to limit business concentration which results from merger or sale of small businesses into competitors, suppliers, customers and conglomerates. See in general, Profile of the Perpetuation Crisis, a study commissioned by the National Association of Wholesaler-Distributors, Hearings on S. 388 at pp. 32-59.

It should be noted, however, that ESOP's can also be utilized in corporate acquisitions. For example, assume the P Corp. wants to acquire S Corp. P Corp could 1) establish
an ESOP, 2) ESOT borrows money from bank which it uses to purchase shares of stock in P Corp. P Corp uses cash to purchase assets of S Corp. Profits and wage base of P Corp. expanded by acquisition to include S Corp. profits and wages thus making loan payoff easier to meet. The result is combination of P and S Corps into one corporation with equity ownership diversified through the ESOP. Similar results could be accomplished without the use of an ESOP, e.g., debt financing by P Corp. in combination with a qualified stock bonus plan. It would appear that ESOP's do not provide tax incentives to business acquisitions which are more extensive than those allowed under existing tax law provisions. Nevertheless, the ingenuity of tax planners should not be underestimated. It is important that continuing review of actual usage of ESOPs be made so as to reveal any possible tax incentives to business concentration that tax planners (more creative than this writer) might devise using ESOP's. Other business concentration effects of ESOP also must be kept under surveillance, e.g., circumvention of antitrust laws by having employer controlled ESOT acquire a competitor, SBA loan guarantees for loans to ESOP's the proceeds of which loan are used by the employer to acquire other firms. See Statement of Herbert Liebenson, on behalf of the National Small Business Association, Hearings on S. 388, supra at 66.
TRASOPs are employee benefit plans like, in many respects, ESOPs. The main difference is that with TRASOPs the employer gets an additional 1% investment tax credit for the contributions to the TRASOP made by the employer of its stock, or cash which is used to purchase its stock. The employer may get an additional 1/2% investment credit for additional contributions if the employees make payments to the TRASOP which match the employer's contributions. The employer gets no deduction for contributions to a TRASOP. For example, if an employer purchased $10,000,000 worth of new equipment during the tax year which qualified for a 10% investment tax credit, the employer would get a $1,000,000 investment tax credit. By contributing $100,000 of employer stock to a TRASOP (or contributing $100,000 cash which the TRASOP invested in employer stock) the employer would get a $1,100,000 investment tax credit.

TRASOP's are of most benefit to corporations which make very substantial expenditures for investment credit type assets, i.e., equipment. For example, if a corporation made annual equipment acquisitions of $100,000 per year, its maximum TRASOP tax credit would be $1,500, which would probably be significantly less than the cost of establishing and operating a TRASOP plan. Clearly, the TRASOP credit is not sufficient incentive for such an employer to create a TRASOP plan. Assuming the employer would have a qualified employer stock bonus type plan anyway, the value of the TRASOP tax credit will depend upon the employer's tax bracket, the amount of annual contributions and the employer's qualified investment in investment credit type assets, as the following chart illustrates:
### VARIATIONS IN EMPLOYER TAX BRACKET

<table>
<thead>
<tr>
<th>Employer's Annual Contribution</th>
<th>Employer's Tax Bracket</th>
<th>Qualified Investment</th>
<th>TRASOP Tax Credit</th>
<th>Value of Tax Deduction</th>
<th>Excess Value of TRASOP Over ESOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,000</td>
<td>17%</td>
<td>100,000</td>
<td>1,000</td>
<td>1,700</td>
<td>(700)</td>
</tr>
<tr>
<td>10,000</td>
<td>30%</td>
<td>100,000</td>
<td>1,000</td>
<td>3,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>10,000</td>
<td>46%</td>
<td>100,000</td>
<td>1,000</td>
<td>4,600</td>
<td>(3,600)</td>
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</table>

### VARIATIONS IN ANNUAL CONTRIBUTION

<table>
<thead>
<tr>
<th>Annual Contribution</th>
<th>Tax Bracket</th>
<th>Qualified Investment</th>
<th>TRASOP Tax Credit</th>
<th>Value of Tax Deduction</th>
<th>Excess Value of TRASOP Over ESOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000</td>
<td>30%</td>
<td>100,000</td>
<td>1,000</td>
<td>300</td>
<td>700</td>
</tr>
<tr>
<td>10,000</td>
<td>30%</td>
<td>100,000</td>
<td>1,000</td>
<td>3,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>100,000</td>
<td>30%</td>
<td>100,000</td>
<td>1,000</td>
<td>30,000</td>
<td>(29,000)</td>
</tr>
</tbody>
</table>

### VARIATIONS IN QUALIFIED INVESTMENT

<table>
<thead>
<tr>
<th>Annual Contribution</th>
<th>Tax Bracket</th>
<th>Qualified Investment</th>
<th>TRASOP Tax Credit</th>
<th>Value of Tax Deduction</th>
<th>Excess Value of TRASOP Over ESOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,000</td>
<td>30%</td>
<td>10,000</td>
<td>100</td>
<td>3,000</td>
<td>(2,900)</td>
</tr>
<tr>
<td>10,000</td>
<td>30%</td>
<td>100,000</td>
<td>1,000</td>
<td>3,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>10,000</td>
<td>30%</td>
<td>1,000,000</td>
<td>10,000</td>
<td>3,000</td>
<td>7,000</td>
</tr>
</tbody>
</table>

The value of the 1% TRASOP credit is maximized to any employer when the annual contribution equals one percent of the employer's qualified investment regardless of the employer's tax bracket. This is so because a tax credit for 100% of an expenditure will always be worth more than a tax deduction in equal amount since tax rates are less than 100%. The value of such maximized TRASOP credit in comparison to a tax deduction would be greater for a low bracket than a high bracket employer. However, for the TRASOP credit to constitute a meaningful tax benefit for the employer, annual investment in qualified assets would probably have to be at
least $1,000,000 per year. Based on this analysis one would expect that TRASOPs would be utilized only by very large corporations and that their contributions to the TRASOP were about equal to the available TRASOP tax credit, resulting in 100% of the cost of this employee benefit being subsidized by the Federal Government for large corporations. The large corporation advantage vis-a-vis small business results from this subsidized benefit for employees of large corporations regardless of whether these tax benefits go to the corporation (by reduction in salary costs) or are totally shifted to the employees (the TRASOP benefits not in anyway reducing the employer's wage costs but representing an additional bonus to the employees which would not have been paid but for the TRASOP). Assuming the TRASOP benefit inures solely to the employees in the sense that it does not allow the employer to decrease his wage costs, it allows the large corporation to pay higher wage benefits than the small corporation, thus giving the large corporation an additional advantage in the labor market.

Comments on Some Proposals For Tax Reform

Public Policy and "Fairness"

In proposing special tax benefits for small business one must not lose sight of the effects of such proposals on the distribution of income and wealth. Owners and investors in small business (defined as any business with assets under $25 million) are a diversified group in terms of income and wealth. Many have large incomes and are comparatively wealthy in comparison with the average wage earner. If we are not to impair the pro-
gressive rate tax system, tax benefits of such special provisions must not inure primarily to the benefit of high bracket taxpayers. This presents a dilemma since many owners of small business are high bracket taxpayers (see Small Business Tax Needs, Hearings at p. 253) and since most taxpayers with investment funds (available or potential) are high bracket taxpayers. The dilemma is compounded by the necessity to provide for the "appearance" of progressivity as well as the reality of progressivity to insure societal satisfaction with our self-assessment taxing system.

Tax incentives for small business which "appear" to discriminatorily benefit high bracket taxpayers may cause as much social unrest as incentives which actually discriminate in favor of high bracket taxpayers. Thus, although analysis of economic impact of incentive proposals is needed, (e.g., impact on small and large business, on high and low bracket taxpayers, on economic efficiency) economic impact should not be the sole criterion for determining the advisability of various proposals.

The dilemma of providing special incentives to small business without discriminatorily benefiting high bracket taxpayers can be resolved in part by distinguishing between benefits which increase a taxpayer's wealth from benefits which increase a taxpayer's after-tax spendable income. It is consistent within our existing system to not tax increases in wealth where there has been no realization of income. The concept of "realization" is one which postpones taxation of increased wealth, e.g., unrealized appreciation in value of property, until some
more appropriate time. Deferral of tax on earnings reinvested in the business is consistent with non-realization of income at the business owners' level of taxation. Business earnings retained in the business represent increased wealth of the business owners (although due to inflation it might not represent a true increase in economic wealth) but arguably should not be taxed as income to the business owner, whether sole proprietor, partner or shareholder, until distributed to the business owner. The taxpayer's increase in wealth due to reinvested business earnings is analogous to unrealized appreciation in other investments and should not be taxed for some of the same reasons, i.e., not an appropriate time to tax because owner has not severed the fruit from his investment tree. Arguably the justification of administrative difficulties as a grounds for not taxing unrealized appreciation in other types of property does not apply to business earnings, but the encouragement of increased business investment would be a basis for not taxing retained business earnings which is not applicable to all other types of unrealized appreciation.

Deferral of tax on business earnings reinvested in the same business can be justified on several grounds. First, it would encourage savings and reinvestment of business earnings. Second, the realization concept increases the appearance of fairness of such deferral. Third, such deferral creates a closer correlation between tax liability and available net spendable income. Fourth, the tax savings may well be shifted to consumers (in the form of lower prices) and employees (in the form of higher wages).
Lowering Tax Rates on Schedule C Income

Although some of the proposed tax legislation to aid small business has the effect of deferral of tax on reinvested earnings, other proposals would reduce taxes on small business earnings, whether or not reinvested in the business. See e.g., the proposal to reduce tax rates on Schedule C earnings, Report A. the President, America's Small Business Economy (White House Commission on Small Business, April, 1980) at p. 27. Such proposals are ill-advised for several reasons. First, although they provide incentive for small business activity, they do not provide incentive for small business capital growth. Second, such proposals give self-employed persons unfair tax advantages vis-a-vis employees. The unfairness can be illustrated by asking whether we want to tax doctors at lower rates if they operate as sole practitioners than if they are employees of community health organizations. Even if such tax savings were passed on to sole practitioner patients, it is arguable that the appearance of tax unfairness is sufficient justification for not accepting this proposal. Encouragement of small business activity is not sufficient justification, in the opinion of this author, to lower tax rates on the realized net spendable income of sole proprietors and partners. In general, special tax benefits for small business could allow permanent lowering of tax rates on earnings withdrawn from the business. There are a broad variety of means available to lower effective tax rates on reinvested earnings, e.g.,
lower corporate tax rates, accelerated depreciation, investment tax credits, cash method inventory accounting, which are likely to have differing benefit values for large and small business.

B) Proposals to Create Small Business Enterprises (SBE)

One author (Michael P. Sampson, "The Impact of Taxation on Small Business: A Proposal for Reform," The Study of Small Business, Part III, Office of Advocacy, Small Business Administration (June 3, 1977) has proposed the creation of a new taxable entity, the Small Business Enterprise (SBE) to aid small business. Sole proprietorships, partnerships and small corporations could qualify as SBEs (id. at p. 54). The income and deductions of the SBE would flow through to SBE equity owners (id. at p. 79) but the equity owners would be allowed a prorata deduction for reinvested earnings of the SBE (id. at p. 128). The deduction would be limited to 50% of the equity owner's pro-rata share of SBE earnings. Furthermore the deduction would be limited by the fact that earnings are considered reinvested only to the extent the equity owner withdraws less than his pro-rata share of SBE earnings. Id. Withdrawals in excess of his share of SBE earnings would be treated as return of capital to the extent of the equity owner's basis in his SBE interest, any excess withdrawal qualifying as capital gain. Id. at p. 84.

This proposal would have the effect of deferring tax on reinvested small business earnings. Putting aside problems of how withdrawals in excess of current earnings should be taxed
(as return of capital, capital gain or ordinary income) the proposal has merit for several reasons. First, tax benefits are tied to increases in business investment, a deferral type provision which promotes business investment without lowering tax rates on income used for consumption as would be possible with lower schedule C rates. Second, the deferral benefits are extended to sole proprietors and partnerships, often the smallest types of small business and thus provide greater horizontal equity among such businesses and corporations than would be provided by more progressive corporate income tax rates. Third, the business would be disqualified from SBE status if it had "investments in other businesses or real estate or personal property unrelated to its business operations in excess of 5% of its total equity" Id. at p. 67. This limitation is, like the Personal Holding Company Penalty Tax and Accumulated Earnings Tax, in that it is designed to prevent avoidance of individual income tax on passive non-business income of the business entity. It also prevents reduction of tax on business income which is retained in the business but not needed in the business. Some such limitations on the deduction for earnings retained by the SBE would be necessary in order to create horizontal equity (or the appearance of horizontal equity if business taxes are shifted) between savings (invested in passive investment) by business owners and savings invested in passive investments by others. It does not however eliminate inequity between savings invested in business assets by owners and such savings by others e.g., wage earners.
Major weaknesses of the SBE proposal are its complexity and its dramatic change in existing tax law. Because of these factors it would take substantial study to analyse all of the details of the SBE proposal. Clearly some of the objectives of the SBE proposal might be accomplished by simpler, less comprehensive tax reforms. For example, tax deductions for investment in inventory, equipment and other business property would produce similar deferral benefits for reinvested business earnings as would the SBE reinvested earnings deduction proposal. Furthermore, tax deductions for investment in business property would reduce the horizontal equity problem of the SBE proposal which conditions the deduction on the source of the income, i.e., business earnings.

Lowering tax rates on small business corporations

Proposals to legislate more graduated corporate income tax rates by lowering rates on corporate income up to $500,000 (see White House Commission on Small Business, id.) have some characteristics of deferral of tax on reinvested earnings and some characteristics of lower tax rates on earnings withdrawn from business. This proposal would lower the effective tax rate on earnings retained in the business and on earnings distributed as dividends. However, most corporations with less than $500,000 of net income probably already distribute free of corporate tax (e.g., as compensation or as interest on loans from shareholders) earnings not needed in the business. If a firm in this income category up to $500,000 were desirous of avoiding corporate income tax on distributed earnings it
might, as an alternative to payment of compensation to shareholder employees, elect Sub-S status, if it otherwise qualified. The analysis of Distributions to Shareholders by Corporate Asset Size, supra in the section on Corporations—Retained Earnings, suggests the likelihood that corporations with $500,000 or less in income might retain up to 90% or more of their earnings. Lower corporate tax rates would lower the effective tax rates only on that small portion of earnings distributed as dividends. It would probably not encourage increased dividend distributions. The collapsible corporation provisions, excess accumulated earnings penalty tax, personal holding company penalty tax and section 482 allocation of income provisions would continue to act as safeguards against the conversion of ordinary income into capital gain by accumulation of earnings and liquidation of the corporation. The more progressive corporate tax rates would thus operate as a kind of substitute for the SBE proposal, i.e., to reduce taxes on earnings retained in the business.

It should be noted that the more progressive rates are not discriminatory against large corporations because all corporations with annual earnings in excess of $100,000 would receive the benefits of this tax reduction. See Tax Needs & Small Business at p. 255. However, although all businesses with income over $500,000 would receive the same dollar amount of tax benefit from the more progressive rates, such tax bene-
fits will be a smaller percentage savings on total tax for larger corporations. Small businesses with annual earnings of less than $100,000 would not benefit from these lower rates.

At first glance it might appear that lowering corporate tax rates on the first $500,000 of corporate income would harm small business sole proprietorships and partnerships. However, it must be remembered that these businesses could elect to incorporate to gain the advantages of lower tax rates on business earnings retained in the business. To the extent sole proprietors and partners do not retain earnings in the business they should be taxed on those earnings withdrawn from the business as they are under present tax laws.

**Tax credits for new equity investment in small, publicly traded corporations**

One shortcoming of current proposals to grant tax credits for equity investments in small, publicly traded corporations (see S. 487, S. 655, S. 3975) is that they contain inadequate provisions for recapture of the credits upon disposal of such equity investments. (The proposed credits would be recaptured only if the equity investment is disposed of within 6 months, S. 487, or 12 months, S. 655, of date of acquisition.) Failure to recapture the tax credit upon sale or exchange of the equity investment, the proceeds of sale invested by the taxpayer in large corporations, results in lowering the tax burden on a taxpayer who has conferred only a short-term benefit on small business. Arguably such benefits are conferred at an important time when the small corporation is seeking to expand its capi-
tal and the purchase price for the equity would be higher than if no tax credits were available. Furthermore, the taxpayer-investor who sells his newly acquired equity interest 18 months after acquisition, assuming business risk factors have remained constant, will likely have to sell the stock at a discount reflecting the fact that his purchaser will get no investment credit but will be taking approximately the same risks as the original taxpayer-investor. The original taxpayer-investor would thus get a tax credit and a capital loss deduction, i.e., tax savings possibly in excess of his actual loss. For example, assume taxpayer in a 60% tax bracket invests $10,000 in a new issue of a small business corporation. Without a tax-credit the corporation would only have been able to sell this equity for $9,000. Taxpayer gets a $1,000 tax credit. Eighteen months later taxpayer sells the stock for $9,000, claiming a $500 deduction (only 50% of $1,000 loss deductible from ordinary income because this is a long-term capital loss, assuming the stock was not § 1244 stock and that taxpayers had no short-term capital gains against which he might offset the entire $1,000 long-term capital loss). Taxpayer will have incurred a financial loss of $1,000 (not counting any interest he might have earned in another investment) and has tax savings of $1,300 ($1,000 tax credit and $300 saved by $500 deduction). The fact that the investor has also lost potential earnings on his $9,000 investment during the 18 month period is irrelevant since such risk was a factor in determining the price of taxpayer's original stock
purchase, i.e., taxpayer made the initial investment because he thought that the potential return on $10,000 of small corporation's stock exceeded the return on $9,000 more safely invested by a sufficient margin to justify the additional risk of the investment in the small corporation. In order to induce continued retention of the investment in small business and to close the revolving door loophole it is necessary to provide for recapture of the investment credit upon disposition of the equity investment which generated the tax credit.

Unlike a consumption based tax system which would provide incentive to reduce consumption and increase savings and investment, the tax credits for investments in small business can expect to have substantial impact on shifting of investments from one form to another but not cause a substantial increase in savings and the pool of funds available for investment. Current proposals to provide tax credits for equity investments in small businesses will cause a shift in investment funds from other types of investment to the types of small business which can utilize such investments, mainly publicly traded corporations with equity capital between $10 million and $25 million. Assuming the pool of funds available for investment does not increase proportionately with the increase in such small (medium?) sized publicly traded corporations, financing costs for others (large corporations, consumers, small closely held corporations, sole proprietorships and partnerships) can be expected to rise. These proposals, if they are not to injure non-publicly traded small
corporations, sole proprietorships and partnerships, must be expanded to provide similar incentives to making financing available to such other categories of small business, or other alternative measures taken to not increase the financing burden of such small businesses.

**Small Business Participating Debentures (SBPD)**

Senate Bill 1481, 96th Cong., 1st Sess., proposes special, favorable taxation of SBPDs. SBPD's are like a combination of stock and debt, having a fixed maturity date and paying a fixed interest rate at least equal to that prescribed pursuant to IRC § 483(c)(1)(B) but would also be entitled to share in the profits of the issuer. See S. 1481, proposed § 44DC(e). Investment in an SBPD would entitle the investor to an investment credit of up to 5% of his investment (§ 44D(a)), ordinary income treatment on interest received and long-term capital gains treatment on distributions of his share of profits. (§ 1256(a)). The investor would also have to amortize and take into income any original issue discount interest (§ 1232(h)) and would get § 1244 ordinary loss treatment for losses on SBPD's. (§ 1244(d)). The issuer of an SBPD would get to deduct as interest all amounts paid as interest and amounts paid as a share of earnings on the SBPD. (§ 163(e)).

SBPD's appear indefensible under existing tax theory other than as an inducement to investment in small business. (SBPD's cannot be issued in face amount in excess of $1 million nor can they be issued by corporations which have stock subject to regulation by the SEC or by corporations or unincorporated busi-
nesses with equity capital in excess of $25 million. (§ 44D(e)(2)). The tax advantages of SBPDs appear to be adequate to accomplish their purpose of facilitating additional investment in small businesses. However, giving long-term capital gains treatment to distributions of earnings on SBPDs arguably goes too far. Such capital gains could induce total payments of interest and earnings greatly in excess of reasonable interest rates in light of the risks inherent in the particular investment. The fact that distributions on SBPDs do not qualify for long-term capital gains if held by a shareholder who owns 10% or more of the value or voting stock of a corporation (see §§ 1256(b)(1)(A) and 44D(b)(2) is somewhat of a safeguard against giving SBPD holders an excessive share of the earnings of the business but could be ineffectual where 11 or more equal shareholders form a corporation. Perhaps S.1481 needs some modification to assure that the returns on stock and SBPDs are equitable and prevent bailouts of all small businesses earnings at long-term capital gains rates.

A more serious shortcoming of S.1481 is that it would be giving tax benefits to groups who are fairly rich. Should investors get a $5,000 tax credit every 10 years for rolling over their investments in small businesses? Should high bracket investors get long-term capital gains on their investment income which does not represent appreciation in their investment but merely a fair return on their investment? Arguably the benefits of SBPD should be limited to better accomplish the purpose of providing needed capital for small business and not unjustly enriching wealthy
investors with tax credits for temporary investments and long-term capital gains on receipt of current distributions of earnings. This might be accomplished by allowing tax deferral on the share of earnings of an SBPD holder which is reinvested in stock or securities of the SBPD issuer. This would induce retention of the earnings in the business rather than distributions of such earnings. Non-taxability to the investor can be justified because there has been no distribution of such earnings to the investor. The business would benefit because of its tax-deduction for interest paid and earnings credited to its SBPD holders. The investor would benefit because he would receive a fixed rate of interest (taxable) on his investment, could have his investment redeemed at maturity without tax, have acquired an equity or long-term debt investment in the business without payment of tax and would get § 1244 ordinary loss treatment on losses on his SBPD. Clearly, the proposed modifications of S. 1481 would reduce its effectiveness in facilitating capital formation for small businesses but such modifications appear necessary to satisfy the longer-term capital needs of small business and prevent wealthy investors from having their cake and eating it too.

APPENDIX A

Effects of the merger on profits before taxes and earnings per share, assuming no change due to changed market power or efficiency, will vary depending upon a number of factors, e.g., whether the acquisition was for cash or for stock, whether the acquiring corporation had a higher or a lower Price-Earnings
ratio than the acquired corporation, whether the merger is accounted for under the cash or pooling method of accounting. See generally, Mergers, Acquisitions and Pooling of Interests, Arthur R. Wyatt 31-12, S. Davidson, Handbook of Modern Accounting (McGraw-Hill 1970). Illustrated below are two examples of mergers, one for stock and one for cash, in both of which a substantial premium above market and book values was paid for the acquired company but which caused no change in earnings per share (EPS) or the Price-Earnings ratio of the acquiring company.

Purchase for Stock - pooling accounting

<table>
<thead>
<tr>
<th>Before Merger</th>
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<tbody>
<tr>
<td><strong>B Corp. (Buyer)</strong></td>
<td><strong>S Corp. (Seller)</strong></td>
</tr>
<tr>
<td>1,000,000 shares</td>
<td>100,000 shares</td>
</tr>
<tr>
<td>Earnings - $10,000,000</td>
<td>Earnings - $200,000</td>
</tr>
<tr>
<td>EPS = $10</td>
<td>EPS = $2</td>
</tr>
<tr>
<td>Market price - $100/share</td>
<td>Market price - $16/share</td>
</tr>
<tr>
<td>PE ratio = 10</td>
<td>PE ratio = 8</td>
</tr>
</tbody>
</table>

Merger - B gives S shareholders 20,000 shares B Co. stock (FMV = $2,000,000 i.e., 20% premium over market price of S stock.

Pooling accounting - merged companies

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<table>
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<tbody>
<tr>
<td>Earnings - $10,200,000</td>
</tr>
<tr>
<td>Shares - $1,020,000</td>
</tr>
<tr>
<td>EPS = $10</td>
</tr>
<tr>
<td>PE ratio = 10</td>
</tr>
</tbody>
</table>

Result - no reduction in EPS of acquiring company even though 20% premium paid for shares in acquired company because acquired company had substantially lower PE ratio than acquiring company prior to merger.

Purchase for cash - purchase accounting
Assume B Co. pays $2,000,000 cash for the shares of S Co. and that B Co. had earned a 3% return on that cash. Further, assume that because of higher depreciation charges and other write offs of the excess of the purchase price in excess of book value of S Co. assets that S Co.'s earnings are reduced to $160,000.

After merger

<table>
<thead>
<tr>
<th>B Co. earnings</th>
<th>$10,000,000</th>
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</thead>
<tbody>
<tr>
<td>less: return on cash</td>
<td>$160,000</td>
</tr>
<tr>
<td>S Co. earnings</td>
<td>$160,000</td>
</tr>
<tr>
<td>Total post-merger earnings</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>

Shares outstanding = 1,000,000

EPS = $10

Result - no change in EPS of merged firm over B Co. because $2 million cash earned much higher rate of return invested in B Co. than it did in other investments. No greater efficiency here by reason of merger unless we can assume that prior shareholders of S Co. will invest $2 million cash proceeds more effectively than B Co. did prior to purchase of S Co.

APPENDIX B

TAX FREE REORGANIZATIONS: HISTORICAL PERSPECTIVE

In a series of cases decided before the enactment of the predecessor of IRC section 318 the U.S. Supreme Court held that taxable income resulted from the conversion or exchange of capital assets. Stratton's Independence v. Howbert, 231 U.S. 399 (1913); Doyle v. Mitchell Brothers Company, 247 U.S.
179 (1918); Merchants Loan and Trust Company v. Smietanka, 255 U.S. 509 (1921). This general principal that income includes gain on the exchange of property is still the law today, with some statutory exceptions. See Treas. Reg. § 1.61-6.

A possible Constitutional limitation on this principal is encountered in Eisner v. Macomber, 252 U.S. 189 (1920). In Eisner v. Macomber the taxpayer had received a stock dividend on shares of common stock she owned in Standard Oil Company of California. The Supreme Court held that receipt of the stock dividend did not constitute a realization of income by the taxpayer because she was not enriched by the stock dividend, she merely had more pieces of paper (stock) representing the same interest she had in the same Corporation before the stock dividend. This lack of change in the extent and nature of the taxpayer's property interest is crucial to the Eisner v. Macomber decision: If there is a change in either the extent of taxpayer's interest in the property or a change in the property in which taxpayer has an interest, a taxable exchange may result. Thus, the Supreme Court decided that the rationale of Eisner v. Macomber did not prevent a corporate reorganization from constituting a taxable transaction where shareholder received shares in a new corporation, in exchange for his shares in old corporation, even though the new corporation took over the assets and conducted the business of the old corporation. United States v. Phellis, 257 U.S. 156 (1921); Rockefeller v. United States, 257 U.S. 176 (1921); Culliman v. United States, 262 U.S. 134 (1923); and Marr v.
In the Marr case the Supreme Court distinguished Eisner v. Macomber, stating, "In Eisner v. Macomber the identity [of the corporation] was literally maintained. There was no new corporate entity. The same interest in the same corporation was represented by more shares of precisely the same character." at p. 540. In the Marr case the Supreme also distinguished the case of Weiss v. Stern, 265 U.S. 242 (192) where the Supreme Court held the reorganization non-taxable. "In Weiss v. Stern a new corporation had, in fact, been organized to take over the assets and business of the old. Technically there was a new entity; but the corporate entity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same State, with presumably the same powers as the old. There was also no change in the character of securities issued." Marr case at p. 541. The reorganizations in the Phellis, Rockefeller, Culliman and Marr cases involved transferring assets of the old corporations to new corporations incorporated in different states than the old corporations. As stated by the Supreme Court in the Marr case (at p. 541)," A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new." Another distinguishing factor in the Marr case was that the
securities surrendered ($15 million of 7% voting Preferred and Common Stock) differed in nature from the securities received ($20 million of 6% non-voting Preferred and Common Stock).

But for IRC Section 368, under the judicial tests of "realization of income" A, B or C type acquisition reorganizations would clearly constitute taxable transactions where the assets of separate corporations are combined into one corporation since the shareholders who exchange their shares in an old corporation for shares in the new corporation would be receiving "an essentially different thing." The judicial tests of realization of income would also make most D, E and F type reorganizations taxable events. Arguably the F type reorganization involved in Weiss v. Stern, supra, would not be within the reach of the income tax laws. The issue of taxability of corporate reorganizations is thus basically a policy issue, i.e., whether Congress should make such transactions taxable or non-taxable. In examining this policy issue it will be useful to trace the legislative history of I.R.C. Section 368.

Corporate reorganizations were made non-taxable by the 1918 Revenue Acts. 40 Stat. 1060 (1919), § 202(b). Legislative history of the 1918 Revenue Act reveals an intent by Congress to make non-taxable gains on "purely paper transactions" such as "when in connection with the reorganization or consolidation of a corporation a person receives in place of stock or securities owned by him
new stock or securities of no greater aggregate par value, or when a person receives in place of property stock of a corporation formed to take over such property . . . " Sen. Rep. No. 617, 65th Cong., 3rd Sess., (1918) 1939-1 C.B. 120. The House amended the proposed law by adding a provision "that when--in the case of any reorganization, merger or consolidation--the aggregate par or face value of the securities received is in excess of the aggregate par or face value of the securities exchanged, the amount of such excess shall be treated as a gain to the extent that the fair market value of the new securities is greater than the cost of the securities exchanged . . ." House Rep. No. 1037 65th Cong., 3rd Sess. (1979), 1939-1 C.B. 132.

The 1921 Revenue Act carried forward the non-taxability of shareholders in corporate reorganizations and also made non-taxable like-kind exchanges of productive property (the predecessor of current I.R.C. section 1031). The rationale for such non-taxability was that although a "technical" gain may be realized in such situations, "the taxpayer actually realizes no cash profit." Sen. Rep. No. 275, 67th Cong., 1st Sess. (1921), 1939-1 C.B. 188. One commentator, Sheldon S. Cohen, while he was Commissioner of Internal Revenue, found some support in the legislative history for concluding that a reason for continuing this favorable treatment of reorganizations in the 1921 Revenue Act was to permit businesses to go forward with readjustments required by the termination of World War I. Sec. 5 Cohen, Conglomerate Mergers and Taxation, 55 A.B.A.J. 40, 41 (1969).
The Revenue Act of 1924 broadened the classes of tax free reorganizations and clarified the non-taxability of the corporation which disposed of its assets in a reorganization. Revenue Act of 1924, §§ 203(b)(2), 203(b)(3) and 203(c).

Justification for these changes was based on not having the tax laws impede ordinary business transactions, House Rep. No. 179, 68th Cong., 1st Sess., 1939-1 C.B. 251, and that the tax free reorganization provisions "are based on the theory that the types of exchanges specified in section 203 are merely changes in form and not changes in substance . . ." Id at 253.

Proposals for the complete elimination of the tax free reorganization provisions in the 1934 Revenue Act were not enacted upon recommendation of the Treasury that, in light of the depressed state of the economy in 1934, elimination of the reorganization provisions would allow many corporate shareholder's to recognize tax losses on the decrease in value of their corporate interests by engaging in corporate reorganizations. House Rep. No. 704, 73rd Cong., 2d Sess., 1939-1 C.B. 564-65. An additional reason that Treasury may have had for opposing elimination of the reorganization provisions is that it would create substantial valuation problems akin to those which would be created by repeal of section 1031 tax free like-kind exchanges. Id at 564. The 1934 Revenue Act as enacted retained the reorganization provisions with some amendments to decrease the possibilities of tax avoidance.

The 1934 Revenue Act reorganization provisions were carried forward substantially unchanged into the 1939 Code and then into the 1954 Code.
In 1954 the House of Representative attempted to restrict the availability of tax-free reorganization corporate acquisitions to situations in which either 1) both the acquiring and acquired corporation were publicly held corporations or 2) in which shareholder's of the acquired closely-held corporation received at least 20 percent of the participating stock (common stock, voting or non-voting) of the acquiring corporation. See H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 132 (1954), U.S. Code Cong. & Ad. News 4025, 4269-71 (1954). The purpose of these restrictions was apparently to limit the potential for bail-out of earnings by shareholders in closely held corporations at capital gains rates. Id. at 4065. The senate eliminated distinctions between publicly held and closely held corporations and the need for shareholders in the acquiring corporation to receive at least 20 percent of the participating stock of the acquiring corporation. S. Rep. on H.R. 8300, 83rd Cong., 2d Sess. (1954), U.S. Code Cong. & Ad. News 4621, 4683 (1954), and the House agreed to the Senate's changes, Conference Rep., H.R. 2543, 83rd Cong. 2d Sess. (1954), U.S. Code Cong. & AD. News 5280, 5293 (1954). The 1954 proposals in the House appear to have been aimed solely at the problem of bail-out of corporate earnings at capital gains rates and not at the problem of business concentration.

Committee's consideration including "(1) Should all acquisitions currently covered by section 368 of the Internal Revenue Code be granted tax free status, or should a distinction be made depending on the size of the companies involved." Id. at 2420. Upon further questioning Dr. Muelles was not prepared to make a recommendation on that question. Other witnesses limited their statements to the bill before the Committee, H.R. 7489, which dealt with the problem of debt-equity switching, primarily in unfriendly taxable reorganizations. One witness, Leonard L. Silverman, attorney, did specifically state that the tax issue was debt-financed acquisitions and not non-taxable reorganizations. pp. 2450, 2453, however, most witnesses did not comment on the possibility of eliminating tax free treatment for acquisitive reorganizations. The main thrust of H.R. 7479 was to prevent takeovers by unfriendly small and medium sized acquiring firms—most large corporations would not be affected by H.R. 7479 since they would usually use their own publicly traded stock in a tax free acquisition rather than debt in a taxable transaction. See statement of Frédéric W. Hickman, id at 2503-2510; statement of Louis J. Appell, Jr., President, Susquehanna Broadcasting Co., id. at 2538.