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# Butters & Lintner: Effects of Taxation: Corporate Mergers Tax Institute: Economic Effects of § 102

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portant principle that a law may be void for indefiniteness,<sup>32</sup> a whole group of federal jurisdictional decisions,<sup>33</sup> and *Grosjean v. American Press Co.*,<sup>34</sup> the outstanding decision on the freedom of the press from discriminatory taxation—these are a living monument to the dead.

Always courteous, good-natured,<sup>35</sup> and diligent, George Sutherland was in every way an outstanding exponent of conservatism in law. Mr. Paschal's excellent book gives real insight into a spirit, exemplified in Sutherland, which not so long ago dominated America, and which, with some adjustment to the problems of a new decade, may do so again.

JOHN P. FRANK†

EFFECTS OF TAXATION: CORPORATE MERGERS. By J. Keith Butters, John Lintner and William L. Cary. Boston: Graduate School of Business Administration, Harvard University, 1951. Pp. xviii, 364. \$4.25.

ECONOMIC EFFECTS OF SECTION 102. Panel Investigation by Tax Institute, Inc. Princeton, 1951. Pp. xxiii, 314. \$5.00.

IN all branches of human life we act—we must act—with little foreknowledge of the consequences. The wise planner does the best he can, never forgetting that his best-laid plans may go awry. When a tax is levied, its ultimate effects are as unknowable as the future life of an infant; so far, at least, neither the theoretician nor the electronic computer has given us greater power to predict the one than the other. Yet in the tax field, perhaps even more than in other areas of human affairs, we are surrounded by soothsayers who confidently promise that one course of action will bring us prosperity while another will return us to the Stone Age. Almost invariably these predictions emerge from a single, and simple, minded devotion to the premise that a tax rests where it first falls, so that a taxed activity is necessarily repressed. The possibility that the levy will be shifted to some other person

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with *Nectow v. Cambridge*, 277 U.S. 183 (1928), one of the extremest due process cases in the reports. There Sutherland's opinion requires the revision of a zoning line for one lot in Cambridge, Mass.

32. *Connally v. Gen. Const. Co.*, 269 U.S. 385 (1926).

33. As examples in addition to the cases cited in note 11, *supra* (one of which, *Hurn v. Oursler*, is perhaps glorified by being described as an accomplishment), consider the cases on the status of the courts of the District of Columbia, *O'Donoghue v. United States*, 289 U.S. 516 (1933), and the Court of Claims, *Williams v. United States*, 289 U.S. 553 (1933).

34. 297 U.S. 233 (1936).

35. Paschal's Appendix C, a private memorandum by Sutherland on a Conference, illustrates that Sutherland tended to "go along with" Taft and Van Devanter somewhat more uncritically than with the rest of his colleagues; but Paschal's text discussion shows that the Justice's relations with all of his colleagues were good.

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or activity is rarely entertained,<sup>1</sup> still less the possibility that in the process of shifting, the originally disfavored activity will prove stronger for having contracted and then thrown off the disease. The business community is almost unanimously persuaded, for example, that a high individual tax rate cripples incentives,<sup>2</sup> disregarding the possibility that when a brake is applied to a treadmill, the inmate may work harder to maintain his former speed. Organized labor, on the other hand, views the sales tax as an enemy comparable in hatefulness to the open shop, though it is perfectly possible that in normal times the tax would provide the impetus for successful wage demands that would recoup the tax, and perhaps produce a surplus to boot. Both the business groups and the unions *may* know on which side their bread is buttered, but there have been no factual investigations to lend authority to their convictions. The economists' theoretical excursions into this area have given us charts that, though possibly self-consistent, are hardly guides to action: this because in the process of bringing the subject into manageable proportions they find it necessary to extract first every trace of human irrationality, leaving only a stylized unpopulated landscape, like a De Chirico canvas.

The two studies here under review are attempts, each in its own way, to assay the actual consequences of tax policy—not in advance or in a mechanical universe, but after the fact in the business world. The Harvard study is a systematic, detailed, and immensely stimulating examination of the extent to which taxes have in recent years contributed to the merger of closely-held corporations into larger enterprises. The Tax Institute contribution is a symposium on the effect on business management and the national economy of Section 102, which imposes a penalty tax on corporations that retain their earnings in order to shield their stockholders from the personal taxes that would be collected if the earnings were paid out as dividends. Though necessarily less systematic than the Harvard study, the comments of the experts assembled by the Tax Institute are of great interest.

The Harvard study supplies us with a particularly interesting contrast

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1. Occasionally the possibility of shifting a tax is recognized. For example, it is sometimes asserted that corporate taxes are in the long run passed on to the consumer. This assertion is often coupled with the following two arguments, both inconsistent with the view that corporate taxes are thus shifted: (a) sales taxes and excises are an essential part of a proper national tax policy because without them lower income groups do not shoulder the cost of government, and (b) corporate taxes destroy business incentives and, coupled with the individual income tax, leave no return for the investor.

2. Fortune recently suggested that high individual tax rates encourage the enterprising businessman to turn from the role of managing large corporations owned by others to the more dynamic role of business on their own. This is because, though salaries are taxed in full, there is no individual tax on the accumulation of corporate surplus and neither a corporate nor an individual tax on the building up of good will or of other unrealized appreciation. This contrast, coupled with the possibility of cashing in on one's own profitable business at capital gains rates (or of passing the business on to one's heirs without income tax), means that the individual enterpriser may amass a fortune that the most lavishly paid corporate executive can never hope for, even if his salary is buttressed by the fanciest of deferred compensation, stock option, and retirement plans. *The New Rich*, Fortune, January 1952, p. 60.

then we hold as follows: if it is the vendor who takes the initiative in the sale, the vendee pays him only 100, while if it is the vendee who comes and draws the object without mentioning terms, he must pay 200."<sup>4</sup>

The phrase "takes the initiative in the sale," to an American lawyer, refers to the maker of the original offer. The text in fact refers to a vendor who accepts the counter offer. Similarly in the same chapter, on page 72, the pronoun "he" in the third paragraph of Sec. 10 refers not to the vendee mentioned in the same paragraph but to the vendor mentioned in the preceding paragraph. The Berlin, 1868, edition of the Hebrew text has the word "vendor" specifically and not the pronoun.

Furthermore, the failure to include critical comment of a comparative law character results in unfortunate concealments. An examination of the index, for example, reveals no reference to trade regulation or fair trade. Yet the text does contain the following:

"A storekeeper is permitted to distribute parched corn or nuts to children and to female slaves in order to accustom them to come to him. . . ."<sup>5</sup>

And:

"The residents of a town can prevent traders who bring their merchandise for sale into the towns from selling it in their town."<sup>6</sup>

Nor are there any references in the index to the right of privacy. Yet the text has scores of paragraphs dealing with this right though Maimonides did not use this Anglo-American term. The same is true of building and zoning regulations. If the meagrest critical comment of a comparative law character had been added, a research student exploring a particular problem would have been able through the use of the index to discover many ancient analogues of modern legal problems. As the volume stands now one must read it in its entirety to make the discovery.

The omission of critical comment is perhaps the fault of the editor more than the translator. The translator, Dr. Klein, prepared a lengthy introduction as part of his doctoral dissertation, which is also not included in the printed edition. That introduction discusses fully the logic of the organization of the materials in this one book of the Code and the discussion sheds much light on the nature of several concepts of Talmudic law. Perhaps the editor feared that the undertaking would become too voluminous if more than the text were printed. It is to be regretted, however, that as a result the value of the work is reduced. The policy ought, therefore, be reconsidered with regard to the volumes yet to come. Nonetheless, grateful we must be for that which has already been done, even if it is not all one could have hoped for.

EMANUEL RACKMAN†

4. Pp. 69, 70.

5. P. 64.

6. P. 179.

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between the soothsayer and the investigator. It quotes the *Monthly Letter* of the National City Bank as attributing the growth of monopoly through merger primarily to "strangling taxation"—to wit, the high rate of individual and corporate taxes, making it less attractive to hold a business than to sell it, and the need for liquid assets to pay estate taxes, requiring the sale of closely-held corporations for cash or for the more readily marketable securities of a larger company. (Of course, a sale to avoid the high individual surtax on salaries and dividends is attractive only because the gain on the sale will be taxed at the lower capital gains rate; increasing the latter would narrow or close this gap, though presumably this is not the National City Bank's policy recommendation.) In contrast to the voice of authority is the conclusion of the Harvard investigators: (1) taxes were of major importance for something less than one-tenth by number (or a little more than one-fourth by total assets) of the manufacturing and mining mergers reported for 1940-1947; (2) these figures "overstate to an unknown but probably large degree the sales in which tax motivations were clearly the decisive factor";<sup>3</sup> and (3) even where taxes were decisive at the moment, other motives might have compelled sale ultimately, so that "from a *long-run* viewpoint the effect of taxes in such cases might more properly be described as accelerating the sale rather than as causing a sale that would not otherwise have been made."<sup>4</sup> Will these dispassionate conclusions calm those whose earlier pronouncements were founded on little or no evidence? Probably not. Even the National City Bank's *Monthly Letter*, which furnished the springboard for the authors' initial chapter, has apparently taken no note of their work.

The conclusions of the investigators are based upon intensive field work covering a substantial sample of the mergers occurring during the period studied; like any other selection, this one may be lopsided, though care was used to insure fair representation. Moreover, interviewers—if they stop short of psychoanalysis—can penetrate only slightly below the interviewee's avowed motives, which of course can be rationalized after, or even before, the fact. Discrepancies may be revealed by intensive questioning or by a comparison of avowals with conduct, but one can be sure that there is a residue of influence which even the frankest interviewee cannot measure. The authors do not discuss this aspect of their methodology; the sources of their statistical material and the criteria of selection, on the other hand, are revealed with commendable admissions of bias and limitations. In the course of their work, they also studied the extent and characteristics of the recent merger movement and compared it with two earlier periods: 1879-1903 and the 1920's. Their

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3. BUTTERS, LINTNER & CARY, *EFFECTS OF TAXATION: CORPORATE MERGERS* 17 (1951).

4. *Ibid.* Life marches on. The enactment in 1950 of § 115(g)(3) (permitting the tax-free redemption of stock held by an estate to the extent of the death taxes) and its liberalization in 1951 have altered the ground rules under which the authors arrived at their conclusions. Thus the study's predictive value, always dependent upon an unchanged economic and psychological climate, is diminished by the necessity of speculating about the extent to which § 115(g)(3), in mitigating the pressure to sell, is itself counteracted by the higher individual and corporate taxes imposed by 1950 and 1951 Revenue Acts.

conclusion that merger activity during the 1940's, as distinguished from earlier movements, has contributed little toward over-all industrial concentration conflicts with a recent report by the Federal Trade Commission but is in harmony with Professor Adelman's still more recent conclusions.<sup>5</sup>

As is the nature of symposiums, the Tax Institute study of Section 102 is diffuse. Basic questions often become lost as the participants drift up side alleys, and there is no assurance that the experience of a single practitioner—or of the group—is sufficiently common to support generalizations. Whether typical or not, this group of experts produces surprisingly little evidence that section 102 as administered seriously affects corporate accumulations that are motivated by genuine business needs; indeed, several speakers commented on the use of camouflage to conceal the tax motivation of some corporate accumulations and indicated their suspicion that clients had sometimes invented "business" reasons for retaining surplus. One Connecticut attorney, whose firm represents some 200 corporations, many being family-controlled and of a size that would invite scrutiny under Section 102, could recall only one case where definite harm resulted from Section 102. He went on to say: ". . . I do not know of a single case where a small corporation hasn't been able to retain a large proportion, or even all of its earnings if it was in a proper reasonable expansion program. . . . I think there is nothing to fear from Section 102, by any management or board who act in good faith. . . ."<sup>6</sup> Not all participants were as sanguine, but the remarks of even the tax specialists—who would presumably encounter the largest group of desperate cases—do not demonstrate that there is well-founded widespread discontent with Section 102.

A questionnaire previously sent by the Tax Institute to 1700 tax practitioners, the results of which were available to the fact-finding panel itself, seems to have tapped both a higher estimate of Section 102's actual effects and a stronger feeling of opposition. Yet only about ten per cent of those questioned replied. In the absence of other evidence to explain this low ratio, it seems likely that those who were without a strong antipathy to Section 102 were more

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5. The Lintner-Butters conclusions are criticized and defended in 33 *REV. ECON. & STATISTICS* 63-75 (1951). Two of the Federal Trade Commission's economists, in their comment on the Lintner-Butters analysis, deny that the FTC intended to aver that industrial concentration has been substantially increased by the recent merger movement; they say "if the Commission had made any general statement on this point, it would probably have concluded, based on its own data, that the recent mergers have *not* 'substantially' increased concentration in manufacturing as a whole." *Id.* at 67, n.12. Perhaps so, but the FTC report will surely be understood to mean just the opposite, and if this is a misapprehension, it will not be corrected by a footnote tucked away in a learned journal. Adelman concludes that whatever the effects of merger on industrial concentration, "they were swamped, and submerged by other forms of growth. A generous estimate is that not over \$5 billion was involved in all manufacturing and mining mergers during 1940-47. But during this period, according to a source which is biased downward, the total assets of all corporations in these fields increased from \$67.8 billion to \$118.6 billion; the increase was over ten times the amount involved in mergers." Adelman, *The Measurement of Industrial Concentration*, 33 *id.* at 269, 294-5.

6. TAX INSTITUTE, *ECONOMIC EFFECTS OF SECTION 102* 124-5 (1951).

likely to toss the questionnaire in the waste basket than those who wanted to crusade against it. Of those who did reply, it is interesting to note that the effect of Section 102 most frequently noted (aside from a stimulus to dividend payments) was the expansion or rehabilitation of plant or the acquisition of new machinery. Presumably this effect is not only to be encouraged in itself, but—since the period under review was 1946-49—the taxpayers concerned could now thank Section 102 for encouraging investment early in a period of generally rising prices!

Nearly all participants at the fact-finding session stressed the existence of ignorance and baseless fear of Section 102, created or fanned by the myriad of tax advisory "services" that plague the land. It is certainly possible that the evil of which such tipsheets often complain—payment of dividends when retention of surplus would be better business policy—is (to the extent that it does occur) not the result of the Treasury's administration of Section 102 but of locker-room gossip that is fed by these very tax advisory reports. I have before me the advertisement for one publication (it is not alone) that will enable the corporate treasurer to "master the language" of taxation "by spending just a few minutes a month" with the advertised product. He may learn the language that way (though certainly not "pleasurably," as he is also promised), but he will probably spout nonsense when he speaks it. Time and again the Tax Institute speakers complain of the misinformation that has been pressed upon clients by both lay publications and inexpert professionals.

After the Tax Institute's "fact-finding panel" exchanged views, the "policy discussion panel" took over "to decide what, if anything, should be done about" Section 102. The proposals of individual participants were by and large surprisingly mild, and the only group recommendations to muster a substantial consensus<sup>7</sup> were innocuous. Two of these are copied from the personal holding company provisions: crediting dividends paid within the first 75 days of the succeeding tax year, and allowing a deficiency dividend credit. Neither would substantially reduce Section 102's potency as a barrier to tax avoidance. The panel also endorsed a proposal to permit accumulating surplus for reasonably foreseeable needs in the distant (as well as the immediate) future. The victim to be sacrificed is, of course, *World Publishing Co. v. United States*,<sup>8</sup> where the court said that even if earnings were being stock-piled for a future need, "[T]he fact that they could not be spent for a number of years during which additional earnings might be expected, in the light of taxpayer's financial history, is a relevant factor to be considered."<sup>9</sup> I cannot believe that the panel's proposal would have affected the outcome of the *World Publishing Co.* case or indeed any other judicial decision on Section 102. The panel also agreed that the burden of proof under Section 102 should be tinkered with. Again, I doubt the importance of the change. If you are caught red-handed it does not matter whether proof must be beyond a reasonable doubt rather than just by a preponderance of the evidence, and by and

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7. The only Treasury representative did not vote.

8. 169 F.2d 186 (10th Cir. 1948).

9. *Id.* at 189.

large Section 102 has been applied only where the government did not really need the statutory presumptions. Moreover, since the assertion of any deficiency is *prima facie* correct, even the elimination of the statutory presumptions (a step that the panel does not advocate) would not open to the taxpayer a royal road to success.

Although the mildness of the panel's recommendations did not stem from complacency, it did reflect the group's general acceptance of the purpose of Section 102 coupled with its inability to propose any better way to achieve that purpose within today's statutory framework. Like the discussion of the fact-finding panel, the conclusions of the policy group cannot be reconciled with the comments on Section 102 that constantly erupt from more heated but less thoughtful sources.

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BROOKS ADAMS: CONSTRUCTIVE CONSERVATIVE. By Thornton Anderson. Ithaca: Cornell University Press, 1951. Pp. xiv, 250. \$3.75.

THIS is an interesting book about one of the most erratic but talented bundle of contradictions of American letters. What manner of man was Brooks Adams? He was a prolific writer, an historian, philosopher, social psychologist, educator and lawyer. The author in two hundred pages gives, in capsule form, the outlines of this strange man's thought. And he does it very well, indeed. He points up the paradoxes of Adams' thinking, the fallacies and often sheer nonsense of his ideas, but is not insensible to the penetrating insight and occasional flashes of intuition that make Adams worth study. The style is easy and the documentation adequate for the task undertaken.

If one can say anything about Brooks Adams, it is that he was a violent man. He could go headlong and furiously down one road and turn suddenly and quite as madly dash the opposite way. He was a man of strong convictions. They did not always make sense individually, and never collectively. But when Brooks Adams changed his mind, he could cling as tenaciously and dogmatically to the new view as he had to the old.

What is one to think of a man who one minute is a thoroughgoing pragmatist and the next is trying to work out a completely conceptual theory of government and society? Who today says he "uses history as little as possible" but tomorrow presents us with a streamlined theory of history based on monetary doctrines and world trade routes? Who one minute asserts that "the prosperity of this country is based on the principle of the trust," the next, advocates government ownership of basic industries and State Socialism?

Some of Adams' ideas were downright evil and it was in defense of them that he often became the most offensive. "The trust must be accepted as the cornerstone of civilization."<sup>1</sup> Of the Spanish-American war, he announced, "I believe in the war and in the policy of expansion which it forced upon us.

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1. Quoted by Anderson, p. 87.