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Undistributed Profits Tax

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TAX REVISION STUDIES, 1937

UNDISTRIBUTED PROFITS TAX

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UNDISTRIBUTED PROFITS TAX

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Summary

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 [illegible]

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - UNDISTRIBUTED PROFITS TAX

SUMMARY

The primary purpose of the undistributed profits tax is to make effective the rates of the individual income tax. To accomplish this, the tax should be sufficient over the major portion of its range to induce the distribution of corporate earnings to the equitable owners thereof, and over the remaining portion of its range should at least compensate the Treasury in part for the individual income taxes lost by the non-distribution of corporate earnings. While the theoretical need for a tax of this character has existed ever since the rates of the individual income tax diverged substantially on the upside from those of the corporation normal tax, this need became acute for the first time in a decade with the high rates of the individual income tax imposed by the Revenue Act of 1932 and subsequent Acts. These rates--at present amounting to as high as 79 percent on segments of income in excess of $5,000,000 and 62 percent, or higher, upon all segments of income in excess of $100,000--could not be made really effective as long as corporate profits could be retained and reinvested without the payment of the individual income tax. The undistributed profits tax, as at present upon the statute books, takes a long step toward making such rates effective. We believe that its efficacy in this direction can be further increased and that certain elements of harshness can be greatly diminished by the changes suggested in this memorandum. A careful canvass of the situation, on the other hand, has failed to reveal any practicable alternative device by which this could be accomplished.

Aside from its primary objective of reducing the inequity and increasing the revenue productivity of the income tax system, the undistributed profits tax has certain social and economic effects. The most important of these are (1) that the tax tends, on balance, to reduce somewhat the proportion of the national income which is saved and to increase somewhat the proportion which is currently consumed, and (2) that it tends to "democratize" the process of capital formation by returning to stockholders the function of deciding whether or not they are willing to reinvest in a particular corporate enterprise their pro rata share of its annual earnings. These effects are inseparable from the tax as such, except to the extent that corporate earnings may be distributed through the declaration of taxable dividends in the form of securities of the corporation itself, or are reinvested by the stockholders through the exercise of coercive rights. While we advocate the undistributed profits tax primarily as a revenue and equitable measure, we believe that these incidental and largely inseparable social and economic effects are, in themselves, desirable and tend to reenforce rather than detract from its revenue and equitable objectives.

In order to make the tax more equitable in its application, to remove certain hardships, and to increase its effectiveness in certain respects, the following changes are suggested:

(1) Coordination with the Privilege Tax. It is recommended that adjusted net income should consist of privilege-tax net income -- that is, net income before the deduction of interest, rents and royalties -- less the privilege tax paid, and that undistributed net income should consist of adjusted net income less dividends, interest, rents and royalties.

(2) Rate Schedule. The following rate schedule is recommended:

Percent of adjusted net income undistributed	Tax (Percent)
0 - 5	3
5 - 15	15
15 - 50	40
50 - 100	60

The rate in the initial bracket has been lowered as compared with the present law, principally in order to make allowance for the margin of error of estimate in net income, while the rates in the last two brackets have been made sufficiently high to induce distribution of earnings in the vast majority of cases, including even those of closely held corporations. The narrowing of the first bracket is necessary to prevent a substantial loss in revenue in view of the change in the base for adjusted net income. It will have an effective width substantially greater than that of the present initial 10 percent bracket for corporations with large amounts of prior charges. These corporations cause little revenue loss, and are the most needful of and the most clamorous in demanding relief in any event, while some relief for them seems especially timely in view of the transitional burden to which they will be subjected by the new privilege tax.

(3) Small Corporations. It is not believed that the contention frequently made that the undistributed profits tax places small corporations at a disadvantage has merit, but the contrary is rather believed to be true. Nevertheless, in line with our consistent policy of granting preferential treatment to small corporations in any event, it is recommended that the specific credit provided in Section 14(c) of the Act be continued at $5,000, that the rate of tax thereon be lowered from 7 percent to 3 percent to conform with the lower rate suggested for the first bracket of the regular tax, and that it be extended in its application to corporations with adjusted net incomes of up to $100,000 (rather than $50,000) in view of the proposed change in the base of adjusted net income. It is further recommended, however, that whatever income remains undistributed beyond the amount included in the specific credit be taxed at the rates applicable if the specific credit had not been granted.

(4) Allowance of Net Capital Losses. It is recommended that an unlimited offset of capital losses be permitted, for the purpose of the undistributed profits tax only, against other income.

(5) Net Loss Carry-Over. It is recommended that a two-year carry-over should be allowed for all losses (including capital losses as merged with other losses by the preceding recommendation) for the purpose of the undistributed profits tax only.

> It is believed that recommendations 4 and 5 taken in conjunction will meet the legitimate complaint that it is often necessary for a corporation incurring substantial capital losses, or engaged in a fluctuating business, to pay an undistributed profits tax, in order to retain its capital intact; whereas, in the contemplation of the law, such a tax should be paid only when it is desired to increase the capital employed in a business by the reinvestment of earnings free from the individual income tax.

(6) Optional Settlement of Subsequently Found Deficiencies. It is recommended that if audit of a corporation return reveals that net income from a previous year should have been reported at a higher figure than that appearing upon the face of the return, and no question of bad faith is involved, the taxpayer should have the option of paying the undistributed profits tax liability thereby created,

with interest, or of paying a special tax of 5 percent of the undistributed profits newly determined by the Commissioner, and adding the remainder of such newly determined profits to adjusted net income in the current year. It is felt that this recommendation will restore to the taxpaying corporation, as far as it is possible to do so, its original option either of paying the undistributed profits tax, in whole or in part, or of distributing its earnings, in whole or in part.

(7) Special Tax on Earnings Exempted from the Undistributed Profits Tax by Reason of Contracts Prohibiting the Payment of Dividends, etc. It is recommended that a tax of 10 percent be levied upon earnings exempted from the undistributed profits tax under Section 26(c) of the Act, because of contracts prohibiting the payment of dividends, etc., and that such tax be levied in lieu of the lowest brackets of the undistributed profits tax in which the amounts so exempted would otherwise have fallen. This tax will take cognizance of the fact that income which remains undistributed as a result of prior contractual obligations both increases the equity of the stockholders and results in revenue loss to the Government in the same measure as though it had remained undistributed as the result of a currently made decision of the Board of Directors of the corporation.

Historical
Background

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 6 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - UNDISTRIBUTED PROFITS TAX

I. HISTORICAL BACKGROUND

Throughout our experience with income tax legislation and administration, the most difficult problem that we have encountered -- next to the definition of income itself -- has been the problem of the proper tax treatment of corporation income. There is one body of opinion that has held that business organizations generally, whether incorporated or not, may be properly subjected to special rates or forms of taxation. There is another body of opinion that has held that corporations, because of the valuable special privileges granted to them by law, may be properly taxed more heavily than other forms of business organization. And there is a third body of opinion which has held that corporations, like other business organizations, are merely conduits through which income flows to individuals and that the taxation of corporation incomes as such is therefore unjustified, since it involves double taxation — first, when the income taxes are paid by the corporation, and second, when the stockholders pay individual income taxes on their dividend receipts.

In the Civil War income tax measures, no tax was levied directly upon the incomes of ordinary industrial and mercantile corporations; but railroad, insurance, banking, and similar corporations were subject to an income tax equal to the lowest rate imposed upon individuals — first 3 percent, then 5 percent, and later 2½ percent. In the Revenue Acts of 1913 and 1916, the rates of 1 and 2 percent, respectively, imposed upon corporation incomes were identical with the normal tax rates on individual incomes, from which, moreover, dividends received from corporations were deductible for normal tax purposes.

So long as the range of normal and surtax rates on individual incomes was narrow — in the Revenue Act of 1913 the maximum surtax rate was 6 percent — and so long as the rate on corporation incomes approximated the normal rate on individual incomes, from which dividends were exempt, it could be said that the law treated incomes derived through corporations on roughly the same basis as incomes derived from unincorporated business and from personal services. In other words, corporation stockholders were neither favored nor penalized to any substantial degree by our income tax laws.

Beginning with the Revenue Act of 1917, however, the surtax rates applicable to individual incomes were increased very drastically, the maximum surtax rate rising from 13 percent in 1916 to 63 percent in 1917, and to 65 percent in 1918. The corporation income tax rate, on the other hand, was raised only to 6 percent in 1917, and to 12 percent in 1918. Although very high excess profits and war profits taxes were also enacted in 1917, they were modified in 1918 to apply only to corporations, and were dropped after 1921. In consequence of the sharp increase in the range and absolute rates of individual surtaxes, without any corresponding increase in corporation income tax rates, a very important disparity arose between the tax treatment of corporation stockholders and the tax treatment of individuals deriving their incomes from partnerships, individually owned enterprises, and personal services. This disparity resulted from the fact that the earnings applicable to the shareholders' interests in a corporation but not currently distributed in dividends escaped the current individual income surtaxes; whereas the earnings applicable to members of partnerships, whether distributed or not, and the earnings of individual business and professional men, whether reinvested or not, were subject in full to the schedule of individual income surtaxes.

The privilege offered to corporation stockholders of allowing their share of corporation earnings to be directly reinvested for them without the current payment of individual income surtaxes thereon aroused considerable debate from the beginning. As early as September 8, 1916, the late Thomas S. Adams, in discussing the proposed Revenue Act of 1917, declared that ".....the undivided profits of a corporation should be taxed at the rates which would apply if such profits were distributed to the shareholders....."

When the Senate Finance Committee first reported the bill that became the Revenue Act of 1917, a provision was included imposing a 15 percent tax, in addition to the regular corporate income tax, on undivided earnings exceeding 20 percent of the total net income. As finally enacted, the 20 percent exemption was eliminated and the rate of additional tax was reduced to 10 percent, applicable to that portion of the total net income, after Federal income taxes, remaining undistributed six months after the end of the calendar or fiscal year; but a broad new exemption was inserted that made the entire provision virtually ineffective. This exemption read in part, as follows:

> "The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business, or is retained for employment in the reasonable requirements of the business, or is invested in obligations of the United States issued after September 1, 1917."

The broad character of the permission to retain earnings, without tax liability, if such earnings are employed "in the reasonable requirements of the business" made it extremely difficult to prove tax liability; and the entire provision was repealed by the Revenue Act of 1918.

It is interesting to note that in the Civil War income tax laws, Congress solved this problem, with respect to ordinary industrial and mercantile corporations (though not with respect to railroad, banking, and similar corporations which were then relatively more important), by providing that individuals were subject to income taxes on their share of the profits and gains in the corporations in which they held interests, whether these profits were divided or not. Such a provision today would probably prove more difficult of effective administration, barring questions of constitutionality. It is significant, however, that the problem met in this way by the Civil War revenue acts, so far as industrial and mercantile corporations are concerned, is, in substance, the same problem that confronted the Congress in 1916, and the very same problem that Congress again attacked through the Revenue Act of 1936.

Under the Revenue Acts of 1921, 1924, 1926, and 1928, applicable to the ten years ended in 1931, the surtax rates on individual incomes were progressively and sharply reduced; so that from 1925 to 1931, inclusive, the maximum surtax rate was 20 percent; and the corporation income tax rate during this period ranged from 11 to 13½ percent. These reductions in the individual surtax rates, coupled with the maintenance of corporation income tax rates higher than the normal rates on individuals, moderated in part the preferential tax treatment of stockholders whose earnings were directly reinvested by their corporations, as compared with the reinvested earnings of individual business men and partnerships. But with the enactment of the Revenue Acts of 1932, 1934, and 1935, whereby individual income surtaxes were again increased substantially, this disparity once more became a serious problem.

Equitable
Basis

II. EQUITABLE BASIS

1. Prior to the Revenue Act of 1936, when corporations distributed their earnings to their stockholders, the dividends were subject to the surtax rates named in our income-tax law. When corporate earnings were not so distributed, the individual stockholders, while enjoying the benefit of these earnings in the form of more valuable investments, were enabled to avoid all payment of surtaxes thereon. Between 1923 and 1929, inclusive, more than 45 percent of the compiled net profits, after income and excess-profits taxes, of all corporations reporting net income was not distributed by the corporations and was therefore not subject to the individual income taxes, or their approximate equivalent, applicable to their stockholders.*

2. Very large proportions of the incomes accruing for the benefit of members of the upper income groups in the United States had previously escaped the individual income surtaxes for long periods or forever in this fashion. Henry Ford, for example, has been liable for individual income surtaxes on only such portions of the profits of the Ford Motor Company as have actually been paid out to him. By allowing his profits to accumulate in and to be reinvested by the Ford Motor Company, he has been enabled to avoid individual income-tax liability for most of his share of such profits. The Federal Government need never get anything like the equivalent of the taxes avoided in this fashion by Mr. Ford (to continue the example), for at Mr. Ford's death his estate will pass to his heirs without any tax liability for the huge capital gains incorporated in this estate, part of which arose through the Ford Motor Company's retention of earnings, nor will the rates of tax applicable to the estate be at all higher than on estates of similar size that may have been created by individuals whose equitable incomes had been subject in such greater measure to our individual income and capital gains taxes unless the latter type of loophole is eliminated in some such manner as is recommended in a companion memorandum on Estates and Gifts Taxes.

3. Our high individual surtax rates were obviously ineffective in large part when their application could be postponed for long periods or avoided altogether through corporate retention of earnings. Further, even when corporate earnings were fully distributed over a period of years, there was unjust discrimination

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* For the same years, 1923-29, all corporations (whether reporting net income or not) withheld 27 percent of their combined compiled net profits, after income and excess profits taxes.

in the distribution of the tax burden. The ability of corporations and of their controlling stockholders to choose the timing of dividend distributions, without any effect upon the corporation's tax liability and without reference to current earnings, often resulted in a loss of revenue to the Federal Government and an unjust avoidance of taxation by stockholders of large personal incomes. The current earnings withheld by a corporation would often, if distributed, have raised the surtax brackets of many stockholders, thereby subjecting such earnings to the higher surtax rates. When withheld for a time and then paid out in years when the other income of important stockholders was smaller, such earnings escaped the higher rates to which they would have been subject. Individual businessmen and partnerships possessed no corresponding choice for the timing of the distribution of earnings for income-tax purposes. All of the income of individuals and members of partnerships is taxable in the year earned, whether saved and reinvested in the business or not.

Moreover, shareholders in corporations that pursued liberal dividend policies were discriminated against as compared with shareholders in corporations pursuing niggardly dividend policies; for the corporation taxes took no account of the differences in dividend policies, while the individual income-tax liabilities were greater for stockholders in corporations making liberal distributions. Stockholders receiving large dividends commonly reinvest much of these, but they are subject to individual income taxes thereon before such reinvestment. Where the corporation made the reinvestment directly for stockholders, such investment took place tax free.

Again, an individual who reinvests in his business the large profits of one year and subsequently experiences losses, is nevertheless subject in full to the income taxes on the profits of his good year; whereas the stockholders of a corporation that similarly reinvested the large earnings of one year and subsequently suffered equivalent losses, escaped individual income taxes on the profits of the good year.

4. It is clear that the most direct method of achieving equality of taxation of all income, corporate and other, would be to include in the taxable incomes of corporate stockholders their pro rata shares of the current earnings of corporations,

whether distributed or not. This method, however, presents numerous administrative, economic and legal difficulties. An increase in the schedule of normal corporation income tax rates might produce the mathematical equivalents in revenue, but would be unfair to stockholders with small incomes and to stockholders of corporations pursuing liberal dividend policies. The President, therefore, proposed to meet these problems of tax avoidance and tax inequality by repealing altogether the normal corporation income, capital stock and excess profits taxes; and to substitute therefor very substantial rates of tax on the undistributed profits of corporations. The thought was that these rates of tax would encourage the distribution of the great mass of current earnings of corporations (no attempt was made to tax previously accumulated surpluses), thereby subjecting them to the individual income taxes; and that the taxes paid by corporations on the retained portions of their earnings would fully compensate the Treasury for the individual income taxes avoided through such retention.

The Congressional committees were disinclined to abolish the corporation income, capital stock, and excess profits taxes, partly because of the legal and economic advantages enjoyed by corporations over individuals and partnerships (particularly by large corporations), partly because such taxes were already well established and therefore reflected in the price of corporate securities, and partly because of the uncertainty attaching to revenue estimates for the new substitute tax. In consequence, the normal corporation income, capital stock, and excess profits taxes were retained in the Revenue Act of 1936, the two former at lower rates. Despite the retention of the normal tax on corporation incomes, the previous exemption of dividends from individual normal tax was eliminated.

5. Such evidence as we have to date supports the belief that the tax has had a profound effect upon corporate dividend policies. During the last quarter of 1936, the period most likely to reflect the influence of the tax, dividend declarations, as reported by the New York Times, amounted to $1,552 millions, compared with $857 millions during the last quarter of 1935. The great bulk of the additional dividends undoubtedly went to members of the higher income groups. Between 1927 and 1934, inclusive, 85.8 percent of the dividends reported by individuals subject to income tax were received by individuals reporting net incomes of $10,000 or more.

6. While the undistributed profits tax, viewed as a whole, results in removing major sources of tax avoidance and inequality, the present rate schedule introduces a new type of discrimination which to some extent offsets these advantages. When earnings are retained and the tax is paid, the burden is borne equally by stockholders of all income groups. In effect, this raises the total tax burden on the portion of such corporation income going to stockholders in the lower brackets sharply above that which they would bear if the income had been distributed and taxed at the regular income tax rates. The only recourse which such stockholders have at present is to shift their investments into corporations distributing substantially their entire earnings.

This inequity, however, can be substantially reduced by a realignment of the present rate schedule. It is greatest in the case of medium rates -- those which are not high enough to induce distribution, and yet are much higher than ought equitably to be borne by stockholders in the lower brackets. It is proposed, therefore, in the recommendations appearing in another part of this memorandum, that the rates of tax applying to the first segment of undistributed net income be made sufficiently low so as not to impose an undue hardship upon stockholders in the lower brackets, even if earnings are retained and the tax paid; and, on the other hand, that the rates applying to the larger percentages of undistributed net income be made sufficiently high to effect distribution and so permit stockholders in the lower income brackets to pay only the rate of tax appropriate to their particular cases. It is believed that by such a revision the inequity in the present law can be reduced to minor proportions.

Objections

III. Discussion of Principal Objections Raised Against the Undistributed Profits Tax

The principal objections which have been advanced against the undistributed profits tax are:

(1) The tax tends to divert current income from saving to consumption and thus to retard the process of capital accumulation.

(2) Corporations that use part or all of their earnings for the payment of short- or long-term debts are subjected to a tax penalty.

(3) Corporations are deprived of a necessary source of capital for expansion, except on payment of a tax penalty.

(4) The tax on undistributed earnings will discourage corporations from creating the corporate surpluses deemed necessary to maintain wages, employment, dividends, and business solvency, through periods of depression.

(5) The tax will prevent small corporations from growing into big ones, and therefore operate to protect established corporations with accumulated surpluses from new competition.

Diversion
of Savings

1. Diversion of Savings

It is objected that the tax tends to divert current income from saving to consumption and thus to retard the process of capital accumulation. It is pointed out that, whether a corporation does or does not distribute its earnings, a vastly increased share of corporate income will go to the Government, from which it ordinarily enters the channels of consumption; and further that, to the extent that a corporation does distribute its earnings, it is unlikely that all or nearly all of the dividends will be reinvested by the receiving stockholders. The objection to the tax on this basis is founded on the orthodox theory of capital, which places no limits on the progress obtainable through increased saving. However applicable this theory may have been to earlier stages of capitalistic society, its validity under our present economy has been sharply challenged by a number of reputable economists, including J. M. Keynes and Harold G. Moulton.

The dissenters from the orthodox theory assert that in an industrial society the tendency is for current savings to become too large for current absorption, thus resulting in unemployment and a depression of the standard of living. This occurs because the construction of new capital assets does not vary directly with the amount of savings available--as the orthodox theory assumes--but is largely dependent upon the markets for the final products. If the savings of the community absorb too large a part of current income, the consequent shrinkage of consumer demand destroys the profitability of investment. Therefore, as the wealth of the community increases, it may be increasingly necessary to reduce the potential savings of the wealthier members, among whom the propensity to save is greatest, and to direct such income to the poorer members.

There are good grounds for believing that there exists in this country a considerable stream of uninvested savings which prevent a full absorption of the potential products of industry. Aside from its equitable advantages, therefore, the tendency of the undistributed profits tax to prevent over-saving by the higher income groups may be considered to be a desirable contribution, particularly in view of the prospective diversion of consumption expenditures by the Social Security taxes.

Debts

2. <u>Alleged unfairness and unsoundness of imposing a surtax on earnings used for debt retirement</u>:

This objection is considered in its proper perspective only if the treatment of corporations is contrasted with that of individuals and partnerships. Individuals owing short-term debts contracted for consumption purposes, or longer-term debts such as mortgage debts on their homes, are not released from income-tax liability for the portion of their incomes used for the payment of such debts. Nor are members of partnerships freed from individual income-tax liability on those portions of their partnership incomes employed for the retirement of partnership debts. The underlying assumption of this objection, therefore, is that corporate debts are of such special character as to merit exceptional treatment. This assumption does not withstand analysis.

Corporate indebtedness consists of two chief types: commercial debts such as bank borrowings for inventory and other working capital purposes; and funded debt, usually represented by mortgage or debenture bonds.

With respect to the first type, that is, short-term loans for the purposes of acquiring inventories, paying wages, etc., it is not usually contemplated that such loans should be repaid out of <u>earnings</u>. On the contrary, it is expected that such loans will be repaid out of the gross proceeds of the business. A department store which borrows $100,000 for the purchase of seasonal merchandise for its Christmas trade is expected to repay this loan out of the gross retail proceeds of perhaps $130,000, and not out of the $2,000 net profit remaining to it after all costs. It is for this reason that such loans are welcomed by banks as self-liquidating.

As a class, moreover, such loans are never completely liquidated because new loan transactions are usually being entered into by the same or other business enterprises as past loans are being liquidated — though not necessarily, of course, in offsetting amounts. They constitute a revolving fund whose aggregate volume has normally exceeded the total statutory net income of American corporations. Their volume for any particular enterprise bears no necessary relationship to the amount of its net profits, and is frequently several times the amount of the proprietors' capital.

It is true that exceptionally profitable enterprises sometimes reduce the average volume of their commercial borrowings by substituting capital funds derived from reinvested earnings. This, as stated above, is not the normal source of repayment of such borrowings. Other enterprises reduce or eliminate their commercial borrowings by the sale of additional securities to their stockholders and others. In general, however, the most economical utilization of the country's capital takes place when short-term needs are supplied by temporarily borrowed rather than by owned and permanent capital funds. Hence, no public purpose would be served by the extinguishment of short-term commercial debts.

Finally, it is obvious that the exemption from corporate surtaxes of earnings employed for the repayment of commercial debts would open wide an enormous door for tax avoidance; Debts could be contracted solely for the purpose of retiring them out of earnings and thereby indirectly reinvesting earnings and adding to the proprietorship capital tax-free.

With respect to bonded and other forms of longer-term indebtedness, somewhat different considerations apply. Much of the proceeds of such loans has normally been employed for plant, machinery, and other fixed assets. Is it fair or wise to place a surtax on earnings employed to retire such debts?

It should be observed in the first place that prudent lenders and prudent borrowers expect a fixed investment financed by such a loan at least to pay for itself during the life of the property. That is, funds for the complete retirement of the investment, if no replacement of the physical property is contemplated, will be provided by depreciation charges deducted from the gross receipts over a period of years. Prudent lenders and prudent borrowers are not likely to contract for loans extending over a longer period than the economic life of the property to be constructed or acquired with the proceeds; though loans are often contracted, perhaps by reason of temporary money market stringency, for periods shorter than the economic life of the property, with the expectation that such loans will be subsequently refinanced. Depreciation charges should provide the necessary funds for the ultimate extinguishment of debts incurred for the acquisition of fixed assets not intended to be replaced; no net earnings should be necessary for this purpose.

It is more commonly true that physical properties financed by bond issues are continuously maintained or replaced. Where this is done by the use of funds allocated from gross receipts for depreciation and similar charges, the retirement of the indebtedness normally takes place in any one or more of three ways; (1) By refunding the debt at maturity or an earlier call period by means of a new issue of obligations (This is by far the most common method among railroad and public-utility companies, which account for about three-fourths of the aggregate funded debt of all non-financial corporations); (2) by funds raised through the sale of additional common or preferred stocks (a method commonly used by industrial corporations); and (3) by funds derived from the undistributed earnings of the corporation.

The character and importance of the third method is the one at issue in this connection. It is clear that this third method differs from the second only in form. In both cases, stockholders' capital is used to retire the debt. In the one case, there is a formal issue of securities to recognize the increased equity of the stockholders in the capital assets. In the other case, the increased equity of the stockholders is recognized by a commensurate addition to the corporate surplus account. The essential identity of the two methods may be seen by contrasting a corporation which refrains from dividend payments for five years and employs the $25 per share of earnings accumulated during that period for the retirement of debt, with another corporation that pays out the $5 per share earnings annually, but which, through an issue of stock rights at the end of that period, obtains $25 per share from its stockholders to retire indebtedness. The fundamental fact is that the use of corporate earnings to retire corporate indebtedness adds to the equity of the stockholders.

It has been suggested that all corporate earnings that are employed for debt retirement be exempted from the application of the surtax. Such proposals possess an emotional appeal because the supporting argument usually runs in terms of a debt-ridden individual -- although, as noted above, the law makes no concession to such an individual. The fundamental fact that corporate debts are parts of corporate capital structures and that the debt element in these structures is voluntary, for the most part, is ignored. Corporations of similar size in the same industry -- competitors -- vary greatly in the character of their corporate structures. Shall one company, because its stockholders desired to increase their

Expansion

own earnings by obtaining part of the corporate capital through the issue of fixed-interest securities, be given a tax advantage over the stockholders of another corporation in the same line of business who chose to supply all the capital through common stock?

We have already called attention to the fact that railroads and other public utility enterprises, which account for about three-fourths of the long-term debt of all non-financial corporations of the United States, commonly regard such debt as a permanent element in their capital structures, meeting the maturities of particular obligations by refunding issues. Such corporations and industrial corporations as well that desire to reduce their long-term debt may employ new capital funds obtained by the sale to stockholders and others of additional equity securities. Under the Revenue Act of 1936, moreover, a corporation need not distribute its current earnings in cash in order to avoid liability for the surtax on undistributed earnings. It may retain the cash and employ it for debt retirement, and nevertheless avoid the surtax by the distribution of taxable dividends consisting of securities, such as preferred and common stocks, where the effect of the distribution is to change the pro rata interest of the shareholders. There would appear to be no logical or practical ground therefore for exempting from the surtax on undistributed earnings such portions of corporate earnings as are used for debt retirement.

The possible effects upon the tax revenues of any substantial exemption from the corporate surtax of earnings used for debt retirement, apart from the possibilities of tax avoidance by the creation of new debts, should full utilization of the privilege take place, may be indicated by the following figures, which show the aggregate indebtedness of all corporations submitting balance sheets with their income-tax returns in 1928 and 1933:

	1928	1933
	(Billions of dollars)	
Notes and accounts payable	27.4	19.3
Bonded debt and mortgages	42.9	45.9
Total	70.3	65.2

3. <u>The alleged unsoundness of depriving corporations of a necessary source of capital for expansion, except on payment of a tax penalty:</u>

It is frequently contended that the direct reinvestment of a large fraction of corporate earnings is essential to the expansion of corporate enterprise; and that the surtaxes imposed under the Revenue Act of 1936 will therefore operate to prevent or seriously to restrict such expansion. This argument is not well founded since ample means for expansion on the part of corporations which command the confidence of their stockholders are available in the form of taxable stock dividends and preferential rights to subscribe to additional securities.

(a) <u>Stock Dividends</u>

In the first place, dividends may be paid in the form of securities constituting taxable income to the stockholders, such as preferred and common stocks (provided such distribution changes the proportionate interests of the various classes of stockholders), and various classes of debt instruments.

That the corporate structure is sufficiently flexible to make wide and effective use of this method of earnings retention is indicated by the similar adjustment made by many corporations following the Supreme Court decision in Eisner v. Macomber, in 1920. This decision, permitting the declaration of nontaxable stock dividends, resulted in an enormous increase in such dividends. In 1922 more than $3.3 billions of stock dividends were declared, and about $5.2 billions in the following seven years. The use of such dividends, therefore, for the purpose of making non-cash taxable distributions will involve no major innovation in corporate dividend policies.

(b) <u>Stock Rights</u>

In addition, for many decades, growing and successful corporations have been able to call upon their stockholders and others for additional capital through the offering of rights to the stockholders to subscribe for additional securities. Through the issuance of such rights, corporations may obtain the reinvestment in their business of capital equal to all or any desired proportion of the current earnings that have been distributed in dividends; and, if need be, more.

Assume a corporation that desired to reinvest in its business its entire earnings of $5 a share, but that, nevertheless, decided to pay out the whole amount in dividends in order to avoid the corporate surtax. Such a corporation could usually obtain the reinvestment in its business of this $5 per share by offering to its stockholders rights to purchase additional capital stock at prices below the prevailing market values. The rights themselves would constitute a valuable marketable instrument which could be sold by any shareholder who was not disposed to reinvest his dividend check. It is equally apparent, of course, that the amount of money which can be obtained in this way is by no means limited to the amount of the earnings of the corporation, but that any reasonable increase in total capitalization can be effected by this means.

During the period between 1921 and 1930, inclusive, the American Telephone and Telegraph Company paid regular dividends at the rate of $9 per share, the dividends aggregating about $850 millions during the ten years. But, during this same ten-year period, the corporation offered rights to purchase additional stock to its stockholders in 1921, 1922, 1924, 1926, 1928, and 1930, and in the aggregate raised about $950 millions of capital from its stockholders through the sale of such additional stock to them — or about $100 millions more than the aggregate dividends paid to them during the period.

The Travelers Insurance Company of Hartford, Connecticut, by successive offering of rights to shareholders to subscribe to new stock at par in 1908, 1910, 1913, 1916, 1920, 1923, 1925, 1926, 1928, and 1929, multiplied its outstanding amount of capital stock twenty times, from $1 million to $20 millions.

One of the many recent illustrations of this obvious means of adjustment to the undistributed profits tax is offered by Montgomery Ward and Company, whose president, Mr. Sewell L. Avery, vigorously criticized the tax for compelling the company to distribute virtually all of its $20 millions of earnings in 1936. This company paid cash dividends of $4 per share during the past year as against nothing in the previous year, but recouped the entire distribution and more by obtaining $25 millions through an offering of additional common stock to its stockholders.

Referring to Mr. Avery's disclosure that the company is now in need of further capital because of its record-breaking volume of sales, the New York Times reported Mr. Avery as saying that the company has three alternative methods by which it can obtain the new capital it needs: First, issuance of new convertible preferred stock with a rate of about 4 percent; second, issuance of convertible debentures; and third, sale of additional common stock such as was sold last year to provide $25 millions.

The Bureau of Business Research of the University of Illinois has estimated that more than $3 billions of capital was raised by corporations in 1929 through offerings of securities to their stockholders. In discussing such stock offerings, Dewing, in his Financial Policy of Corporations, a standard work on this subject, says, "They occurred almost as frequently in 1922 and 1923 as they did in 1928 and 1929". The number of corporations, relatively small and unknown as well as large and well-known, that have been using this means of raising capital funds during the past twelve months is substantial.

Medium-size corporations with scattered stockholders are less advantageously situated to recapture earnings from their stockholders than either small or large corporations. On the one hand, they are less able than small corporations to secure the informal and ready assent of their stockholders to the reinvestment of dividends; and on the other hand, they lack the ready access to the general capital markets that obtains for large corporations. Nevertheless, their managements possess in addition to the device of taxable stock dividends a highly coercive power to recapture, through rights to additional securities, a large portion of the earnings distributed in dividends.

The fact that this practice has been less employed by most moderate-size corporations than by large corporations is not attributable to any inherent and decisive difficulty. So long as new capital funds could be obtained by direct reinvestment of earnings, most moderate-size corporations, whose dividend policies were less subject to the critical appraisal of a large body of stockholders, found no special advantage in raising funds through rights to their stockholders. Now that the undistributed profits tax provides such an advantage, the coercion applied to stockholders by the preferential offering of new securities at very attractive prices may be expected to be employed more extensively by moderate-size corporations than in the past, with effective results.

In addition to the funds which may thus be raised by nearly all profitable corporations, large and small, through the offering of new stock to their stockholders, large corporations, in particular, will continue to possess, as they always have, access to the organized capital markets for the direct flotation of securities to persons other than their existing securit holders and so will be able to raise such additional funds as they may need through the offering of stocks and bonds for public subscription.

Nevertheless, there are some who argue as if capital funds obtained by direct reinvestment of earnings, and therefore credited to an account called surplus, have a special magic about them that makes them more valuable to a corporation than capital funds obtained through the sale of equity securities. Thus, it is contended that corporations with large accumulated surpluses are in a stronger competitive position than corporations with smaller or no surpluses. This contention does not stand examination. The item of surplus occurs on the liability side of a corporation's balance sheet and does not necessarily represent cash or marketable securities or inventories or any other type of liquid asset. In many cases, a corporation is born with a surplus as a result of the expedient of undervaluing its capital stock on its books and

Depressions

calling the rest of its paid-in capital "surplus". In other cases, the surplus is the result of giving a large and sometimes fictitious value to such intangible assets as good will or patent rights. In no case can it be truly stated that a non-financial corporation with an accumulated book surplus is in a better competitive position than another corporation with equal assets and similar liabilities and equally good management that has no book surplus. The latter corporation could create a book surplus at any time by a reduction in the par or book value of its capital stock.

It is sometimes argued that these considerations are more applicable to corporations engaged in stable than to those engaged in highly fluctuating industries because the latter corporations experience frequent and prolonged periods during which low earnings or actual deficits preclude successful appeals to stockholders for additional capital funds. However, such corporations were previously able to obtain substantial amounts of capital funds through reinvested earnings only during prosperous years, and under the new law, they may continue to utilize prosperous years to accumulate capital funds by the sale of additional securities to their stockholders.

It is further objected by some that stockholders may be reluctant or even unwilling to reinvest in any given enterprise any large fraction of the earnings distributed to them in dividends. But this argument assumes that corporate managements may justly reinvest earnings in a particular enterprise against the desire of the stockholders. In the last analysis, however, the earnings of a corporation belong to its stockholders; and stockholders are entitled to exercise a choice, which, under the present corporate practices they do not always possess, with respect to the disposition of these earnings. Insofar as one effect of the undistributed profits tax will be to encourage corporate managements to obtain the consent of their stockholders for capital expansion, and to give to stockholders -- the real owners of the corporation -- a greater control over the disposition of their earnings, this effect is altogether desirable. It has often been remarked that corporate managements are far more prudent in the use of capital funds obtained through formal financing with the aid of investment bankers than in the use of capital funds arising out of reinvested earnings. A more disciplined use of the latter source of capital is no less desirable.

4. <u>The contention that the tax on undistributed earnings will discourage and impede the creation of corporate surpluses necessary to maintain wages, employment, dividends, and business solvency through periods of depression:</u>

Critics of all forms of undistributed profits taxation have attempted to rest much or most of their case on this contention. It has been widely charged that one of the principal results of the tax will be to make future depressions far more severe because the accumulated corporate surpluses that in the past have cushioned corporations, their creditors, their stockholders, and their employees from the full effects of a declining or low level of industrial activity, will, by reason of the new tax, be available in much smaller volume. Such contentions possess a surface plausibility, but they do not withstand analysis.

In the first place, much of the plausibility of these contentions arises out of a very widespread misapprehension of the nature of corporate surpluses. A corporate surplus appears on the liability side of a corporate balance sheet and not on the asset side. The account does not represent a pool of liquid assets, cash and the like, which corporations keep available for use in emergencies. It very commonly represents fixed assets in large part, such as plant and machinery; or intangible assets, such as good will, patent rights, contracts, etc., none of which can be "spent" to meet depression needs or to repair damages caused by floods, or for any other emergency. Corporations with capital deficits are quite frequently far better situated, so far as liquid assets are concerned, than corporations that publish balance sheets containing large surplus figures.

In recent years particularly, the size and character of corporate surpluses, as the expression is used in corporate accounting, have been profoundly influenced by considerations of convenience, taxation, and financing; and the size of a corporate surplus today bears no necessary relationship to the amount of accumulated earnings nor to the liquid resources of a corporation. Stock transfer and similar taxes, for example, often make it advantageous for a new corporation to place a small book or par value on its stocks, or for an established corporation to revalue its existing capital stocks in this direction, and in both cases to transfer the remainder of the stockholders' equity to the surplus account. Aside from the taxation and similar advantages involved, this change is purely one of bookkeeping. It does not affect the corporation's ability to withstand depressions or to undertake new expenditures.

The case is not much different for a corporation whose surplus account actually represents accumulated earnings. If these earnings have been invested in the construction or purchase of additional plants and machinery, the large surplus account offers no measure of the corporation's ability to meet financial difficulties. If an investment banker or an investor examines the balance sheet of a corporation to determine whether the stockholders' equity provides an adequate margin of safety for a bond issue, he looks to the whole stockholders' equity, part of which will be found in the capital stock account and the rest of which will be found in the surplus account. It makes very little, if any difference to him whether the surplus account is large and the capital stock account is small or vice versa, provided only that the book figures accurately measure the real value of the stockholders' equity.

It is not the size of a bookkeeping figure called "surplus" that determines the ability of a corporation to meet a depression or other contingency. It is the amount of the total assets of the corporation as compared with its obligations (particularly its short-term obligations), and the proportion of its assets which it keeps in liquid form, that are significant in this connection. Corporations with relatively large amounts of liquid assets, whether derived from previous earnings or from previous issues of securities, are in a position to meet unusual financial needs, irrespective of the size of the balance sheet item called "surplus".

There is no doubt that a corporation may increase the volume of its liquid resources by withholding current earnings from its stockholders. When it does so, however, it is obtaining new capital funds from them. It could equally increase its liquid resources by distributing all of its current earnings in dividends and offering its stockholders rights to purchase additional stock with a portion or all of their dividend receipts. The undistributed profits tax places no limit upon the aggregate volume of a corporation's resources nor upon the proportion of these resources that it may keep in relatively liquid form.

There are some who defend the previous system of corporate taxation on the ground that the corporate surpluses that are built up free from surtaxes serve a public function by enabling corporations to maintain employment at a higher level than would otherwise be possible in periods of depression.

This view has been forcefully expressed by Colonel Leonard Ayres of the Cleveland Trust Company.* Citing figures of the Department of Commerce to the effect that the national income paid out exceeded the national income produced by a total of $26.6 billions between 1930 and 1934, inclusive, Colonel Ayres concludes: "That sum represents the contribution that business savings made to emergency relief during five depression years. These payments, in excess of income, were made possible because surpluses had been accumulated".

*Cleveland Trust Company Business Bulletin, March 15, 1936

Now, the most obvious fact bearing on this argument is that it simply did not work when, in 1929, the greatest depression this country has ever experienced came upon us. Not only do we now know that the corporate surpluses accumulated in the Twenties were not used to any great extent, in the aggregate, to maintain employment during the depression, but we also have some ground for suspecting that the very accumulation of these corporate surpluses assisted materially in causing the depression.

Thus, it has been argued by very respectable economic authorities, that among the causes of the depression was the starving of consumption through the withdrawal of too large a proportion of our national income for corporate capital expenditure. It is also held by many that one of the vicious influences contributing to the great stock market boom of the late Twenties was the piling up of liquid corporate resources through excessive retention of corporate earnings. Stock market speculation, which had already been stimulated by the rapid growth in corporate earnings, was further stimulated by the volume of funds representing undistributed earnings that was poured into brokers' loans by corporations.

But let us examine specifically the contention that these accumulated surpluses were actually used during the depression to maintain employment, dividends, and other payments. The Department of Commerce figures are frequently cited to represent the aggregate losses of corporations during the depression. Either by direct statement or by implication, the contention is made that these losses represent the amounts which corporations have had to pay out, in excess of their receipts, to workers, suppliers of materials, bond holders, and the like; and that only their previously accumulated surpluses allowed them to do this without bankruptcy.

We have been at pains to examine the matter in detail on the basis of the actual income-tax returns filed by corporations, and we find that the figures reported each year to the Bureau of Internal Revenue are strikingly at variance with this contention or belief. Some of our findings are as follows:

If we consolidate the income accounts of all corporations for each of the three years 1931-1933, inclusive, we find that they reported an aggregate net deficit for this three-year period, after taxes, of $6.6 billions. We also find, however, that this aggregate net deficit was arrived at after deducting some $11.2 billions for depreciation, some $761 millions for depletion, some $3.7 billions for bad debts, and some $5.1 billions for loss on the sale of capital assets; deductions which, in the main, did not represent current cash outlays making for employment, dividends, etc. In other words, the aggregate net income of corporations before these valuation deductions, in the worst depression in history, was a little more than $14 billions, and their cash dividends a little more than $13 billions. For corporations as a whole, dividends, wages, and other payments, came out of current receipts, primarily, and not from accumulated liquid surpluses. The book surpluses of corporations were, indeed, reduced; but they were reduced in the aggregate, not by actual cash disbursements, but by the writing down of assets on the books of corporations.

It may well be objected that these figures may be deceptive because they include financial as well as nonfinancial corporations. But the figures for nonfinancial corporations alone, which include all of our manufacturing, mining, merchandising, and similar business corporations, tell the same story. Nonfinancial corporations reported a net aggregate deficit after taxes for the three years 1931-1933, inclusive, of $3.9 billions. Their net income before valuation deductions, however, amounted to $11.1 billions, and the dividends paid, to $10.6 billions. It is obvious that the previously accumulated surpluses of nonfinancial corporations, while reduced by valuation deductions, did not represent liquid resources that were drawn upon, in the aggregate, to pay wages or dividends.

Even if we confine our attention to deficit nonfinancial corporations, that is, nonfinancial corporations reporting no statutory net income, we find that valuation deductions, rather than cash operating losses, accounted for the largest part of their aggregate net losses during the depression. During the three years 1931-1933, inclusive, the aggregate net losses after taxes of those nonfinancial corporations that reported no net income amounted to $12.1 billions; but $9.5 billions of this aggregate, or 78 percent, represented valuation deductions, primarily, rather than cash operating disbursements in excess of cash receipts. It should be borne in mind, moreover, that a corporation is included in the deficit group only in those years in which it reports no net income; so that the figures just cited <u>include</u> the losses of all corporations during their worst years of the depression, <u>and do not include</u> their net income, if any, in other years of the depression.

The figures cited above were obtained from the income-tax returns actually filed by corporations with the Bureau of Internal Revenue. It should be pointed out that there were other reductions in the book "surplus" of corporations besides losses allowed for income-tax purposes, and some of these represented cash outlays. It should also be made clear that the figures presented for all corporations, for all nonfinancial corporations, and for deficit nonfinancial corporations only, are aggregate figures, and are subject to the limitations of all aggregate and composite data. They are not necessarily representative of the experience or practices of any particular corporation. It is also true that in many cases corporations employed a portion of the receipts charged off as valuation items for necessary replacements of plant and machinery. Finally, it should be observed that most corporations are permitted to exercise a liberal range of discretion in the valuation of their assets on their own books and for their own purposes. Many of them revalue their assets upward during periods of prosperity, thereby creating direct additions to their surplus accounts, independently of their current income. Similarly, in periods of depression, many corporations make large write-downs in the valuation of their assets on their own books and they make corresponding reductions in their book surplus accounts.

Although the accounting methods of corporations vary considerably, such variations do not affect the income and deficit figures presented above, because the regulations of the Bureau of Internal Revenue, as well as the statutes, lay down substantially uniform rules for the determination of taxable income. Only a limited use can be made of the balance sheet data submitted with corporation income-tax returns because, in contrast to the uniform rules for the determination of taxable income, the Bureau has not prescribed detailed regulations for balance sheet data. It should also be said that our Statistics of Income are not strictly comparable from year to year, because of changes in law, in affiliations for consolidated returns, and other factors.

Nevertheless, these limitations of the data obtained from corporation income-tax returns do not impair the general conclusions drawn above respecting the character of corporation deficits during the depression and the uses made, such as they were, of the accumulated corporate surpluses. It must be emphasized that reductions in book surpluses arising in the fashion just outlined do not represent funds paid out to employ labor, to purchase materials, or to pay interest or dividends.

In general, then, the figures reported to the Bureau of Internal Revenue clearly indicate, first, that for corporations as a whole, valuation deductions greatly exceeded the aggregate net losses reported during the depression; second, that valuation deductions, rather than net cash outlays, account for the largest part of the losses reported even by deficit nonfinancial corporations; and, third, that corporate surpluses in the aggregate have not been drawn down in fact to maintain employment, dividend payments, and other disbursements during the depression.

It is no doubt true, however, that the existence of corporate surpluses facilitated or made legally possible the continuance of dividend payments in excess of current net earnings in many instances during the depression; and it is probable that one effect of the undistributed profits tax will be to make dividend payments less regular and less uninterrupted than they have been. Even this consideration, though meriting some weight, may easily be given exaggerated importance. For one thing, many corporations during the depression deliberately devalued the book or par value of their capital stocks in order to create or increase their book surpluses for the precise purpose of continuing dividends. Moreover, the $13 billions of dividend payments made by all reporting American corporations during the three years 1931-1933, inclusive, included a very large volume of dividends on cumulative preferred stocks and dividends on stocks of companies in relatively stable lines of business, such as operating electric light and power companies. The general run of industrial and mercantile corporations eliminated or severely contracted their dividend disbursements, particularly on common stock, regardless of the size of their book surpluses.

It is doubtless true that the previously accumulated real capital of the country, consisting of buildings, machinery, etc., enabled us to operate during the depression without full current maintenance thereof. This was true, however, regardless of the form in which ownership of this capital was held -- whether in the form of corporate debt instruments, common and preferred stocks, corporate surpluses, or individual ownership. But the bookkeeping recognition of unreplaced wear and tear, and of declines in values arising out of other causes, created no employment. To hold that such write-downs in value provided contributions by business to emergency relief would also require us to assert that the holders of stocks and bonds listed on the New York Stock Exchange contributed $86 billions of emergency relief between September 1929 and April 1933, this figure being the aggregate decline in the market value of their securities.

The record with respect to employment and payrolls is even less favorable than with respect to dividends. The Federal Reserve Board index of manufacturing output declined by 47 percent between 1929 and 1932; the decline in the index of factory employment was 37 percent; and the decline in the index of factory payrolls was 58 percent. Widespread part-time employment, such as in the steel industry, where workers were retained on the payrolls though given only a day or two of work a week, prevented the employment index from reflecting fully the actual decline in the real volume of employment, such as could be measured by the number of man-hours worked. The index of factory payrolls not only declined much farther than the index of factory production — 58 percent versus 47 percent — but it also dropped far more than the Bureau of Labor Statistics index of cost of living, which declined by only 21 percent, and the Bureau of Labor Statistics index of wholesale prices, which declined by only 32 percent in this period. These figures provide no supporting evidence whatever for the contention that the losses of corporations during the depression can be attributed in any substantial degree to the maintenance of employment or payrolls at levels higher than those justified by the reduced volume of business.

The fact of the matter is that, in general, though with widespread exceptions which, however, are unimportant in the aggregate, corporations cannot be expected, regardless of their book surpluses or even of their total liquid resources, to retain more workers nor to maintain larger aggregate payrolls than the minima required to maintain their plants and to conduct current operations. Depreciation of plant and equipment takes place irrespective of the volume of business done, very largely, and any current operations that yield more than their out-of-pocket costs reduce the aggregate net loss of a corporation. Hence, corporations find it profitable to continue operations and to retain the workers needed therefor even though after valuation deductions, a loss is recorded. The retention of portions of a working force under these conditions is no evidence of philanthropic activity on the part of corporations; and is altogether unrelated to the size of the book surplus account.

Small Corporations

5. <u>The contention that the tax will prevent small corporations from growing into big ones and will therefore operate to protect established corporate enterprises with accumulated surpluses from new competition;</u>

This contention hardly merits formal analysis, but it represents a fairly widespread misconception.

It may be observed, first, that the Revenue Act of 1936 accorded preferential treatment to small corporations in two ways. First, it provided for lower normal taxes; and, second, it limited to 7 percent the surtax applicable to the first $5,000 of undistributed net income of those corporations that report adjusted net incomes up to $50,000. In consequence, a corporation with net income of $20,000, for example, could retain $5,000 of its earnings undistributed and still be liable to total normal and surtaxes some $160 less than the normal tax liability alone on the same income for the taxable year 1935.

The change in base between the present normal corporation income tax and the corporation privilege tax recommended in an accompanying memorandum, and the corresponding change in the base and manner of application of the undistributed profits tax proposed elsewhere in this memorandum, make impossible an exact comparison of the total burden of Federal corporation taxation to which small corporations would be subjected under the terms of our proposals, taken as a whole, as compared with either the present law or the Revenue Act of 1935. It is clear, however, that our proposals would retain a very substantial tax advantage for the small corporation. In the first place, the privilege tax proposed to be substituted for the normal corporation income tax is itself graduated. Furthermore, it is proposed in another section of this memorandum that the specific credit of $5,000 allowed in Section 14 (c) of the present law be retained and extended in its application to corporations with adjusted net income of up to $100,000, and that the rate of tax applicable to the portion of adjusted net income falling within the specific credit be reduced from 7 percent to 3 percent. The effect of these changes will be to reduce the total amount of undistributed profits tax paid by the great majority of small corporations.

But the capital funds available for profitable corporations, whether large or small, are not limited to the amounts that they can save directly from earnings. In the case of small corporations with a limited number of stockholders, it is almost as easy to pay out earnings in dividends and have all or a part of them resubscribed by the stockholders for additional shares of the corporation's stock, as to reinvest them directly. Which method shall be followed is merely a matter of convenience and tax economy. Under the previous system of income taxation, these considerations tended to favor the process of direct reinvestment, and hence a body of examples taken from the growth of corporations over the period during which the previous system operated will naturally show that numerous small corporations grew into large ones by this method. The method of resubscribing dividends, however, would be equally effective, except for that part of the dividends which is absorbed by the shareholders' individual income taxes.

We have already observed that small corporations are given preferential treatment in the Revenue Act of 1936, and will continue to be given preferential treatment under our present proposals, with respect to both the normal (or privilege) tax and the surtax on undistributed earnings. They also enjoy two advantages in the process of growing through resubscribed earnings. In the first place, the very compactness of most small corporations permits this process to be carried on with a directness and informality which is impossible for the larger corporations. The whole operation of declaring out the year's profits as dividends and resubscribing all or a portion of such dividends for additional shares of the corporation's stock, either pro rata or in such proportions as might be mutually agreeable to the shareholders, can be completed in the course of a short stockholders' meeting.

The other advantage which, generally speaking, small corporations have over large ones arises out of the relatively larger proportion of dividend receipts that their stockholders would have available, after payment of individual income taxes thereon, for subscription to additional securities, as compared with the important stockholders in larger corporations. It is generally true that the principal stockholders of small corporations are individuals of much smaller incomes than the principal stockholders of large, prosperous and well-established corporations. To the extent that both large and small corporations look to the dividends paid to their stockholders as sources of additional capital funds for expansion, debt retirement, and the like, small corporations are in a relatively better position, by reason of our steeply graduated individual income taxes. Dividends which go to individuals reporting surtax net incomes between $10,000 and $12,000 are subject under present law to individual income taxes aggregating only 11 percent; whereas dividends received by individuals reporting surtax net incomes between $100,000 and $150,000 are subject to income taxes aggregating 62 percent.

The considerations presented above apply with full force to corporations with a body of stockholders small or compact enough to act with an easy informality or a realization of their community of interest. Such corporations constitute the vast majority of all corporations — not merely in the small, but even in the medium-size income brackets. Attention has already been called, however, to the fact that not all of these considerations are equally applicable to medium-size corporations which have a relatively large number of stockholders, and, consequently, are unable to arrange for the reinvestment of corporate earnings through the medium of subscriptions to new corporate securities with the same ease. This type of corporation undoubtedly constitutes the most serious problem in the application of the undistributed profits tax. It is believed, however, that these problems can be solved through the media of taxable stock dividends and coercive or semi-coercive preferential subscription rights, as previously discussed. In the individual cases where the demand of the stockholders for a cash distribution renders the application of these means for the reinvestment of earnings impracticable, a grave question ought to be raised — to say the least — whether the corporation managements are justified in endeavoring to reinvest earnings in defiance of such demand.

Miscellaneous
Objections

6. <u>Miscellaneous objections</u>:

In addition to the five primary objections to undistributed profits taxation just reviewed, a number of miscellaneous objections have been made. The more important of these are treated below:

(a) <u>The danger of capitalizing all corporate expansion</u>

Expansion through the sale of additional securities, it is contended, leads to constantly increasing capitalization in good years, with the result that such losses as are suffered during bad years involve capital deficits. If a surplus account is built up during good years, such losses and, in addition, investments for expansion which has proved unwise, can be written off against that account without difficulty; but to write down capital, it is argued, is a more serious matter.

If the prevailing practice among American corporations were to maintain a consistent relationship between the carrying or par value of capital stock and the stockholders' investment, such value would have a definite and consistent meaning, though not one of primary significance. In actual practice, however, except for corporations under public regulation, there is no necessary or uniform relationship between the amount of the stockholders' investment and the par or carrying value of the capital stocks. Most corporations today are born with a surplus which is created at the outset by giving a smaller carrying or par value to the capital stock than the value of the assets presumably invested by the stockholders. Nearly every day one or more corporations is increasing its surplus account by reducing the par or carrying value of its common stock, or is reducing its surplus account by dividends payable in capital stock.

Whether expansion is financed directly from earnings or is financed by the sale of additional securities to stockholders, the corporation is, clearly, employing new capital funds -- and new capital funds provided by the stockholders. If the corporation does not desire to reflect the new capital funds in its formal capitalization, it is able in the one case, scarcely less than in the other, to reflect the additional capital funds by additions to its surplus account rather than by additions to the aggregate formal par or carrying value of its capital stock. It may reduce the latter virtually at will, with no perceptible effect upon the market value of its securities or upon its credit standing. A corporation which sold to its stockholders at $50 per share 100,000 shares of additional stock of $5 par or carrying value, would increase its surplus account by $4,500,000, and its capital stock account by only $500,000. It could then write off losses against this surplus account in the same way as against an earned surplus.

It is no doubt true that stockholders are apt to be somewhat more exacting with respect to the uses of the capital funds that they formally contribute than they are of capital funds which they contribute in no less degree, though less formally, through the direct corporate retention of earnings. Hence, an unwise use by corporate managements of funds contributed through the former, as contrasted with the latter, method may involve greater embarrassment for corporate managements at stockholders' meetings. But it does not appear that any sound public purpose is served by disguising instances of unwise use of stockholders' capital. Such losses may be reflected either by a charge to the surplus account created in the manner previously mentioned, or by a reduction in the carrying or par value of the capital stock, or even by an unvarnished deficit account, without important effect upon the credit of the corporation or upon the market values of its securities. The United States Rubber Company, with a balance sheet deficit of $17.3 millions on December 31, 1936, found on the same day its 5 percent bonds selling at 107, its non-dividend paying preferred stock selling at 97-1/2, and its common stock selling at 47-3/4.

(b) <u>The tax penalizes corporations with impaired capital</u>

This objection takes two forms: First, that a corporation with impaired capital is in no position to pay dividends until its capital is replenished; and, second, that many State laws prohibit the payment of dividends where such payment would impair or add to a previous impairment of a corporation's capital, and hence, a corporation is subjected to a tax penalty if it obeys the applicable State law.

The first objection rests on merely formal grounds. Virtually all corporations that have balance sheet deficits are in a position to eliminate them by minor recapitalization, such as a reduction in the nominal or par value of the capital stock. To allow such corporations to retain earnings free from surtax until accumulated deficits have been removed by reinvestment of earnings would be to introduce tax discrimination in favor of a particular category of corporation losses, and moreover, of a category resulting from accidents of bookkeeping policies.

Furthermore, any attempt to make the exemption rest upon a balance sheet deficit, which can be created by bookkeeping just as easily as a balance sheet surplus, would encourage evasion. A corporation can easily eliminate a balance sheet surplus by the declaration of a stock dividend; and it can create a balance sheet deficit by a downward revaluation of plants and equipment. The legal and administrative difficulties that have arisen in connection with the determination of taxable income should certainly discourage the proposal of a revenue provision which would entail equally difficult problems in the valuation of corporate assets and liabilities. The United States Rubber Company, previously cited as a corporation with a large balance sheet deficit, had net profits of $6.5 millions in 1935 and more than $10 millions in 1936, and wound up the latter year with net working capital of $57 millions.

The second form of the objection is that in many States dividends may not legally be declared if capital stock or capital would be impaired. This is the rule in about 35 States. This, also, in the vast majority of cases, presents only a formal difficulty, because most of these deficits could presumably be eliminated by reductions in the par or nominal values of the capital stock. Further, the Federal Government would be setting a precedent of extremely dubious merit if it permitted an important part of its tax structure, which was adopted for reasons of equity and other considerations of public policy, to be distorted by exemptions or special treatments in recognition of greatly varying formal restrictions obtaining in the different States. To do so would also involve the practical difficulty of a serious loss of revenue and of possible competition by the States to enact laws which would provide the maximum relief from the Federal surtax.

Most industrial and mercantile corporations are free to obtain their charters from the State offering the greatest tax economy, freedom from restrictions, or other inducements. To recognize the State law as controlling in this connection would be to introduce another element into the prevailing competition among a number of States for charter-granting. It would appear to be sounder policy to allow the State laws to accomodate themselves to the new Federal statute or to allow corporations to make the necessary adjustments in their capital structures or in their place of incorporation.

(c) Capital gains and losses and net loss carry-over

Under the present law, capital losses suffered by corporations are permitted to be offset against capital gains enjoyed in the same year, but may be offset against other income to the extent of $2,000 only. No carry-over of net losses from one year to another is permitted either for net capital losses or for operating losses. These provisions apply equally for the normal corporation income tax and for the undistributed profits tax. Waiving any discussion of the propriety of these provisions with respect to either the present normal corporation income tax or the proposed privilege tax, it is urged that they present a peculiar hardship with respect to the undistributed profits tax. It is believed that this objection to the undistributed profits tax has greater merit than any other now currently urged. In the recommendations presented elsewhere in this memorandum, it is, therefore, proposed that a two-year carry-over for all types of losses be permitted for the purpose of the undistributed profits tax only, capital net losses being permitted to be offset against operating profits and vice versa.

The disallowance of capital losses as deductions from income other than that realized from capital gains in the same year (except for $2,000) has never been seriously defended upon the basis of equity, but was inserted in the law with respect to the individual and normal corporation income taxes as a matter of revenue expediency only. This limitation, when extended to the undistributed profits tax, has a particularly harsh impact, since the disallowance of capital losses for the purpose of the undistributed profits tax tends to dissipate corporate capital resources. Corporations suffering net capital losses are, in effect, required to pay an undistributed profits tax, in order to maintain their capital intact, whereas such a tax is normally contemplated only when a corporation seeks to increase its capital through the reinvestment of earnings.

The same type of situation is presented when corporations with widely fluctuating returns, which have just suffered heavy net losses, are, nevertheless, subjected to a large undistributed profits tax liability, unless they pay out practically their full net earnings during subsequent good years. The retention of earnings in such cases often represents merely a desire to maintain corporate capital intact rather than a desire to expand; and so, ex hypothesi should not be subjected to undistributed profits taxation. The provision proposed would avert both types of injustice, within the limit of time provided by the net loss carry-over.

(d) <u>Timing of dividend disbursements</u>

It is contended that the requirement that current earnings be distributed within the taxable year in order to qualify for a dividend-paid credit is unduly stringent for virtually all corporations, and is especially severe upon certain types of industries and enterprises.

For corporations generally, it is held, the amount of corporate earnings cannot be closely estimated until some time after the end of the taxable year. In consequence, corporations are forced to determine dividend policies upon the basis of incomplete information. In some cases, this leads to a greater distribution of earnings than would have been made had the year-end results been accurately available; and in other cases, it may lead to a greater surtax liability than the corporation would have chosen to incur. It has therefore been proposed that corporations be allowed a dividend-paid credit against the adjusted net income of any taxable year for distributions made in the first sixty days following the end of that taxable year.

The decisive consideration that presumably dissuaded the House Ways and Means Committee and the Senate Finance Committee from recommending such a provision was the large and permanent loss in revenue that it would entail. It would have meant that corporations could avoid 1936 surtax liability by distributing earnings in the first two months of the calendar year 1937 without making their shareholders subject to individual income taxes on the dividends incorporating these 1936 corporate earnings until the latter half of the fiscal year 1938 and the first half of the fiscal year 1939. Similarly, in the taxable year 1937, corporations could withhold all or an extremely large portion of their earnings, and yet avoid surtax liability to the extent that these were disbursed in the first two months of 1938. And their shareholders, though receiving dividends representing 1937 corporate earnings, by reason of the receipt in the first two months of 1938, would not pay individual income taxes thereon until the latter half of the fiscal year 1939 and the first half of the fiscal year 1940, and so on.

It is apparent, therefore, that the Treasury could lose forever one full year's tax revenues on that proportion of the corporate earnings which avoided corporate surtaxes by reason of distribution in the forepart of the ensuing year and which avoided individual income taxes until the next following calendar year. The loss in revenues would not consist of regular annual recurring losses, but would be of the character of a capital loss — the loss would consist primarily of the first year's postponement of tax liability; but this loss would never be retrieved until the books were balanced on Judgment Day or the law altered. Such a provision would offer a very strong inducement to all corporations to concentrate a very large proportion of their dividend disbursements in the two months following the close of their taxable year.

A further disadvantage of such a provision would be the inducement offered to evasion of both the corporate and individual surtaxes by the use of a chain of holding companies. Company A received dividend income in 1936 which it distributes to Company B in February 1937, which Company B distributes to Company C in February 1938, which Company C distributes to Company D in February 1939, which Company D distributes to Company E in February 1940. In each of these cases the corporation has avoided surtax liability by full distribution of its income without making any shareholder subject to individual income tax liability. The principal deterrent under present law to the use of a device of this character for the substantial postponement, at least, of income tax liability, is the corporate normal tax applicable to 15 percent of dividends received by corporations. This tax amounts to something less than 2.25 percent of dividend income. An individual might find it more profitable to pay this tax ten times over on the same income during a series of years than to receive the income himself in a year when he was subject to high surtaxes. This deterrent factor would be much more important, however, should the proposed privilege tax be adopted with the provision that intercorporate receipts of dividends, as well as of interest, rents and royalties would be subject to the full force of the tax.

Although it is doubtless true that some risk of over- or under-estimating earnings is involved by the requirement that distributions must be made before the end of the taxable year to enjoy the dividends-paid credit, it must be remembered that more than eleven months of the taxable year elapse before a corporate management faces this problem of estimating, and that the twelfth month's business is already well in hand. Moreover it is recommended in this memorandum that the first bracket of 5 percent of adjusted net income remaining undistributed be taxed at the rate of only 3 percent. Finally, a dividends-paid credit is allowed for any dividends paid in excess of earnings during the two preceding taxable years.

A different but somewhat related objection to the required timing of dividend disbursements is made on behalf of corporations whose taxable incomes often consist in substantial measure of additions to their inventories of raw materials, as is frequently the case with leather and metal companies; or of additions to their holdings of promissory notes or instalment payment contracts, as is frequently the case with farm equipment companies, it being realized in these cases that the distribution of such earnings is impossible within a limited period without serious curtailment of their business.

As against this objection, however, it might be said that such corporations have the clear option of paying out their earnings in the form of additional securities -- securities that would represent the additions to their inventories in value and quantity, or the additions to their accounts and notes receivable. To grant a special exemption from the surtax for portions of corporate earnings used to increase inventories or holdings of receivables would not only invite widespread tax avoidance, but would also be exceedingly arbitrary and inequitable as between different enterprises engaged in the same or similar lines of business.

Deere and Company may show an increase of $12 millions in its holdings of farmers' promissory notes and this increase may represent virtually all of its earnings in a single good year. Another farm equipment manufacturer sells its farmers' paper to an instalment finance company and its earnings may therefore take the form of an equivalent increase in cash. Shall Deere and Company be accorded preferential tax treatment because it chooses to engage in the banking business as an adjunct of farm equipment manufacturing?

Kennecott Copper has a far smaller refining and fabricating capacity in relation to its copper output than has Anaconda Copper. In consequence, Anaconda must maintain far larger inventories of copper metal than Kennecott. Shall Anaconda be given preferential tax treatment because it chooses to integrate its operations more fully than does Kennecott?

In these and similar cases, earnings taking the form of increased inventories or increased portfolios of receivables may be distributed to stockholders in the form of securities without reducing the resources of the corporation available for maintained or increased operations.

Recommendations

IV. RECOMMENDATIONS

The fundamental principle of the undistributed profits tax is sound and should be retained. It will be necessary, however, to alter its manner of application considerably, in order to coordinate it with the corporation privilege tax proposed in an accompanying memorandum. It is believed that the adoption of the privilege tax and the method of coordinating it with the undistributed profits tax herein proposed will in themselves result in substantially increasing the equity of both types of corporation taxation. In addition, we are also recommending certain changes in the undistributed profits tax itself, designed to increase the effectiveness and diminish the hardships of this tax as such. These recommendations would stand in broad outline even should the imposition of the privilege tax and the proposed coordination of the undistributed profits tax therewith be abandoned.

1. Coordination with the Privilege Tax.

It is recommended that adjusted net income should be redefined to consist of privilege-tax net income less the privilege tax paid. Under such a definition, adjusted net income would be income before the deduction of interest, rents and royalties, as well as of dividends paid, and it is recommended that undistributed net income should consist of adjusted net income less all such payments. Credit would, of course, be allowed only for interest, rents and royalties actually paid during the taxable year; but, aside from this shift from an accrual to a cash basis with respect to these deductions, undistributed net income would be the same as at present defined. Adjusted net income, however, would be larger for all corporations having prior charges; and, therefore — assuming that the brackets and rates of tax remained unchanged -- the absolute amount of undistributed profits tax upon the retention of any given amount of income by any such corporation would be reduced and the reduction would be very substantial in the case of corporations having a large amount of prior charges.

The difference in the effect of the application of the undistributed profits tax upon the new base, as compared with the present base, in the case of a corporation with heavy prior charges can be illustrated by the following example:

	Corporation A	Corporation B
Net income after corporation privilege tax (or normal income tax), but before provision for interest, rents and royalties	$1,000,000	$1,000,000
Interest, rents and royalties	-	800,000
Income available for dividends	$1,000,000	$ 200,000
Dividends paid	800,000	-
Undistributed net income	$ 200,000	$ 200,000
Percent considered undistributed, present basis	20%	100%
Percent considered undistributed, proposed basis	20%	20%
Undistributed profits tax (present rates), present basis	$ 19,000	$ 41,000
Undistributed profits tax (present rates), proposed basis	$ 19,000	$ 19,000

Corporation A in the above example has no prior charges whatsoever, while Corporation B has prior charges so heavy that it earned them only 1.25 times during the year in question. The example is meant to be extreme, but is by no means unrepresentative. Corporation B may be "debt-ridden", but it has a great deal of company. Time was when a railroad or public utility bond earning its charges 1.5 times was considered of good quality. The Northern Pacific Railroad Company earned its fixed charges 1.13 times during 1936, and its 4-1/2 percent bonds sold at 105 on the last day of that year.

It will be noted that both Corporation A and Corporation B had identical amounts of net earnings available for the persons equitably entitled to participate therein, irrespective of the technical form of instrument by which this right of participation was evidenced; and, consequently, had the same privilege tax net income and paid the same privilege tax. In both cases also, the amount disbursed to such equitable owners was the same and the amount remaining undistributed was the same. In each case, $1,000,000 of potential individual income was created through the activities of the corporation, and $800,000 was sent on its way to the individual income tax mill, while $200,000 was retained — perhaps as seed corn -- but, in any event, was not available for processing under the individual income tax.

It would appear, therefore, that the two corporations ought to receive the same treatment with respect to the undistributed profits tax. The only argument advanced to the contrary is that the corporation is already under compulsion to disburse its interest, rents and royalties, while dividend disbursements are voluntary; and, therefore, pressure need be applied to that income segment alone. Assuming, however, that it is the fact of distribution which is important, it would seem an inadequate concept of the nature and purpose of the undistributed profits tax to deny credit to a corporation for disbursements made under contractual coercion (originally self-imposed, in most cases), while allowing credit only for disbursements made voluntarily or under governmental coercion.

The proposed manner of coordination of the undistributed profits tax with the corporation privilege tax would be fair and equitable for the reasons just stated, even if (a) the income of every corporation could be determined with accuracy, (b) such incomes were sufficiently constant so that corporations with heavy prior charges could count upon earning such charges in future years with confidence, and (c) interest, rents and royalties had always been included in the base for the corporation privilege (or normal) tax, and so presented no transitional problem. None of these hypotheses is true, however, and the untruth of each constitutes an important collateral argument for the adoption of the plan of coordination herein proposed.

(a) All corporation income is subject to a considerable margin of error of estimate. The situation of most corporations in this respect is greatly dissimilar from that of most individuals, who report their incomes on a cash basis. Most corporations, on the other hand, report their incomes upon an accrual basis, many of the accruals being estimates subject to a large margin of error and with many years to run before any final check can be made upon their accuracy. Taxable net income, in particular, may vary rather widely from true economic net income, not merely because of the difficulty inherent in the determination of true economic income in any event, but because the rigid application of uniform rules and definitions necessary in the computation of income for tax purposes makes difficult or impossible proper allowance for bona fide variations in conditions between industries, localities, and individual firms. A more important source of error in the determination of taxable income is that each taxpayer is attempting to report as little income as possible and the Government, which is well aware of this, has leaned the other way in the formulation of its own rules and regulations. Statutory income, therefore, as contrasted with economic income, is determined, not by a painstaking search for truth, but by a competitive tug of war in which sometimes the taxpayer and sometimes the Government gets the better of it.

The base to which the margin of error of estimate should properly be applied is net income available to all of the equitable owners of a corporation rather than that available to the stockholders only. To revert to our example, the margin of error of estimate expressed in dollars is the same for both Corporation A and Corporation B, other things being equal. It is the million dollar figure in both cases which is subject to error of estimate — the $800,000 of prior charges of Corporation B are no guess, but a hard fact. If true income in each case should be 10 percent less than the million dollar estimate, it would result in a diminution of only the same percentage in the income available for the stockholders of Corporation A, but would result in a decrease of 50 percent in the amount available for the stockholders of Corporation B. Since the scale of graduation hereinafter proposed for the undistributed profits tax is based more upon the margin of error of estimate in net income than upon any other single factor, it seems only reasonable that it be applied to the same base as that to which the error applies.

The matter of margin of error of estimate is of far greater importance for the undistributed profits tax than for the normal or privilege taxes. If income is overestimated for the purpose of the normal tax, it merely results in the individual concern paying a higher rate of tax upon its real economic income than that overtly stated in the law. If all incomes are equally overstated for the purpose of this tax, there is no injustice at all.

and such injustice as there is in actual practice comes only from different degrees of over- or underestimation of income. The case is entirely different with respect to the undistributed profits tax, however, for here a general overestimation of economic income and the consequent distribution of larger amounts than really earned will cause a general dissipation of capital, and the overestimation of the income of a particular firm will, in most cases, result in a dissipation of its capital.

(b) The distribution of a given proportion of its total income available for all classes of participants places a greater strain upon a corporation with a large amount of prior charges than it does upon a corporation with a small amount of such charges, or none at all. Referring again to our example, Corporation A can pay out all or substantially all of its million dollar earnings to its stockholders with a light heart, since it knows that if it earns nothing next year it is under no obligation to make any payments to its security holders; and even should it suffer a loss, its sound capital structure will always enable it to raise additional funds. Corporation B, on the other hand, if it pays out in dividends any of the $200,000 it has earned for its stockholders, must do so with trepidation, since it knows not only that next year there will recur another $800,000 in charges which it must meet — income or no income — or else be taken over by its creditors; but also that its top-heavy capital structure will make it difficult to raise additional funds. It is true that Corporation B's present capital structure may not be involuntary, but rather the result of the eagerness of its owners to trade on their equity to the maximum extent possible; and, consequently, it is entitled to no tax favoritism. Nevertheless, its plea for equal consideration with Corporation A for having passed on $800,000 of its million dollars of income toward the tax mill ought to receive our respectful attention.

(c) The change in the base of the normal or privilege tax from income available to stockholders only, to income available to all persons entitled equitably to participate in the earnings of the corporation, while eminently fair from the longer-term point of view, places a heavy transitional strain upon corporations with substantial amounts of prior charges. Referring again to our example, if we suppose that a 15 percent "normal" corporation income tax is replaced by an 8 percent "privilege" tax, the tax upon Corporation A would be reduced from about $177,000 to about $87,000, while the tax upon Corporation B would be increased from about $35,000 to about $87,000, the new tax being the same upon both corporations. These figures, of course, include only the "normal" or "privilege" taxes. This heavy transitional strain placed upon corporations with substantial amounts of prior charges makes it particularly urgent that these corporations receive their full measure of equity in the coordination of the undistributed profits tax with the new privilege tax.

2. Rate Schedule

The proposed schedule of surtax rates applicable to stated percentages of adjusted net income remaining undistributed is presented and compared with the present schedule in the following table:

Present Schedule

Percent undistributed	Percent tax
0 to 10	7
10 + to 20	12
20 + to 40	17
40 + to 60	22
60 + to 100	27

Proposed Schedule

Percent undistributed	Percent tax
0 to 5	3
5 + to 15	15
15 + to 50	40
50 + to 100	60

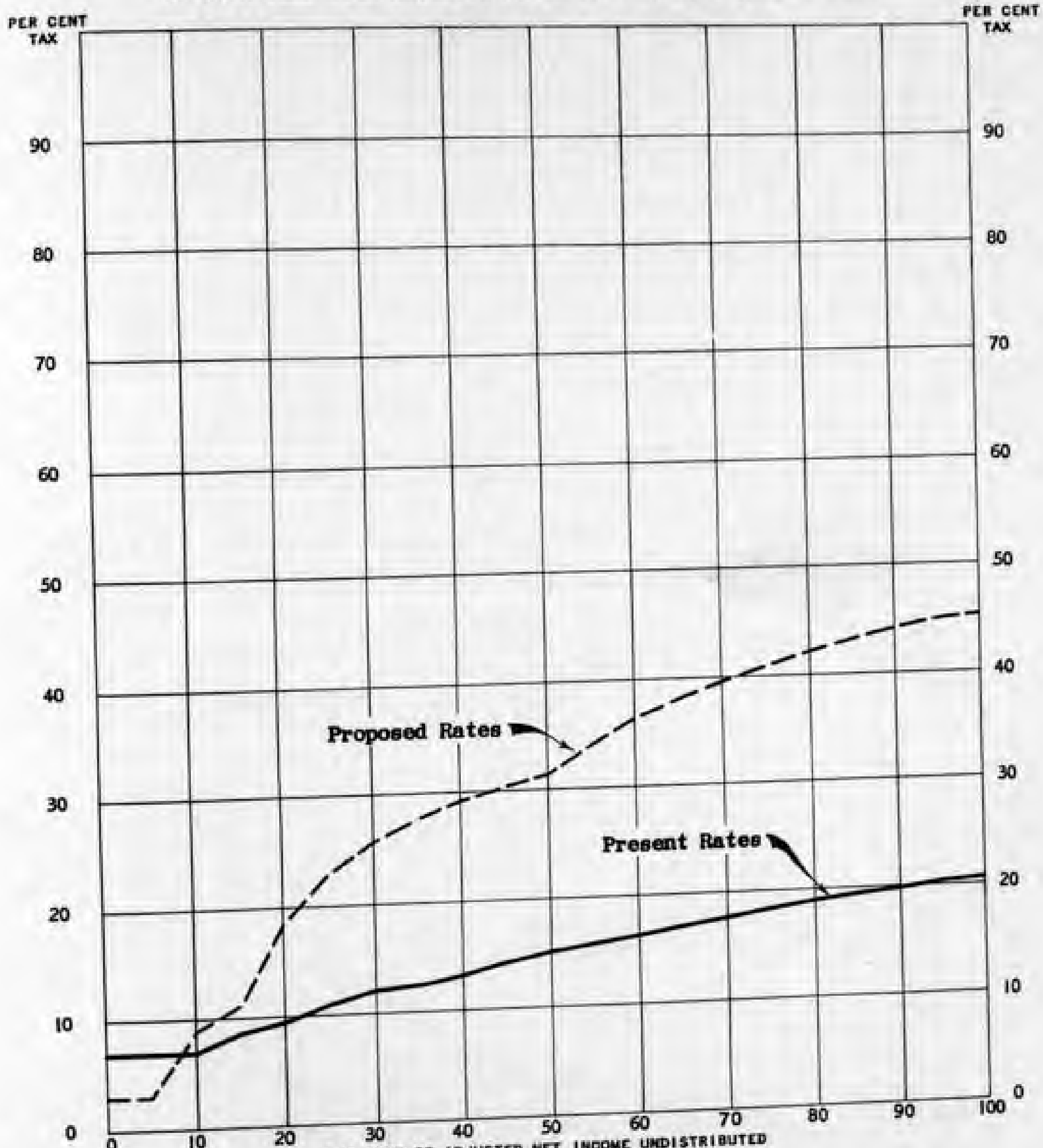
The following table and the accompanying chart compare the relative severity of these two schedules in terms of effective totality rates:

Percent undistributed	Effective totality rate, percent	
	Present 1/	Proposed 2/
10	7.0	9.0
20	9.5	18.3
30	12.0	25.5
40	13.3	29.1
50	15.0	31.3
60	16.2	36.1
70	17.7	39.5
80	18.9	42.1
90	19.8	44.1
100	20.5	45.7

1/ Applies to corporations with adjusted net incomes over $50,000.
2/ Applies to corporations with adjusted net incomes over $100,000.

EFFECTIVE TOTALITY RATES FOR SELECTED PERCENTAGES OF UNDISTRIBUTED NET INCOME

Corporations with Adjusted Net Incomes of $100,000 or More



NOTE:- THE TOTALITY RATES ARE NOT DIRECTLY COMPARABLE SINCE THE PROPOSED SYSTEM WOULD INCLUDE IN "ADJUSTED NET INCOME" ALL PAYMENTS OF INTEREST, RENTS, AND ROYALTIES, AND WOULD GRANT CREDIT FOR SUCH PAYMENTS IN DETERMINING THE PERCENTAGE OF ADJUSTED NET INCOME REMAINING UNDISTRIBUTED.

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Office of the Secretary of the Treasury
Division of Research and Statistics

It should, of course, be noted that the comparison made by the tables and the chart is formal only; and they must be used with extreme caution in comparing the effective rates of the present and proposed schedules, since, as discussed at some length in the preceding section, the base and manner of application of the proposed schedule are very different from those used in the present law. In general, the proposed rates are much less severe, in comparison with the present ones, for corporations with prior charges than would appear from the tables, — and the greater the amount of prior charges, the greater is the disparity between the real and apparent severity of the two schedules.

The proposed schedule has been framed with the following three fundamental factors in mind:

(a) The rate in the first bracket has been set at only 3 percent. It is believed, particularly in view of the margin of error of estimate applicable to all income figures, that corporation managements should be allowed to retain a moderate proportion of adjusted net income if they feel that this is necessary to maintain their capital intact over a period of years. This allowance is also of some assistance in lessening such hardship as is incident to the requirement that dividends be paid in the same taxable year in which earned — a requirement which is believed necessary on other grounds. In general, the removal of a small segment of adjusted net income from the impact of the tax may properly be compared with the removal of a small amount of water from a tank under high pressure — the reduction in pressure is far more than proportional to the amount of fluid removed.

(b) It is felt that rates of intermediate severity are an evil which should be avoided as far as possible. Such rates — ranging perhaps from 10 percent to 30 percent -- may not be sufficiently high to induce distribution of earnings; yet, if paid by corporations, impose an inequitable burden upon stockholders in the lower individual income tax brackets. The tax of 15 percent actually proposed is, for example, higher than the individual income tax on all amounts of surtax net income of less than $16,000. While it is felt impracticable to eliminate such intermediate rates altogether, the proposed schedule confines itself to one such rate — 15 percent on amounts of earnings retained between 5 and 15 percent of adjusted net income.

(c) Over the remainder of the scale — constituting 85 percent of total adjusted net income — it is felt that the tax ought to be high enough to induce distribution of the amount of adjusted net income falling in such brackets in substantially all cases. The present rates of undistributed profits tax are quite inadequate to do this when earnings are withheld for tax purposes, as is clearly indicated by the comparison between the rates of the undistributed profits tax and the lower limits of surtax net income, upon which an equal or a higher rate of individual income tax (normal tax and surtax combined) would be levied than of undistributed profits tax shown in the following table:

Percent of adjusted net income undistributed	Rate of undistributed profits tax	Lower limit of surtax net income taxable at same or higher rate
0 to 10%	7%	$ 4,000
10 + to 20	12	12,000
20 + to 40	17	18,000
40 + to 60	22	26,000
60 + to 100	27	38,000

It is true that it is inaccurate to make a direct comparison between the rates of the undistributed profits tax and the rates of the individual income tax since, if income upon which an undistributed profits tax has been paid in one year is distributed in a subsequent year, it is subject to the full rates of the individual income tax, notwithstanding the prior payment of the undistributed profits tax. Since such a subsequent distribution is always possible, the payment of the undistributed profits tax never gives complete assurance that no further taxation will be exacted, whereas the payment of the individual income tax does — at least within the limits of the ability of any tax payment to give such assurance. To put it in another way, <u>money can always be transferred tax-free from the individual pocket to the corporate pocket, whereas the reverse is not true.</u>

It seems reasonable to infer, therefore, that a rate of undistributed profits tax substantially lower than that of the individual income tax to which a distribution would be subjected, will be sufficient to induce distribution, in so far as this is determined by tax considerations.

It is with this consideration in mind that it has been estimated that the top rate of 60 percent, applying to the bracket of between 50 and 100 percent of adjusted net income undistributed, will be sufficient to induce distribution even in closely held corporations. It should be noted, however, that for individuals in the highest individual income tax bracket — 79 percent — the net amount remaining after the payment of the individual income tax is only a little over half that remaining after paying an undistributed profits tax of 60 percent. It is therefore believed that a maximum bracket of 60 percent is necessary. The 40 percent bracket applying to amounts of adjusted net income between 15 and 50 percent ought, of course, to be sufficient to induce distribution in the vast majority of cases.

3. Small Corporations

It is not believed that the contention frequently made that the undistributed profits tax places small corporations at a disadvantage has merit, but the contrary is rather believed to be true. Nevertheless, in line with our consistent policy of granting preferential treatment to small corporations in any event, it is recommended that the specific credit provided in Section 14 (c) of the Act be continued at $5,000, that the rate of tax thereon be lowered from 7 percent to 3 percent to conform with the lower rate suggested for the first bracket of the regular tax, and that it be extended in its application to corporations with adjusted net incomes of up to $100,000 (rather than $50,000).

This extension is necessary principally in order to maintain the effect of the present specific credit, which is that the first bracket should in every case have a width of an absolute amount of $5,000, or of the whole adjusted net income if less than that amount. In view of the decrease in the percentage width of the first bracket from 10 percent to 5 percent, it is necessary to increase the application of the credit from $50,000 to $100,000 if this rule is to be maintained, and if the effect of the credit is to fade out gradually rather than ending abruptly. An additional reason for the upward extension of the application of the credit is the change in the base of adjusted net income, since a corporation with an adjusted net income of $100,000 on the new base might easily have an adjusted net income of $50,000 or less on the present base.

It is further recommended that whatever income remains undistributed beyond the amount included in the specific credit be taxed at the rates applicable if the specific credit had not been granted. At present the specific credit has the effect of taking income off the top bracket and transferring it to the first bracket. Under the proposed modification it would merely have the effect of transferring income to the first bracket from the immediately adjacent brackets.

4. Allowance of Net Capital Losses.

It is recommended that an unlimited offset of capital losses be permitted, for the purpose of the undistributed profits tax only, against other income.

5. Net Loss Carry-Over.

It is recommended that a two-year carry-over should be allowed for all losses (including capital losses as merged with other losses by the preceding recommendation) for the purpose of the undistributed profits tax.

> It is believed that recommendations 4 and 5 taken in conjunction will meet the legitimate complaint that it is often necessary for a corporation incurring substantial capital losses, or engaged in a fluctuating business, to pay an undistributed profits tax, in order to retain its capital intact; whereas, in the contemplation of the law, such a tax should be paid only when it is desired to increase the capital employed in a business by reinvestment of earnings free from the individual income tax. This complaint is directed primarily not against the undistributed profits tax itself, but rather against the underlying tax structure upon which it is superimposed; and, consequently, the principal discussion of the points involved is in the memoranda upon the corporation privilege and capital gains taxes. Nevertheless, it must be recognized that the impact of the

disallowance of net capital losses and of net loss carry-over is particularly harsh when applied to the undistributed profits tax. Consequently, if only a limited amount of relief is to be given in these respects, the undistributed profits tax should receive first consideration.

6. <u>Optional Settlement of Subsequently Found Deficiencies</u>.

It is recommended that if audit of a corporation return reveals that net income from a previous year should have been reported at a higher figure than that appearing upon the face of the return, and no question of bad faith is involved, the taxpayer should have the option of paying the undistributed profits tax liability thereby created, with interest, or of paying a special tax of 5 percent of the undistributed profits newly determined by the Commissioner, and adding the remainder of such newly determined profits to adjusted net income in the current year.

It often happens that the Commissioner finds that the net income reported upon the face of a return has been understated. While this may be due to bad faith on the part of the taxpayer, it is more often due to other causes, ranging from totally innocent bookkeeping errors or misunderstandings of the law, up to the taxpayer giving himself the advantage of the doubt on all possible issues, but falling short, nevertheless, of the legal concept of fraud or bad faith.

Such delays in the final determination of tax liability were relatively harmless prior to the introduction of the undistributed profits tax, since any additional amounts of tax which were found to be due would have had to be paid by the taxpayer in any event. In such a case it rendered substantial justice to both parties for the Commissioner to levy such additional tax with interest, the latter being at a sufficiently high rate both to compensate the Government for the delay in the collection of the tax and to discourage taxpayers from being overly generous to themselves in their interpretation of doubtful points of law or accounting. A totally new difficulty is introduced by the undistributed profits tax, however, since the corporation might have avoided the tax altogether by a timely distribution of earnings had it known that such a liability existed. To require the corporation to pay a back undistributed profits tax with interest because of subsequently determined net income would appear to be inequitable if the corporation had made its original return in good faith and had always stood ready to distribute all or a large portion of its adjusted net income. The inequity of such procedure, moreover, would be greatly increased by the application of the new surtax rates suggested in this memorandum.

7. Special Tax on Earnings Exempted from the Undistributed Profits Tax by Reason of Contracts Prohibiting the Payment of Dividends, Etc.

It is recommended that a tax of 10 percent be levied upon earnings exempted from the undistributed profits tax under Section 26 (c) of the Act, because of contracts prohibiting the payment of dividends, etc., and that such tax be levied in lieu of the lowest brackets of the undistributed profits tax in which the amounts so exempted would otherwise have fallen, provided that the total undistributed profits tax liability should never be increased by the operation of this provision.

The present relief granted by Section 26 (c) seems to be based upon the hypothesis that the undistributed profits tax is a penalty, and that, therefore, corporations which are unable to distribute their earnings and profits in taxable dividends, because of contractual restrictions, should not be penalized. This conception is incorrect. The tax on undistributed profits is not a penalty applied to a morally opprobrious act, but is a compensation to the Government for the non-taxation of the undistributed income under the individual income tax. If current income remains undistributed as a result of prior contractual obligations, it results in as much revenue loss to the Government as if it had remained undistributed as the result of a currently made decision of the Board of Directors of the corporation. It would appear, therefore, that if relief is to be extended to any special cases of this character the appropriate form thereof is not a complete exemption from the undistributed profits tax, but rather the substitution of a moderate flat rate of undistributed profits tax upon the relevant segment of income in lieu of the sharply graduated rates that would otherwise apply. This principle was recognized in the House Bill in which most of such "relief" provisions carried a 22½ percent flat tax (it should be noted in this connection that the House Bill did not provide for any normal tax).