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May 9, 1936.

SUGGESTED AMENDMENTS TO THE PROPOSED TAX ON UNDISTRIBUTED CORPORATE EARNINGS

In the President's message to the Congress on March 3, 1936, requesting increased taxation, three of the objectives laid down were (1) raising $620,000,000 additional revenue; (2) attaining equality of tax burden on all corporate income, whether distributed or withheld from the beneficial owners; and (3) simplifying tax procedure. A tax on the undistributed earnings of corporations was recommended.

In the form in which the proposals were passed by the House there is serious question whether these aims will be achieved. The following changes are suggested as a means of insuring that the objectives will actually be attained.

1. The retention of the corporation income tax. If sufficient additional revenue is to be raised, necessary exemptions made, and the form and administration of the proposed tax to be kept simple, it appears essential to retain the present corporation income tax.

The argument for repeal of this tax rests on two grounds, both of which may be questioned. In the first place, it is said that the present corporate income tax constitutes a deduction from the income of present stockholders, with no reference to ability to pay. This is true, however, only on the assumption that for all the people who have purchased stock since the corporation income tax was first enacted the tax has not been discounted in the purchase price. The invariable practice is to look upon the corporation income tax as an expense of production and to calculate earnings per share _after_ taxes. If the corporation income tax were raised

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100 percent this would be immediately discounted in the price of stocks, and hence the burden would fall on present holders. Future purchasers would buy stocks on the basis of expected earnings per share after the additional tax. Similarly, removal of the tax would constitute an unexpected gain for present holders of stocks. Per share earnings would be increased anywhere from 15 percent in the case of operating companies with no preferred stock outstanding to 100 percent or more in the case of holding companies that could benefit from the leverage factor.

In the second place, it is said that the corporation income tax imposes a burden on the corporate form of business as contrasted with partnerships and individuals. Available evidence indicates, however, that small corporations retain a substantial portion of earnings, on which no personal income taxes are paid, so that the relative tax burdens are to this extent equalized. Moreover, the corporate form of enterprise has certain concrete advantages over partnerships and individuals.

It would appear, therefore, that it is difficult to make a strong case for retention of the corporation income tax on the grounds that it involves injustice to present owners of corporations. Furthermore, there is no reason why an undistributed earnings tax cannot be levied as a supplement to the corporation income tax. There is no necessary connection between a tax on undistributed earnings and the corporate income tax which requires that one replace the other. They can be handled as separate matters. In fact there are decided advantages in handling them separately at the present time. The corporation income tax will apply to all

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corporations, including the great majority of corporations for whom an undistributed earnings tax is unnecessary, and the undistributed earnings tax can be levied on the small number of large corporations whose practice of accumulating earnings gives rise to most of the problems the new legislation is designed to meet.

One advantage of retaining the corporation income tax is that such a course would entail no risk of lessened revenue. Whatever additional amount an undistributed tax yielded either directly or indirectly by forcing higher dividends would be a net gain for the Treasury, as would be also the additional yield from the removal of the exemption of dividends from the normal tax. Another advantage would be that it would permit easier handling of the necessary and desirable exemptions discussed below, which would greatly simplify the tax on undistributed earnings.

The retention of the present corporation income tax need not entail abandoning the proposal to remove the exemption of dividends from the normal income tax. Corporation earnings have been increasing very rapidly and the bulk of the dividends go to well-to-do people. Moreover, a partial compensation will be afforded by the removal of the excess profits and capital stock taxes.

2. The exemption of earnings up to $15,000 from the undistributed earnings tax. In 1933 only 14,815 corporate returns out of 446,842 returns for active corporations reported net earnings of $15,000 and over, and this small group of returns accounted for over 90 percent of the net income for that year.

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Even in 1929 when corporations reported for income tax purposes the largest net incomes of the post-war period, only about 50,000 of the 456,000 reporting corporations would have been required to file returns for the proposed tax on undistributed earnings if there were an exemption of $15,000. This small group of corporations, furthermore, would have accounted for 94 percent of the corporate net income reported for that year. With the proposed exemption, therefore, the tax on undistributed earnings would not apply to the great bulk of corporations which account for a small percentage of total corporate earnings.

It is generally agreed that small corporations must depend for their growth mainly on ploughing back earnings. Unlike the large corporations, they have no access to the capital markets, and banks are naturally reluctant to extend capital loans. This fact was recognized by the Government when it provided special loaning facilities for smaller businesses. It was also recognized by the House when it provided that lower rate schedules should apply to the undistributed earnings of corporations with adjusted net incomes of less than $10,000. The House was unable to exempt them altogether because it proposed to repeal the corporate income tax. This would have meant that the owners of small corporations could escape Federal income taxation by leaving earnings undistributed. It will be seen, therefore, that a simple and equitable treatment of these corporations depends upon the retention of the corporate income tax. Under such an arrangement a tax of from 12½ to 15 percent will apply irrespective of whether

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earnings are withheld, or disbursed, and this will be a larger tax in most cases than the owners would pay under the House bill if all earnings were distributed.

This exemption would strengthen enormously the public appeal of the new proposals, since it would limit the opposition to a few thousand big corporations who could no longer use the argument that the proposed tax discriminates against small corporations.

The exemption of small corporations from the undistributed earnings tax, while leaving them subject to a well-understood corporate income tax, will be a major contribution toward the simplification of the Tax Bill. It will permit simplification of the undistributed earnings tax by substituting one rate schedule for two complicated schedules, each shown in the proposed law in two different ways, and a complicated method of using both sets of schedules in some instances. It will also permit the Treasury to concentrate its administrative staff on a relatively small number of returns, 15,000 or so during the next few years, instead of trying to examine several hundred thousand. It is, of course, true that this small group of corporations will include the most complicated corporate organizations of the country but this makes it all the more important that the Treasury use its already overburdened staff for truly effective administration of a new tax.

It has been suggested that an exemption of small corporations would permit wealthy individuals to continue to evade surtaxes by substituting a large number of small personal holding companies for existing large ones. This objection to the exemption could be met by provisions denying this

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exemption to personal holding companies as now defined by law, that is, to corporations 50 percent or more of whose stock is held by closely related individuals and 80 percent or more of whose gross income is derived from property, that is, dividends, interest, and profits from the sale of assets.

5. A low rate should apply to earnings withheld for debt retirement. Although the House recognized the necessity of special treatment for earnings devoted to debt retirement or withheld because of charter or statutory provisions prohibiting payment of dividends, a comparatively high rate of 22½ percent was applied to earnings devoted to such purposes. If the corporate income tax is retained, this special rate applying if corporations choose to withhold earnings for repayment or debt could be lowered to 8 percent. A rate of 8 percent would impose little burden on those corporations which for various reasons are forced to withhold earnings for the above purposes. It is high enough, however, to encourage the liquidation of debt through new stock issues in the cases where this is practicable.

It is not accurate to say that there is no difference between a flat 22½ percent rate on the one hand; and a corporate income tax rate of 15½ percent, and an additional rate of 8 percent on the other. In the former case a corporation which is legally prohibited from paying out earnings or has to devote them to debt retirement has to pay 22½ percent more than other corporations that can pay out all earnings. In the latter case it would only have to pay 8 percent more. The difference appears in a comparison with other corporations rather than in a comparison for a single corporation of payments before and after the proposed changes.

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In addition to requiring a rate high in comparison with that corporations with no debt would have to pay, the House Bill specifies that this rate apply to earnings withheld for certain types of debt only, and is limited to the excess of such debt over accumulated earnings. All debts outstanding on March 3, 1936, were incurred with the expectation that they could be retired out of earnings without penalty; it would appear equitable to make this provision apply to all debts outstanding on that date. There would appear to be no economic justification for limiting this provision to the excess of debts over accumulated earnings. The task of determining the amount of accumulated earnings is almost insuperable. In any case, furthermore, it is a bookkeeping item that has no reference to current or future ability to repay debt. Earnings accumulated in the past do not represent cash funds. They may very well have been invested in plant which is now worthless.

4. Higher tax rates than those adopted by the House. One of the most significant phenomena in connection with discussion of the House bill is the lack of intensive opposition by big corporations. The explanation can be found in the fact that the House bill proposes a relatively low scale of rates on undistributed earnings in place of the corporation income tax rates. It is widely appreciated that many corporations, particularly the large ones, can retain as large a proportion of their earnings as they have in the past and still pay no greater tax. From 1923 to 1929 non-financial corporations reporting net income retained about $25,000,000,000 of earnings. Their dividends aggregated 57 percent of their earnings available for dividends. Under the House schedules the tax on a corporation which pays out

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57 percent of its adjusted net income in dividends will amount only to 14½ percent of its adjusted net income. If corporations find it advantageous to retain as large a proportion of their earnings as they have in the past, four of the major objectives which the bill could achieve will be jeopardized. In the first place, wealthy individuals will still be enabled to avoid high surtax rates by leaving incomes undistributed with corporations. Secondly, the revenue yielded by the pooposed changes will be lessened. Thirdly, the growth of uneconomic bigness will not be discouraged and consequetly the trend toward lessened competition will not be impeded. Fourthly, the tax will fail to discourage the accumulation of cash on the part of large corporations, a practice which lessens the effectiveness of monetary control.

In order to attain the objectives of the tax it is imperative that higher rates be applied to undistributed earnings in excess of the specific exemption of $15,000 and the earnings used to meet contractual obligations or to repay debt. It is suggested that the scale of graduation be along the following lines:

Percent of earnings undistributed	Rate of tax on undistributed earnings
Not more than 50 percent	40 percent
More than 50 percent	60 percent

Two other suggestions are made in connection with applying these rates:

(1) It is suggested that, following British practice in levying estate taxes, the highest rate applicable shall apply to all the undistributed earnings. For example, if 55 percent of earnings are undistributed,

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the 60 percent tax would apply to all undistributed earnings rather than a rate of 40 percent on the first 50 percent undistributed and a rate of 60 percent only on the balance.

(2) It is also recommended that, in determining the percentage of undistributed earnings, preferred stock dividend requirements be excluded from dividend disbursements, that is, that dividend requirements for preferred stock be included as a deduction in computing adjusted net income and be excluded from the dividend credit.

While preferred stock is called _stock_, it resembles a junior debenture much more closely than it does an equity. With few exceptions, preferred stockholders do not share in increased earnings. Preferred stockholders, therefore, do not have income on which they can evade taxation by leaving it with corporations. Under the House bill, common stockholders may point to a 60 percent distribution of their corporation earnings when actually a much smaller percent of their earnings (i.e., net available for common) is distributed. This is particularly important at the present time when many corporations have cumulated preferred stock dividends to pay before payments can be made on common stock.

The Government should, of course, direct its tax toward the realities of the situation and not allow itself to be circumvented in its objectives by the legal usage which confers the name _stock_ on both preferred and common. In this particular case the reality of the situation is the evasion of taxation by _common_ stockholders. By determining the tax on the basis of

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earnings available for equity holders and undistributed to them, equality of treatment would be assured stockholders of corporations having preferred stock outstanding and those not having preferred stock outstanding.

This provision should apply only to non-participating preferred stock. Since it is proper to regard cumulative preferred stock as a junior debenture it would follow that arrears of dividends on preferred stock could be considered as a debt of the corporation, and be subject to the same treatment as other debts of the corporation. That is, earnings devoted to the payment of preferred stock dividend arrears should be subject to the 8 to 10 percent tax.

5. Suggested changes of a less important nature.

(1) It is recommended that the House provision be eliminated which permits a special low tax of 15 percent on the retention of current earnings which only serve to wipe out an accumulated deficit. This provision was apparently based on the theory that a corporation with an accumulated deficit is in a straitened condition and should be accorded special treatment. But a bookkeeping figure of accumulated earnings or deficit has little relation to the financial condition of a corporation, nor to its current or future earning capacity. The retention of the provision will permit widespread evasion because of the extreme difficulty of determining the figure of accumulated earnings.

(2) It is recommended that the provision in the House bill relating to dividends paid to holding companies be eliminated. As has been pointed out in the Press, this provision may result in a multiplication

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of holding companies, rather than a reduction, when the dividend receivers take steps to insure that less than 50 percent of the dividends be paid to a single company. In those cases where this cannot be done grave injustices will be suffered by existing holders of holding company stocks, which include not only holding companies but minority holders. It is one thing to seek to remedy the abuses connected with holding companies. It is another to wreak great hardship on existing stockholders by adopting unexpected provisions in a tax bill in which so much depends on the purely arbitrary percentages selected.

It is said that the purpose of this provision is to prevent evasion whereby a chain of holding companies would pay neither taxes to the Government nor dividends to individuals. This would result from the definition of the dividend year which would pernit the lower holding company to pay its dividend in the period January 1 - March 15 to the next holding company, which in turn may pay its dividend in the corresponding period of the next year to the next holding company, and so on. But in the bill as passed by the House this definition of the dividend year was finally amended to coincide with the taxable year for earnings. This particular explanation of the holding company provision becomes, therefore, irrelevant.

(3) It is also suggested that for the purpose of the undistributed earnings tax, dividends received by a corporation shall be included in income, as proposed in the House Bill, but that they be exempt from the

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corporate income tax to the extent provided by existing law.

(4) With the present corporation income tax retained, it is suggested that the special exemptions for certain classes of corporations, banks, insurance companies, and companies in receivership be handled mainly by exempting such corporations from the undistributed earnings tax. In the case of banks, however, it is suggested that the exemption of earnings from the undistributed earnings tax be permitted only so long as the unimpaired capital and surplus, as determined by the supervisory authorities, is less than 15% of deposits.

Conclusion. If these suggested changes are adopted, the objections to the new tax proposals will be greatly lessened and the purposes of the proposals more surely achieved. There will be more assurance that the wealthy will pay their share of income taxes than under the present proposals; there will be more assurance that money will actually be forced out of corporations, either in the form of debt repayment, or in dividends, or in taxes; and, finally, these suggested changes would make for a tax far less complex than that passed by the House, which could be more easily explained and defended.

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