

May 11, 1936.

*Revised copy
of memo left with you*

SUGGESTED AMENDMENTS TO THE PROPOSED TAX ON UNDISTRIBUTED CORPORATE EARNINGS

In the President's message to the Congress containing the suggestion of a tax on undistributed earnings three of the objectives laid down were the raising of \$620,000,000 additional revenue, attaining equality of tax burden on all corporate income, whether distributed or withheld from the beneficial owners, and effecting simplification in tax procedure. In the form in which the proposals were passed by the House there is serious question whether any of these aims will be achieved. The following changes are suggested for the purpose of attaining these objectives:

1. The retention of the corporation income tax. In order to be certain that revenue will be raised, after making necessary exemptions, and that the form and administration of the proposed tax will be kept simple, it appears essential to retain the present corporation income tax.

The argument for its removal rests on two grounds, both of which may be questioned. In the first place, it is said that the present corporate income tax is inconsistent with the principle that taxation should be in accordance with ability to pay because it taxes rich and poor stockholders alike. This statement disregards the fact that the great majority of stockholders, all those who have acquired the stock since the enactment of the corporate income tax, have purchased the stock at a price based on the prospects of dividends after the tax has been paid. 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 100 percent this would be

immediately discounted in the price of stocks, with a consequent loss for present holders. In the future, however, purchasers would buy stocks on the basis of expected earnings per share after the additional tax and would suffer no loss. Similarly, a removal of the tax, in the absence of other equivalent taxes imposed at the same time, would constitute an unexpected gain for present holders of stocks. In cases where the company would distribute its earnings and not pay the new tax on retained income, 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 corporations as contrasted with partnerships and individuals. This can be true only of small corporations because large ones certainly pay less tax than would individual recipients of similar income; and owners of stock in small corporations, under existing law, benefit by the fact that a portion of the earnings is retained in the business and, therefore, escapes the personal income tax which it would have to pay if it were received by the individuals. Moreover, the corporate form of enterprise has certain concrete advantages over partnerships and individuals.

It would appear, therefore, that the retention of the corporation income tax involves no injustice to present owners of corporations. There is no reason why adoption of the principle of taxing undistributed earnings should result in elimination of the present corporate income tax. There is no necessary connection between the two matters. In fact it is easier to achieve the desired objectives by retention of the corporate income tax. This tax could remain applicable to all corporations, including the small corporations which constitute the great majority and for which an undistributed earnings tax is unnecessary, while the undistributed earnings tax could 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 eliminate the risk of losing revenue. If the normal tax is retained, then any additional amount produced by the tax on undistributed earnings would be a net gain for the Treasury. This would be true, whether the earnings were distributed and became subject to personal income taxes or retained and subject to the new tax. Another advantage would be that it would permit the necessary and desirable exemptions discussed below. Still another advantage would be that it would permit the tax on undistributed earnings to be greatly simplified.

The proposal to remove the exemption of dividends from the normal income tax should be retained. Corporation earnings have been increasing

rapidly and the bulk of the dividends go to well-to-do people. A partial compensation for removing this exemption will be afforded by the removal of the excess profits and capital stock taxes.

2. The exemption of earnings of \$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, the latest for which figures are available.

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. They do not have the same access to the capital market as have corporations, and they have

difficulty in obtaining loans for capital purposes from banks. It is for these reasons that the Government provided special facilities for capital loans for small concerns, through the R. F. C. and the Federal Reserve banks. In the House bill the needs of small corporations are recognized by the provisions that lower rates should apply to the undistributed earnings of corporations with earnings of less than \$10,000. The House was unable to exempt them altogether since, with the proposed repeal of the corporate income tax, this would have meant that the owners of small corporations could escape all income taxation by leaving earnings undistributed. Retention of the corporate income tax makes it possible without revenue loss to exempt small businesses altogether from the new tax. Even if all earnings were retained by these corporations they would still pay a tax of from 12½ to 13 percent, which in most cases would be more than would be paid by the stockholders if the earnings were distributed.

This exemption would have a great public appeal. It would remove the opposition of nine-tenths of the corporations, and would make it necessary for the few thousand large corporations to show how taxing their undistributed earnings would be undesirable, rather than to plead the cause of the small corporations, as they have shrewdly done.

The exemption of small corporations from the undistributed earnings tax, while leaving them subject to a well-understood corporate income tax, would be a major contribution toward the simplification of the Tax Bill. It would 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 would also permit the Treasury to concentrate its administrative staff on a relatively small number of returns, instead of trying to examine several hundred thousand. It is true that this small group of large corporations includes the most complicated corporate organizations of the country but this makes it the more important for the Treasury to have the use of its entire available staff for the effective administration of the new tax on these complex companies.

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 could be met by provisions denying this exemption to such personal holding companies, 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, rents and royalties, and profits from the sale of assets.

5. Higher tax rates than those adopted by the House. When it comes to the tax on undistributed earnings the House bill proposes a relatively low scale of rates. Under the terms of the bill many corporations, particularly the large ones, could retain as large a proportion

of their earnings as they have in the past and still pay no larger tax. From 1923 to 1929 non-financial corporations reporting net income retained \$24,657,000,000 of earnings. Their dividends aggregated 57 percent of their earnings available for stockholders after taxes. Under the House schedules the tax on a corporation which pays out 57 percent of its adjusted net income in dividends will amount only to 14 $\frac{1}{2}$ percent of its adjusted net income. If corporations under the new tax will find it advantageous to retain as large a proportion of their earnings as they have in the past, the major objectives of the bill 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 proposed changes will be lessened. Thirdly, the growth of uneconomic bigness will not be discouraged and consequently 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:

<u>Percent of earnings undistributed</u>	<u>Rate of tax on undistributed earnings</u>
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, 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 which is in effect a junior lien rather than an equity be included as a deduction in computing adjusted net income and be excluded from the dividend credit.

With few exceptions, preferred stockholders do not share in increased earnings and, 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 proposed law should be directed towards the prevention of tax evasion by common stockholders, and participating preferred stockholders. By determining the tax on the basis of 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.

4. A low rate should apply to earnings withheld for debt retirement.

Although the House recognized the necessity of according special treatment to earnings devoted to debt retirement or withheld because of charter or statutory provisions, the omission of the corporate income tax necessitated the adoption of a 22½ percent tax rate on earnings devoted to such purposes. Such a rate would in many cases be prohibitive. If the corporate income tax is retained it would be equitable to lower this rate 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 would be high enough, however, to encourage the liquidation of debt through new stock issues in cases where this is practicable. There is a great difference between a flat $22\frac{1}{2}$ percent rate on earnings used for debt retirement, and a corporate income tax rate of 15 percent plus an additional rate of 8 percent on earnings used for this purpose. 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 $22\frac{1}{2}$ percent more than other corporations that are in a position to pay out all earnings. In the latter case a company which is obliged to repay debt would only have to pay 8 percent more than one that is not. 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.

Furthermore, the House bill permits exemption with a flat rate only for certain types of debt, and limits it to the excess of such debt over accumulated earnings. Since, in the case of all debts outstanding on March 3, 1936, there were expectations at the time they were incurred 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. It would be an almost impossible task to determine accumulated earnings, and in any case it is a bookkeeping item and has no reference to current or future

ability to repay debt. Accumulated earnings do not represent cash funds; they may be represented by plant which is now worthless.

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 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 cases where this cannot be done grave injustices will be suffered by existing holders of intermediate holding

company stocks, which include not only holding companies but minority holders. The stocks acquired at prices based on existing tax laws should not be suddenly made to suffer severe depreciation by a change in the basis of taxation, particularly since the inclusion or exclusion of a company from the effects of the tax must depend on arbitrarily selected percentages.

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. Such an evasion might have resulted from a definition of the dividend year (incorporated in an early draft of the bill) which would permit 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 amended to coincide with the taxable year for earnings. This particular explanation of the holding company provision is, therefore, no longer relevant.

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 corporate income tax to the extent provided by existing law.

Conclusion. If these suggested changes are adopted, the objections to the new tax proposals will be greatly lessened and their purposes

will be more surely achieved. Additional revenue will be raised; there will be more assurance than under the present proposals that the wealthy will pay their share of income taxes; the purpose of forcing funds out of corporations, either in the form of debt repayment, or in dividends, or in taxes, will be better served; and, finally, these suggested changes would make for a tax far less complex than that passed by the House; a tax that could be more easily explained and defended.