

THE PRESIDENT'S MESSAGE OF MARCH 3, 1936
PROPOSING ADDITIONAL TAXES

TO THE CONGRESS OF THE UNITED STATES:

On January third, 1936, in my annual budget message to the Congress, I pointed out that without the item for relief the budget was in balance. Since that time an important item of revenue has been eliminated through a decision of the Supreme Court, and an additional annual charge has been placed on the Treasury through the enactment of the Adjusted Compensation Payment Act.

I said in my budget message:

"* * * the many legislative Acts creating the machinery for recovery were all predicated on two interdependent beliefs. First, the measures would immediately cause a great increase in the annual expenditures of the Government - many of these expenditures, however, in the form of loans which would ultimately return to the Treasury. Second, as a result of the simultaneous attack on the many fronts I have indicated, the receipts of the Government would rise definitely and sharply during the following few years, while greatly increased expenditure for the purposes stated, coupled with rising values and the stopping of losses would, over a period of years, diminish the need for work relief and thereby reduce Federal expenditures. The increase in revenues would ultimately meet and pass the declining cost of relief.

"This policy adopted in the spring of 1933 has been confirmed in actual practice by the Treasury figures of 1934, of 1935, and by the estimates for the fiscal years of 1936 and 1937.

"There is today no doubt of the fundamental soundness of the policy of 1933. If we proceed along the path we have followed and with the results attained up to the present time we shall continue our successful progress during the coming years."

If we are to maintain this clearcut and sound policy, it is incumbent upon us to make good to the Federal Treasury both the loss of revenue caused by the Supreme Court decision and the increase in expenses caused by the Adjusted Compensation Payment Act. I emphasize that adherence to consistent policy calls for such action.

To be specific: The Supreme Court decision adversely affected the budget in an amount of one billion and seventeen million dollars during the fiscal year 1936 and the fiscal year 1937. This figure is arrived at as follows;

Deficit to date (expenditures charge-
able to processing taxes less process-
ing taxes collected) in excess of
that contemplated in the 1937 budget ... \$ 281,000,000

Estimated expenditures to be made from
supplemental appropriation approved
in the Supplemental Appropriation
Act, 1936 296,000,000

Estimated expenditures to be made
under the Soil Conservation and
Domestic Allotment Act 440,000,000

Total additional deficit 1936
and 1937, due to Supreme
Court decision and adjusted
farm program \$1,017,000,000

For the purposes of clarity, I divide the present total
additional revenue needs of the Government into the permanent and the
temporary ones.

Permanent Treasury income of five hundred million dollars is
required to offset expenditures which will be made annually as a result
of the Soil Conservation and Domestic Allotment Act recently enacted
by the Congress and approved by me; and an additional sum recurring
annually for nine years will be required to amortize the total cost of
the Adjusted Compensation Payment Act.

The net effect of paying the Veterans' Bonus in 1936, in-
stead of 1945, is to add an annual charge of one hundred and twenty
million dollars a year to the one hundred and sixty million dollars
already in the budget.

We are called upon, therefore, to raise by some form of per-
manent taxation an annual amount of six hundred and twenty million
dollars. It may be said, truthfully and correctly, that five hundred
million dollars of this amount represents substitute taxes in place of
the old processing taxes, and that only one hundred and twenty million
dollars represents new taxes not hitherto levied.

I leave, of course, to the discretion of the Congress the
formulation of the appropriate taxes for the needed permanent revenue.
I invite your attention, however, to a form of tax which would accom-
plish an important tax reform, remove two major inequalities in our
tax system, and stop "leaks" in present surtaxes.

Extended study of methods of improving present taxes on income from business warrants the consideration of changes to provide a fairer distribution of the tax load among all the beneficial owners of business profits whether derived from unincorporated enterprises or from incorporated businesses and whether distributed to the real owners as earned or withheld from them. The existing difference between corporate taxes and those imposed on owners of unincorporated businesses renders incorporation of small businesses difficult or impossible.

The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends; while the shares of stockholders who can afford to leave earnings undistributed escapes current surtaxes altogether.

This method of evading existing surtaxes constitutes a problem as old as the income tax law itself. Repeated attempts by the Congress to prevent this form of evasion have not been successful. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the Federal revenue. Thus the Treasury estimates that, during the calendar year 1936, over four and one-half billion dollars of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of stockholders and there taxed as is other personal income. But, as matters now stand, it will be withheld from stockholders by those in control of these corporations. In one year alone, the Government will be deprived of revenues amounting to over one billion three hundred million dollars.

A proper tax on corporate income (including dividends from other corporations), which is not distributed as earned, would correct the serious two-fold inequality in our taxes on business profits if accompanied by a repeal of the present corporate income tax, the capital stock tax, the related excess profits tax and the present exemption of dividends from the normal tax on individual incomes. The rate on undistributed corporate income should be graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of stockholders.

Such a revision of our corporate taxes would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the nation. It would constitute distinct progress in tax reform.

The Treasury Department will be glad to submit its estimates to the Congress showing that this simplification and removal of inequalities can, without unfairness, be put into practice so as to yield the full amount of six hundred and twenty million dollars - the amount I have indicated above as being necessary.

Turning to the temporary revenue needs of the Government, there is the item of five hundred and seventeen million dollars, which affects principally the current fiscal year. This amount must in some way be restored to the Treasury, even though the process of restoration might be spread over two years or three years.

In this case also the formulation of taxes lies wholly in the discretion of the Congress. I venture, however, to call your attention to two suggestions.

The first relates to the taxation of what may well be termed a windfall received by certain taxpayers who shifted to others the burden of processing taxes which were impounded and returned to them or which otherwise have remained unpaid. In unequal position is that vast number of other taxpayers who did not resort to such court action and have paid their taxes to the Government. By far the greater part of the processing taxes was in the main either passed on to consumers or taken out of the price paid producers. The Congress recognized this fact last August and provided in Section 21 (d) of the Agricultural Adjustment Act that, in the event of the invalidation of the processing taxes, only those processors who had borne the burden of these taxes should be permitted to receive refunds. The return of the impounded funds and failure to pay taxes that were passed on result in unjust enrichment, contrary to the spirit of that enactment. A tax on the beneficiaries unfairly enriched by the return or nonpayment of this Federal excise would take a major part of this windfall income for the benefit of the public. Much of this revenue would accrue to the Treasury during the fiscal years 1936 and 1937.

The other suggestion relates to a temporary tax to yield the portion of five hundred and seventeen million dollars not covered by the windfall tax. Such a tax could be spread over two years or three years. An excise on the processing of certain agricultural products is worth considering. By increasing the number of commodities so taxed, by greatly lowering the rates of the old processing tax and by spreading the tax over two or three years, only a relatively light burden would be imposed on the producers, consumers or processors.

FRANKLIN D. ROOSEVELT

The White House,

March 3, 1936.

INEQUITIES IN PRESENT TAX SYSTEM

The inequities of present Federal taxes on business profits, due to certain inequalities in our tax law, but more largely to methods used by some stockholders to defeat its equitable provisions, appear from a consideration of the following classification of taxpayers whose incomes are derived from business profits.

Income derived from an unincorporated business (whether individual or partnership) is subject to the individual income tax as earned, the smaller taxpayer paying the 4% normal tax thereon and the larger taxpayer paying 4% plus whatever surtax our present scale of surtaxes imposes on the income group to which he belongs, in accordance with the principle of ability to pay and benefits received. It is not suggested that this difference represents an inequity. Indeed, it avoids the injustice of treating as equal those who are in fact unequal.

To these two classes of taxpayers deriving income from business profits, must be added the four different classes receiving the earnings of incorporated businesses. They may be either small taxpayers or large taxpayers, and each of these two classes in turn must be subdivided into those to whom business profits are distributed as earned and those whose business profits are retained by, or left in, the corporations earning them. Serious inequities appear, when the tax position of each of these four classes of stockholders is compared with that of the other three and with that of the taxpayers deriving income from unincorporated business.

(a) The stockholder who has a small total income and who receives corporate profits as earned does not pay

the 4% normal tax thereon, but the corporation has already paid out of his share of corporate earnings the corporate income tax, ranging from 13 $\frac{1}{2}$ % to 15%, and also the capital stock and excess profits taxes, while a man of equal total income receiving an equal amount from an unincorporated business pays only the 4% normal tax.

(b) The stockholder with a large total income who receives corporate profits as earned does not pay the normal tax of 4% thereon, but has had deducted therefrom by the corporation the three taxes just mentioned and is subject to the surtaxes applicable to the income group to which he belongs. His tax position is to be contrasted with that of the large taxpayer deriving income from an individual business or a partnership who does not have subtracted the corporation income, capital stock, and excess profits taxes. On the other hand, his tax position is to be contrasted with that of the large taxpayer who leaves corporate earnings in the corporation, thereby avoiding or postponing surtaxes to which the other two classes of large taxpayers are subjected.

These are the inequalities removed by the reduction of all corporation taxes to a tax on undistributed corporate income. Under it, business income of whatever kind and by whomever received is treated alike and treated like all other kinds of income.

Taxes on Corporation Stockholders

	Stockholders in low income groups		Stockholders in high income groups	
	Present	Proposed	Present	Proposed
Corporation net income:				
Portion distributed	12½ - 15%	4%	(12½ - 15% (surtax)	4%) (surtax)
Portion undistributed	12½ - 15%	4%	(12½ - 15% (4%) (surtax)
Capital stock tax	\$1.40 per \$1,000 capital stock	0	\$1.40 per \$1,000 capital stock	0
Excess profits tax	6 - 12%	0	6 - 12%	0

Taxes on Owners of Unincorporated Businesses

	Owners in low income groups		Owners in high income groups	
	Present	Proposed	Present	Proposed
Business net profits	4%	4%	4% + surtax	4% + surtax

Advantages of the Proposal to Substitute a Tax on Withheld
Corporate Earnings for the Present Corporation Income,
Capital Stock, and Excess Profits Taxes.

1. The primary purposes of this proposal are to eliminate an important source of unfair discrimination, tax avoidance, and unjust duplication of taxation in our income tax law; and thereby to increase the Federal revenues.

2. It is proposed to do this by repealing the existing corporation income, excess profits, and capital stock taxes, and substituting therefore a tax averaging about $33\frac{1}{3}$ per cent on that portion of any corporation's earnings that is not currently distributed to its stockholders. The exemption of dividends from normal tax would be repealed since its basis is the present taxation of corporate earnings whether distributed or not.

3. When distributed to stockholders, corporate earnings are subject to surtaxes ranging up to 75 per cent. Corporate earnings which are not currently distributed in dividends escape these surtaxes for long periods or altogether, thereby creating an unfair discrimination. All the earnings of a partnership or of an enterprise owned by a single individual, whether reinvested or not, are now subject to our income surtaxes. The present proposal would tend to place all business, whether incorporated or not, on the same basis for income tax purposes.

4. The present law also discriminates against corporate stockholders with small incomes. The corporate earnings are subject to the $12\frac{1}{2}$ to 15 per cent corporation income tax. As against these rates of $12\frac{1}{2}$ to 15 per cent taken out of the earnings, the stockholder's

dividend receipts are exempted only from the 4 per cent normal tax. Under the proposal, there would be no corporation taxes to reduce the amount distributed as dividends, and the small stockholder would pay no tax at all, only the normal tax, or only that tax plus a moderate surtax, according to his total income.

5. Further, the present ability of corporations and of their controlling stockholders to choose the timing of dividend distributions, without any effect in the corporation's tax liability and without reference to current earnings, often results in a loss of revenue to the Federal Government and an unjust avoidance of taxation by stockholders of large personal incomes. The earnings withheld by a corporation would often, if distributed, raise 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 is smaller, such earnings escape the higher rates to which they would have been subject. Individual businessmen and partnerships possess no corresponding choice for the timing of the distribution of earnings for income tax purposes.

6. The earnings withheld by corporations add no less to the wealth and taxpaying ability of the shareholders than the earnings distributed in dividends; for the reinvestment of corporate earnings becomes reflected in the market prices of the stock, and in the increased earning power of the corporation. Shareholders in corporations that pursue liberal dividend policies are discriminated against because they are not permitted to reinvest tax-free the corporate earnings received as dividends; whereas stockholders in corporations pursuing

niggardly dividend policies, under the present law, in effect reinvest their share of the corporate earnings without payment of individual income taxes thereon.

7. A discrimination in favor of incorporated business in the present law is to be found in the fact that 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 reinvests the large earnings of one year, and subsequently suffers losses, escape individual income taxes on the profits of good years which are so wiped out.

8. It is estimated that a tax averaging about 33-1/3 per cent on undistributed corporate earnings would approximately equalize the individual surtaxes escaped by the undistributed earnings. With such a tax in effect, the Federal revenues would not be dependent on the dividend policies adopted by corporate management.

9. If the corporation income, capital stock, and excess profits taxes were repealed, it is estimated that the net income available for dividend distribution in the calendar year 1936 would approximate \$6,909 millions. The anticipated dividend disbursements to individuals by corporations during 1936 amounts to \$2,131 millions; thereby leaving \$4,778 millions available for additional dividend disbursements. If, by reason of the proposed tax, this additional amount were distributed, and all dividends were made subject to the 4 per cent normal tax, it is estimated that the Treasury's collections under the individual income

tax would be increased by approximately \$1,608 millions. The repeal of the corporation income, capital stock, and excess profits taxes would reduce the net gain in Federal revenue to about \$640 millions.

10. If, on the other hand, corporations decided to withhold from their stockholders the \$4,778 millions of earnings available for distribution, and paid an average tax thereon of 33-1/3 percent, the net increase in Federal revenues, inclusive of the 4 per cent normal tax on such dividends as were declared, would approximate \$676 millions. In other words, the proposed rate of 33-1/3 per cent on withheld corporate earnings would approximately equalize the loss in Federal revenues occasioned by the withholding from the personal income tax of reinvested corporate earnings.

11. It is clear that this proposal, far from imposing any new taxes on business, actually removes the largest single tax paid by business enterprises. The tax on withheld corporate earnings could not be passed on to consumers nor passed back to workers. No corporation need pay this tax. To avoid it, the corporation need only pass on to its stockholders, as earned, the earnings that belong to them anyhow. Nor does the proposal involve any increase in the individual income tax rates. Its primary result would be to make effective the present income tax rates on a very large volume of income that now escapes an important part of ordinary income taxation.

12. The effect of this plan of taxation of business profits would be to unshackle business in important respects, among which

is the effect of the proposed repeal of the capital stock tax and the excess profits tax. Such repeal would leave business executives entirely free to set up or alter their capital structures wholly on the basis of what sound business administration requires. They would not need to consider the possible effect of changes in their capital set-ups on the taxes which corporations would pay to the Federal Government. This would give latitude for any changes in capital set-up designed to reduce fixed charges.

13. It may be objected that the proposed tax and the resulting liberal dividend policies would tend to limit the expansion of business enterprises by removing a present source of additional capital. It is clear that this is not the case. Corporations that desire additional capital for expansion, or additional liquid funds as reserves against future plans or other contingencies, could obtain such capital, as many of them regularly do now, by the sale of additional shares to their stockholders or the latter's nominees. To take an extreme case, let us assume a corporation that desired to reinvest in its business the entire earnings of \$5 per share, but that, nevertheless, decided to pay out dividends of \$5 per share in order to avoid the proposed tax. Such a corporation could easily obtain the reinvestment in its business of this \$5 per share by offering to its stockholders rights to purchase additional capital stock at prices well below the prevailing market prices. 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 in additional stock of the issuing corporation.