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Text of address by Randolph Paul,  
former General Counsel of the Treasury,  
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SOME PROBLEMS OF CORPORATE TAXATION

Introductory

I am very glad to be with you tonight and particularly flattered by the subject you have given me -- Federal Taxation. Artisans of economic policy, such as accountants and controllers, need not be reminded of the amount of territory that subject covers, nor how imperative it is, now that we are emerging from our postwar hangover, that all of it be explored. But there is a limit to the amount of tax talk which can be taken -- or even given -- in a single dose. Therefore, I propose to concentrate on that phase of Federal taxation which I believe interests you most. I am going to discuss "Some Problems of Corporate Taxation." They are hard problems and they are a long way from being solved. Perhaps together we may be able to make some progress toward a solution.

We face far-reaching questions in these exciting days. Our staggering task and responsibility is to secure an efficient economy with high levels of employment and income. I believe we can attain and maintain those goals, if we have the will to do it. But the job will be hard and long, and at times discouraging. At the outset we must remove every obstacle in our pathway, including any that may inhere in our corporate tax structure. That will not be the end of the job, but it will at least be an intelligent beginning.

The "Double Taxation" Charge

It is almost a masterpiece of understatement to say that the critics of our corporate tax system have not been inarticulate in recent years. One of their loudest complaints is lodged against the so-called "double tax" on income which is distributed as

dividends. The first tax is on the corporation, reducing profits available for dividends. The second tax is on the stockholder in the form of the individual surtax upon the dividends he does receive. While the "double taxation" indictment is principally leveled at the treatment accorded to distributed profits, it is also aimed at the "double taxation" of undistributed corporate profits to the extent that they are reflected in the capital gains of stockholders who sell their stock. However, on the latter count the complaint is less bitter because of the relatively low rate of the capital gains tax.

More specifically, the "double tax" is said to be unfair because it results in the taxation of dividend income more heavily than other income. The comparison between dividend income and interest income is particularly obnoxious. Interest paid by a corporation can be deducted in computing its taxable income, but dividends paid cannot be deducted. Unfairness in this territory becomes bad economic policy, for the discrimination against equity capital represented by shares of stock encourages debt financing by bonds. With a 38-percent tax rate a corporation must earn approximately \$1.61 to pay \$1 of dividends. To pay \$1 of interest it needs to earn only \$1. The corporation tax is therefore credited with making debt financing more attractive than equity financing. While the advantages of this premium on the use of borrowed capital may sometimes be exaggerated, there is little doubt that it effects a distortion of the capital structure of many corporations. To the extent that debt financing is encouraged and equity financing discouraged, the resulting corporate capital structure is too flimsy to withstand the stresses of bad times.

The "double taxation" indictment contains still other counts. Since it reduces profits available for dividends, the existing corporation tax is said to make outside financing more difficult because it deters investors from purchasing stocks. Whether any great number of people are discouraged, or whether their reaction is economically important, is hard to determine, since it is entirely possible that individual investors may from time to time change their standards of reasonable return. At any rate, to the extent that it is valid, this argument has no bearing upon internal corporate financing. On the corporate level the charge is that new investment in plant and equipment will not be made unless the prospective return is sufficient to offset the fear of loss of principal invested and to indicate a minimum return on principal.

"Double taxation" is also denounced as having an adverse effect upon the revenue because it puts a premium upon the retention of profits in corporations. Only by withholding profits from distribution can the so-called "double tax" be avoided or postponed or minimized. Avoidance of the personal income tax is complete if the stock is held until death. The tax is postponed where profits are held for distribution to stockholders in their low income years. There is minimization of tax where profits are allowed to accumulate for a period and then are finally

realized by the stockholder in the shape of a profit on a sale of stock rather than by virtue of a dividend distribution. This is one of the ways in which tax considerations are said to exert an inordinate influence upon corporate policy.

Implicit in these counts in the indictment against "double taxation" is the assumption that the corporation tax is not shifted to consumers in the form of higher prices and to wage earners in the form of lower wages. If the final burden of the corporation tax falls on consumers and wage earners, the grounds for these complaints disappear. There is then no "double taxation" because one of the two taxes imposed upon dividend income -- the tax supposed to be paid by the corporation -- is actually passed on to others. In this situation the corporation tax might be held guilty on a charge of reducing consumption by raising prices and depressing wages, but it would be exonerated from charges of inequity and discrimination and discouraging investment.

"Double taxation" is an elusive concept which calls for careful scrutiny. The premise of the criticism implied in the term is that corporation and stockholders are one economic entity. The distinction between the corporation and its stockholders becomes no more than a legal formality, a fiction which the law recognizes only for limited purposes. On the more basic economic level, according to this theory, the corporation is no more than an aggregation of individual stockholders, a variety of partnership, a species of joint venture in search of profits for its members. From this viewpoint one critic has described corporations as nothing more than "words on a piece of paper."

Of course, this definition does not hold good on a strictly legal level. "It leads nowhere," as Mr. Justice Holmes has said, "to call a corporation a fiction. If it is a fiction, it is a fiction created by law with intent that it should be acted upon as if true." The Supreme Court upheld the Federal corporation tax of 1909 as an excise upon the privilege of doing business in a corporate capacity. Moreover, taxpayers are quick enough to insist upon the separateness of corporation and stockholder, when that doctrine permits tax avoidance or is otherwise advantageous to them. Nor should it be forgotten that at several points our tax system favors corporations over unincorporated business. Such factors as relative corporate and individual income tax rates, stockholders' income, and how much and how long profits are retained, enter into the complicated question whether one form of doing business or the other gets the better break in a particular case.

From the legal and constitutional standpoint the taxation of corporations as separate entities is completely justified. Corporations are creatures of the law, owing all their rights and privileges to public grant. It is true that corporate

charters are issued by the states rather than the Federal Government, but the Supreme Court has decided that this does not preclude the imposition of a Federal tax. Nor is it relevant at this point to insist that incorporation is open to everyone on relatively easy terms. Privileges granted by the state should be open to all citizens; the terms of the grant need bear no relation to economic value as long as there is no discrimination. Furthermore, while the grant of powers to corporations may very well be in the public interest, it does not legally follow that no tax price should be charged for the privilege of doing business as a corporation. The question here is one of policy, not of law. As a matter of legal history, "double taxation" is no novelty in the United States, and "double taxation," if it hits all alike, can be perfectly equitable. It is not a crime per se; as Mr. Justice Holmes has said, "The Constitution no more forbids double taxation than it does doubling the amount of tax."

From the policy standpoint a corporation has many characteristics that distinguish it from the individuals for whom it is supposed to act. It gives limited liability to stockholders; they are not responsible for its debts as are the partners of a partnership. It has perpetual life and operative continuity as compared with the limited life span of an individual or partnership. Its entity permits easy transfer of ownership and management. It has access to nation-wide, sometimes world-wide, sources of financing which are not available to other forms of enterprise. Its structure permits intercorporate affiliation with or without integration of management. Finally, individual stockholders may have little practical control over either the day-to-day operations or the major policies, including the dividend policies, of many corporations. They have inchoate ownership of the corporate assets and earnings, but that is quite different from the direct type of ownership enjoyed by partners. These special characteristics of corporations are integral parts of modern big business operation; whatever their origin as legal fiction, they have become economic reality protected by law.

The problem of "double taxation" has to be even more fundamentally considered. It is necessary to inquire into the impact of the corporation tax upon stockholders in terms of the prices they have paid for their stock. Many taxpayers may not bear the full impact of the corporation tax because they bought their stock after the tax was in effect and paid a price which took the tax into account. An unforeseen rate increase will, of course, be reflected -- other influences being equal -- in a drop in stock prices, because it will diminish profits available for dividends; on the other hand, an unforeseen rate decrease will raise stock prices. An unforeseen increase will, therefore, work a hardship upon stockholders; conversely, an unforeseen decrease will be a windfall. In a perfect market stock prices would always discount the effect of the corporation tax. New purchasers would, in effect, escape the tax when they bought

their stock by making it an element of purchase price. In the long run, neither an increase nor a decrease of the corporation tax is very likely to affect the attractiveness of stocks in relation to other types of investment.

The economic argument that the corporation tax destroys incentive and kills the desire to take risks also stands in need of candid re-examination. It seems almost axiomatic that business men would be more inclined to go into perilous ventures if they could keep more when they won. But some business men might reduce their risk-taking if they could make a satisfactory profit without risk. Others would not be satisfied with any particular amount of profit and would go on being venturesome. The temperament of each business man would determine his reaction. The chance for higher rates of profit would embolden some, but not others.

There is another chapter in this story -- the fact that through taxes the government shares in business losses, both corporate and individual. While the government always shares in gains, it does not share completely in losses, since the provisions for loss offset are limited. If they were complete and part of the investor's loss were always absorbed in a reduced tax bill, the investor's risk would be commensurately reduced and risk-taking would not become less attractive. However, the investor's income would also be reduced. To make up the difference he might take more risk by reducing his cash position and increasing his investment, or by switching from less to more risky investments.

The extent to which investors may use the limited loss provisions of existing law depends primarily upon how much other income they have available. Obviously, taxpayers' positions differ widely in this respect. There are discriminations between large and small corporations; large corporations are more likely to have income against which to offset losses. The loss carry-back provisions give a greater certainty of loss offset to old corporations with past net income than to new corporations with no past net income. Inequities of this type increase economic concentration and tend to lower the volume of new investment. A large part of the answer to the problem of increased risk-taking may, therefore, be in an improved method of loss offset as well as lower rates. Here improvement lies in the direction of averaging income over the years, extending the carry-forward period for losses -- a proposal which would not be subject to the same criticism as the carry-backs -- and a less discriminatory treatment of capital losses. Accelerated depreciation might also help.

But an improved method of loss offset cannot alone solve the problem of diminished incentive. Even an unlimited carry-over provision would not insure full loss offsets for corporations which never realized income equal to their unsuccessful

investments. However, we need not rush desperately to the conclusion that the corporate tax should be abolished because it limits investment to some unascertainable degree. We do not abolish taxes solely because they impose the measure of regulation and economic impediment involved in all taxes. Our attempt should rather be to eliminate defects and reduce economic impediments to a minimum. This approach gives us the benefit of taxes without avoidable harmful effects.

### Is the Corporation Tax Regressive?

Another charge against the corporation tax is that it is regressive and violates the principle of ability to pay. This criticism is made regardless of whether the tax is shifted. If the tax is shifted to consumers, it is a concealed sales tax and is obviously regressive. If it is shifted to wage earners it is equally regressive, since wages constitute a higher proportion of low incomes than of high incomes .

If the tax is not shifted, analysis is more difficult. It is true that the corporation tax takes no account of the differences in income of stockholders. In one sense it falls as heavily on widows and orphans as on multi-millionaires. But in evaluating the final effect of the tax on different stockholders we must remember that stockholders are subject to the progressive individual income tax, and that part of what is taken by the corporation tax would have been taken in any event by the individual income tax on distributed profits. More would be taken by this tax from high-income stockholders than from low-income stockholders. The relevant question is what stockholders have left in their pockets after both taxes.

Regressiveness is a serious charge against a tax system which takes pride in relying upon the principle of progression. But the issue is not as clear-cut as this charge makes it appear. In the first place, the varying importance of dividends in relation to total income in different individual income classes has not yet been appraised. In the second place, it can be demonstrated that the corporation tax is broadly progressive when account is taken of all factors of its impact.

Corporate tax critics often cite the wide distribution of stockholdings to prove that the tax is unfair to low-income groups. They mention such examples as the General Electric Company with 235,000 stockholders, the General Motors Corporation with 423,000 stockholders, and the American Telephone & Telegraph Company with more than 650,000 stockholders. Of course, no one knows how many names are duplicated on various stockholder lists, but these figures do show wide distribution. They tell nothing, however, about the distribution of dividend income by income classes. Treasury figures reveal that individuals with income under \$5,000 received only a little more than \$1 billion in dividends out of a total of \$3.2 billion of dividends received by individuals who filed tax returns in 1942. The fact that such a

substantial part of dividend income goes to stockholders with high incomes is not so helpful to the critics of the corporation tax. A tax which reduces dividends going in such large part to high-income taxpayers cannot truthfully be said to have a wholly regressive effect.

The effect of the corporation tax on the progression of our whole tax system can only be determined by looking at feasible alternative sources of revenue. If we replaced the corporation tax by increases in the individual income tax, with a set of postwar individual rates somewhat lower than present rates and roughly the present dividend distribution by income classes, additional surtaxes of about 2 percent on incomes of less than \$2,000 to about 7 percent on incomes of more than \$8,000 would be necessary. This rate increase assumes that as more dividends were paid, more taxes would be paid by individuals. But the revenue added by increased dividends would not make up for the elimination of the corporation tax. We should still have to raise individual rates by approximately 2 to 7 percent. This replacement would be about the equivalent of the existing corporation tax on profits distributed as dividends -- not in the sense that it would fall upon exactly the same individuals, but rather in the sense that it would fall upon the same income classes. Assuming that funds released by the remission of the corporation tax would be entirely distributed and not retained in the corporation, the increased individual income tax would have much the same effect upon consumption as the corporation tax it replaced. Any retention of released corporate funds would, of course, necessitate a boost in replacement rates.

The moral is plain. The corporation tax is more progressive than payroll taxes and excises, and less progressive than the existing individual income tax. It could be replaced by increases of individual income tax at rates varying with the proportion of remitted tax which would be distributed as dividends. But to the extent that corporations failed to distribute the remitted tax, a replacement tax would be borne by the stockholders of distributing corporations and by others who did not own stock. Moreover, non-taxable individuals and institutions and foreign stockholders -- who now participate in the tax upon corporate profits -- would be distinct winners, for their exemption would hold against a tax imposed directly upon them.

### The Problem of Undistributed Corporate Profits

It is obvious that our corporation tax system is far from perfect. But it is not difficult to imagine a worse alternative. Suppose we abolished the corporation tax outright and made no provision for taxing undistributed corporate profits. In this situation corporations would

be able to accumulate tax-free profits indefinitely. Stockholders could realize cash by occasional sales of stock, and gains on these sales would receive preferential capital gains treatment. Stock unsold during life could be passed on to heirs without the payment of any income tax. The estate tax would eventually reduce the amount of untaxed profits, but there would be left a substantial amount of transmitted wealth upon which taxes had been completely avoided.

It is perhaps gratuitous to belabor the consequences of outright elimination of the corporation tax. Unincorporated business would be almost helpless in the face of the discrimination in favor of incorporated business. Stockholders as individuals would be completely favored over individuals who owned no stock. Stock owners at the time the tax was eliminated would have windfall gains; it is almost impossible to imagine what would happen to the stock market if the corporation tax were repealed. The tax escaped by corporations on their savings would have to be recovered from some source; without doubt a large share of the burden would fall more heavily on consumption. Consumption would necessarily decline, and the market for manufactured products would correspondingly shrink. In the end we should be almost impossibly handicapped in achieving our goals of high employment and high national income.

### Methods of Coordinating Individual and Corporate Taxes

Three basic methods have been suggested for diminishing the inequities of our corporate tax system and reducing its restraints upon enterprise without involving ourselves in the worse alternative of permitting indiscriminate accumulation of corporate profits. The first would disregard corporate entity and tax corporate profits as if the stockholders were partners; a logical extension of the method would be to allow stockholders to treat corporate losses as their own. Under this plan stockholders would be taxed at their regular personal rates on both distributed and undistributed profits. This approach has many administrative difficulties, but could probably be applied with some compromises to a large number of closely-held corporations with simple capital structures. It probably could not be applied to large corporations with wide stock distribution. To the extent that its application is practical, it would solve many of the problems inherent in the existing system.

The second method leaves a corporation tax, but gives the corporation a deduction for dividends paid to stockholders. The corporation tax would apply in full to



undistributed profits, and not at all or only in part to distributed profits. Without modification the greatest defect of this approach is that it would play into the hands of large corporations which were in a position to distribute most or all of their profits. It appears possible, however, to develop modifications which would relieve small and medium-sized corporations from this disadvantage, and the method certainly would solve most of our problems.

The third method would give the corporation no deduction for dividends paid. It would tax all corporate profits, distributed and undistributed, but would give stockholders a tax adjustment or credit on account of dividends. This could be done in two ways: first, by treating all of the tax paid by corporations as a withholding tax on dividend income; and, second, by allowing stockholders a credit or exemption for dividends received. The credit might consist of a partial exclusion of dividends received from taxable income. One serious count against the withholding approach is the administrative difficulties involved, but the method would solve the problem of "double taxation" and accomplish other desirable results. The allowance of a credit or exemption for dividends received is open to the grave objection that it is heavily weighted in favor of high-income stockholders. It would offer no benefit to stockholders who were not subject to the individual income tax; among stockholders subject to the individual income tax it would give greater benefit to those with large incomes than to those with small incomes. In extreme cases a smaller tax would be collected from high-income individuals on distributed corporate profits than would be collected if no corporate normal tax were imposed and corporate distributions were subject only to the individual income tax.

### Recommendations

It is pleasant to linger in the realm of academic discussion, particularly when solutions are so difficult and almost any course of action must involve doubts as to its correctness. But the time for decision on the corporate tax front can no longer be postponed. We must decide -- and soon -- whether the corporation tax is to continue in our Federal tax system, and what kind of tax is to remain, if any remains at all. I shall therefore discard misgivings and offer some recommendations for the consideration of this meeting. I hope you will take my suggestions in the humble spirit in which they are given, and as representing an honest effort to find the best answers.

1. Whether or not corporations are separate economic entities seems to me finally to resolve itself into a question

of degree about which reasonable men may honestly differ. It is a question which cannot be answered categorically for all corporations. Economically speaking, many small, closely-held corporations are nothing more than partnerships. Many large corporations with widespread ownership are so much more than partnerships that a difference in degree becomes a difference in kind. In between are many hybrid corporations which are something more than partnerships and something less than economic entities distinct from their stockholders. The solution of the problem of taxing corporations and their stockholders on a rational basis, consistent with what is best for our whole economy, begins with drawing a workable line between corporations which derive sufficient advantage from economic separateness to justify tax, and those which do not. Any line we draw may be arbitrary, but the resulting classification will at least be better than our present confusion.

2. Where should the line be drawn? Here also is much room for sincere difference of opinion. I can do no more than state a guiding principle. The basic principle of selection is the one I have indicated -- between corporations which are economically, and not only legally, separate from their stockholders and those which are not. There are several possible tests for this selection. Do the stockholders have a real voice in the formulation of important corporate policies, such as wage, price, and dividend policies? Does the fact of incorporation bestow substantial economic advantage, such as accessibility to world capital markets and the protection of foreign commerce? Are corporate characteristics -- such as limited liability of stockholders, easy transfer of ownership, and perpetual life -- essential to the very manner of doing business? These attributes suggest the economic separateness of the corporation and justification for corporate tax. If they are sufficiently absent, the imposition of corporate tax is much more questionable.

3. I believe that a substantial tax should be imposed upon corporations which may be classified as economic entities distinct from their stockholders. A corporation tax is justified by the economic advantages these corporations enjoy and by revenue considerations which dictate that no potential sources of revenue should be left untapped. I can not believe that such a tax will stifle the incentive to risk investment, or that it would unduly hamper management in its price, wage, and other policies, particularly if a differential is made for distributed income, and adequate provision is made for offsetting losses and, perhaps, for accelerated depreciation. Of course, the tax would be a stiffer brake upon risk-taking than no tax at all. If, to some extent, enterprise is cramped, the result is unavoidable. The choice may be between the frying pan and the fire. Revenues must come from somewhere, and the same burden, placed directly upon individuals through the individual income tax or indirectly by excises, might well produce even more disastrous results. We must choose our sources of revenue on the basis of minimum

harm to the economy as a whole.

4. I would eliminate the corporation tax -- or charge only a nominal franchise tax -- for corporations which, in a predominant sense, may not be classified as economic entities distinct from their stockholders. In general, these would be small corporations with a limited number of stockholders. The corporation tax could be eliminated by granting these corporations and their stockholders the privilege of reporting as partnerships. This method of reporting could perhaps be made mandatory rather than optional.

5. The partnership method of reporting corporate income would give complete relief from "double taxation" and wipe out the discrimination in favor of interest income. Where it was not applied -- to large corporations with separate economic entity -- I believe relief should be given by making a substantial differentiation in favor of corporate profits which are distributed as dividends. A differential in favor of distributed corporate earnings would partially offset the existing premium on the use of borrowed, rather than equity, capital.

It is not easy to decide what form this differential should take. It is much easier to state the form it should not take. I am unalterably opposed to techniques which concentrate relief in the high brackets. Both an adjustment of the corporate tax for dividends paid and a withholding tax approach could be made fair to low-bracket stockholders. On the economic level these two methods would help consumption.

6. To give maximum encouragement to risk capital, it may not be enough to provide a tax differential in favor of distributed corporate earnings. Although a differential would promote distribution and the substantial corporation tax on undistributed earnings would minimize the use of corporations as instruments to avoid taxes, inside financing might remain difficult. Getting corporate earnings distributed is not a complete solution to this complicated problem. In many cases it is much better for the corporation -- and the economy -- to retain earnings for use in the expansion of the corporate business and in new ventures.

One basic remedy for this condition is appealing, however forbidding administrative obstacles may be. If we could allow some deduction for purposes of the tax on undistributed earnings -- or the entire corporation tax if the differential in favor of distributed earnings takes the form of a credit to stockholders -- on account of investment in new capital additions, new investment would be encouraged. If we resorted to this heroic remedy, no deduction should be allowed for the purchase of an old plant, but only for the construction of a new plant. This expedient comes so close to being a subsidy

that I believe it should be adopted only if it is absolutely necessary to stimulate the expansion and increased production that are indispensable to a high level of income and full employment,

7. The limited character of the loss provisions of tax law may be as much, if not more, responsible than high rates for business inertia. More generous loss provisions are a necessary step forward in the taxation of corporations and individual business. Instead of the present two-year carryover, I believe there should be at least a five-year carry-forward of net operating losses. A provision of this kind would substantially benefit small business where profits are subject to greater fluctuation, and are therefore less available for loss offset, than the profits of big business. With this more liberal loss provision in the statute business men could strike out into new territory with a greater sense of safety, for they could count on the government to share in their bad, as well as their good, fortune.

8. Part of the problem of undistributed corporate earnings stems from the fact that from the stockholders' viewpoint these savings constitute untaxed capital gains. Other things being equal, the value of stock rises as undistributed corporate profits accumulate. If the stockholder sells his stock, the undistributed profits are at least indirectly subject to capital gains taxation. But if the stockholder does not sell his stock, a potential capital gain escapes taxation. Although this gain will ultimately in many instances be subjected to estate tax, our tax structure should contain a provision to stop this serious income tax leak. I believe the most feasible technique would be a tax upon the gain -- with perhaps a corresponding treatment of any loss -- at the time of any gift of the stock -- even to a charity -- and at the time of death. A provision of this kind would capture the tax in the end, although somewhat tardily if no gift were made.

### Conclusion

As we ponder the problems of today, it is hardly surprising if sometimes we are overwhelmed by their vastness. Our corporate tax problems are only one small segment of a wide area of doubt and controversy in the tax field. And the whole tax problem is only part of the much larger problem of full employment and rising living standards. We cannot afford to fail to reach these economic goals. Yet the obstacles in our pathway are tremendous. We shall remove them only if we assemble all the courage at our command.

Yet we need not be overwhelmed. We can rather be challenged by the greatness of our opportunity. More than a

century ago Alexis de Tocqueville, a clairvoyant Frenchman who understood us better than we understood ourselves then, and perhaps better than some of us understand ourselves today, said that this nation seemed "marked out by the will of heaven to sway the destinies of half the globe." Recent events have more than vindicated de Tocqueville's modest prediction. If we respond to our opportunity, our lives will not be easy, but they will be well worth living.