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No. 20

# THE UNDISTRIBUTED PROFITS TAX

BY

M. SLADE KENDRICK

POONS.

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## DIRECTOR'S PREFACE

The nature of this pamphlet and the circumstances under which it was prepared are so fully set forth in the text that no further comment is necessary here. The undertaking seems to us to emphasize anew the possibilities of frank and co-operative approach to the practical realities of our national problems of economics-in-action. To bring the business man, the legislator, and the professional economist into collaboration in the study of such a problem is a modern application of an American spirit as old as our democracy. We trust the resulting publication will prove fruitful in advancing better general understanding of this particular aspect of our problem of national taxation.

EDWIN G. NOURSE  
*Director*

Institute of Economics  
December 1937



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## THE UNDISTRIBUTED PROFITS TAX

When the undistributed profits tax became law in 1936, an idea long held by various persons of prominence in the field of taxation, and at times hesitantly followed in the revenue acts, finally found aggressive expression. So great is the change introduced by this measure in comparison with the faint traces of the idea included in earlier revenue acts, that it may be said with substantial truth to be the first real statutory imprint of the theory that the undistributed earnings of corporations ought to be subject to special taxation.

The significance of the undistributed profits tax was pointedly set forth by the President in his message of March 3, 1936. Taxation of the undistributed earnings of corporations was urged as "a matter of fundamental equity," the aim of which was "to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners." It was argued that the problem of attaining an equitable distribution of taxation was aggravated by the deliberate withholding of income in the form of corporate surpluses. Spokesmen of the Treasury presented the undistributed profits tax not only as a fiscal measure but also as a device that would operate significantly to prevent business depressions (see page 87).

Economists, accountants, and experts in taxation not in the federal service differ greatly in their opinions of this tax law. Some scholars are strongly opposed to it; others have argued that it has merit

both as a fiscal measure and in its effects on the operation of the economic system. Business men in general are violently opposed to this tax and, both individually and through their organizations, have made many protests against it. Pending proposals for its amendment in the present Congress point the need for serious study of whatever evidence has been yielded by experience with the law since its passage. Such is the purpose of the present pamphlet.

### THE TAX DESCRIBED

The undistributed profits tax is a levy on corporations only, and is laid on that part of their net income which is retained in the business. By distributing the whole of its earnings, a corporation could avoid liability for any payment of this tax. As more of the earnings are retained by the corporation, not only is the tax base enlarged but the rate of the tax also increases. That is, the tax is "progressive," starting at a rate of 7 per cent if 10 per cent of net income is retained by the corporation and rising to a rate of 27 per cent on any earnings retained in excess of 60 per cent. These rates and the payments that they entail for a corporation with earnings of 1 million dollars subject to this levy are shown in the following table:

TAX RATES AND AMOUNTS OF TAX

Bracket	By Brackets			Cumulatively		
	Amount Retained	Tax Rate (Per cent)	Tax Payment	Amount Retained	Tax Rate (Per cent)	Tax Payment
First...	\$100,000	7	\$7,000	\$100,000	7.00	\$7,000
Second...	100,000	12	12,000	200,000	9.50	19,000
Third...	200,000	17	34,000	400,000	13.25	53,000
Fourth...	200,000	22	44,000	600,000	16.17	97,000
Fifth....	400,000	27	108,000	1,000,000	20.50	205,000

Thus if our hypothetical corporation retains 10 per cent of its net income, it pays a tax of \$7,000. If it retains 40 per cent of its net income, it pays a cumulative rate of 13.25 per cent or a total tax payment of \$53,000; whereas, if it retains all its net earnings, it must pay a cumulative rate of 20.50 per cent or a total tax payment of \$205,000.

The first step in applying the tax is to compute the net income of the corporation as for purposes of the regular or normal corporation income tax. From this figure, the "adjusted net income" is derived. This term means the net income less the sum of the normal tax, a credit for interest received on certain obligations of the United States and of government corporations, and, for holding company bank affiliates and national mortgage associations, certain special credits. The last step in the series of calculations is to subtract from the adjusted net income the sum of the dividends paid, and a credit for payments under contracts restricting dividends. This subtraction gives the undistributed net income to which the rates in the foregoing table apply.

In common with other tax measures, this law has its exceptions from the general rule. Thus a specific credit, which may not exceed \$5,000, is given corporations with an adjusted income of less than \$50,000. Corporations exempt from the tax include banks; firms in bankruptcy under federal law, or insolvent and in receivership in any court; insurance companies; foreign concerns; enterprises deriving a specified proportion of their gross income from sources within a possession of the United States; firms organized under the China Trade

Act; and finally, joint stock land banks established under the Federal Farm Loan Act.<sup>1</sup>

The undistributed profits tax, as proposed by the President in his message of March 3, 1936, contemplated repeal of the corporation income, capital stock, and excess profits taxes. The new tax was to be in lieu of these other federal levies. Aside from the larger motives that governed his advocacy of this source of revenue, the President held that this revision of the corporate tax structure "would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the nation." All this was, however, not to be. The bill was amended in many important particulars during the legislative process. As finally enacted, it was in addition to all other corporate levies, not a substitute for them. Corporations are taxed as before, and must pay also a tax on earnings that they withhold.<sup>2</sup> The rates of the regular corporation income tax begin with 8 per cent on incomes of \$2,000 or less, and increase to 15 per cent on incomes of more than \$40,000. Thus a corporation earning more than \$40,000 a year and desiring to retain all its earnings would pay a total corporate income and undistributed profits tax

<sup>1</sup> We have presented here only the broad and general outlines of the law. It will be necessary, from time to time, as the analysis proceeds, to supplement portions of this outline with a more detailed account. See particularly pp. 51-55.

<sup>2</sup> The determination of the tax base, the provisions for valuing inventories, the treatment of prior losses, the matter of capital gains and losses—with the provisions of the law and their interpretation in the regulations or by the courts bearing upon the determination of net income—have been carried over from the previously existing corporate income tax to the undistributed profits tax. It will therefore be necessary at various places in our discussion to examine these provisions, designed for another tax, in order to see how effectively they function in connection with the present measure.

of approximately 32 per cent of its net income—disregarding the effects of the graduation below \$40,000 and the specific credit, if applicable. It is thus not unnatural that the corporate official (or even stockholder) should think of this total amount rather than the specific burden added by the new law.

The undistributed profits tax cannot be fully analyzed without regard to the issues of corporation taxation as a whole and even the taxation of incomes of individuals, since these embrace the business earnings of partnerships and individual proprietors that operate alongside the corporate form of enterprise. These broader issues cannot be covered in the present study, but when possible they will be pointed out in their bearing on our immediate inquiry. Furthermore, a system of taxation cannot be adequately appraised without a realistic examination of the part played by taxation in the whole economic system and its effect on the production and distribution of the national income. These wider issues can only be glimpsed as background of our immediate field of study, which for practical reasons must have its focus narrowed to the problem of determining how well this particular tax works, what hardships if any it imposes, and what relief could be obtained through amendment. In view of the probability that some change in the law will be made by the present Congress, there seems good reason for undertaking a study directed to these practical ends.

#### **ORIGIN AND CHARACTER OF THIS STUDY**

But how may we find the actual results of this tax? Since corporations feel the first impact, it

would seem that their managers would know the nature of the effects brought on by the tax. To be sure, special interest may lead to special pleading. But, on the other hand, the Olympian height of detachment gives a poor view, missing many essentials of the problem. A closer view and a realistic approach are necessary. The corporation officials have something to contribute and it happened in the present instance that the fruits of their experience with the tax had been made ready to our hand. It is the major task of this pamphlet to sift their testimony for its contribution to understanding of the problem.

The work of obtaining this testimony was undertaken in a remarkably comprehensive way by Senator Frederick Steiwer of Oregon. Having received complaints as to the operation of the tax and considering whether such difficulties might be removed through amendment, he prepared a detailed and carefully constructed questionnaire (a copy of which is included as Appendix A) for submission to business corporations. From the total number of corporations included in *Moody's Industrials*<sup>3</sup> for 1936, the following classes were eliminated: Oregon corporations, foreign corporations, and the subsidiaries of parent corporations. To each of the remaining corporations—some 3,600 in number—the questionnaire was mailed in June 1937. The replies received numbered 1,560. Practically without exception these replies were made by high-ranking officials. They give every evidence of having received informed attention. Many are complete with detailed explanations of corporate situations and the effects of the tax. Some are documents extraordi-

<sup>3</sup> Thus excluding the important field of the railways.

nary in their content of fact and argument. All in all, they provide a sweeping view of the impact of the tax on American industry—as seen by the officers of corporations.

This body of material was submitted by Senator Steiwer to the Brookings Institution for analysis. Complete freedom in its use was given. The sole condition imposed by the Senator was one by which he himself was bound; namely, that the identity of no particular corporation or official should be disclosed.

The method of examination followed by us was first to read all the replies made to the questionnaire. Thereby a general view of the issues, as seen by corporate management, and an impression of their relative significance were obtained. Second, a statistical tabulation of the replies to the questionnaire was made. Finally, extensive notes and extracts were taken from letters containing the more important material, whether in the form of fact, argument, or suggestion. Through this selection, an attempt was made to bring everything of significance in the questionnaire to bear upon the problem.<sup>4</sup>

We now proceed to analysis of the issues developed from the questionnaires. What effects of the tax do corporation managers find? Are these reactions valid; that is, do the corporate executives submit a true bill? On this question two points of view are to be noted—that of the corporation and that of the economic welfare of our people as a whole. The managers are naturally interested pri-

<sup>4</sup> Some important supplementary data were secured from investment bankers and others, and this material will be utilized in due course as the analysis proceeds.

marily in the effect of the tax on their particular corporations. We need to know whether their verdict on these effects is accurate. But there is also the larger point of view of the welfare of the economic system. We need to know the effects of the tax upon that. These points of view may overlap but are not necessarily antagonistic. Any conflict between them would, for purposes of this analysis, be resolved in favor of the well-being of the public. That is the fundamental consideration to which both a particular tax and the whole tax system should conform.



## THE DIVIDEND PAYMENT

Our examination of the views of business men as to the actual operation of the undistributed profits tax reveals first a practically unanimous chorus of complaint against the way in which the dividend period is defined. Of 1,195 replies covering this point, 1,164 expressed a desire for a change. The law establishing the undistributed profits tax provides that "the dividend-paid credit shall be the amount of dividends paid during the taxable year." The regulations interpret this statutory provision as follows:

A dividend will be considered as paid when it is received by the shareholder. A dividend-paid credit can not be allowed unless the shareholder receives the dividend during the taxable year for which the credit is claimed.

The corporation managers point out that this provision makes necessary an estimate of earnings a considerable period in advance of the time that earnings can be known. They say that estimates of this kind inevitably lead to errors, and errors to hardships of one kind or another. Suppose now we let a number of these officials speak, each for his firm. In order to save repetition, after the first testimony of this kind, it will be generally understood that mention of the company implies that an official representing it or giving his own informed opinion is speaking.

An executive in a large retail store points out the time requirement for the mechanics of a dividend distribution:

Usually about six weeks' time is allowed between the declaration of a dividend and its payment, since the New York Stock

Exchange requires ten days' notice of the date of record, and the disbursing agent needs from two to three weeks in which to make the necessary calculations and issue checks.

### A large oil company :

No large corporation can determine its profits exactly at the close of its fiscal year. At least two months should be allowed for that purpose, and at least another month for the declaration and payment of dividends, since the physical preparation of dividend checks after the record date takes considerable time in the case of a corporation having a large number of stockholders.

### A drug firm :

We are engaged in an international business, which requires at least three months in which to receive a report of operations at the close of the year, and to close our books completely. In other words, not having a grace period, we are forced to guess in the decision on a dividend without having real facts. This is hazardous, and with the main thought of minimizing the undistributed profits tax the general tendency is to lean toward making the estimate of earnings as high as possible, and if actual operations are less than the estimate, the corporation is further penalized.

### A lumber company :

It is impossible for any company, particularly in a line of business that handles a more or less speculative commodity such as lumber to determine with any reasonable degree of accuracy the earnings for the year until the books are closed and inventory taken. The amount of earnings cannot be determined without a physical inventory. Large volumes of lumber are difficult and expensive to inventory and this is done only once a year. At the very best, it is impossible to know what the earnings for the year are until approximately sixty days after the close of the year.

### An auto supply company :

It was necessary for us to make an estimate on November 1, 1936, of our earnings for the calendar year 1936, for the purpose of declaring a dividend which we thought would limit to a considerable extent the amount of surtax that we would have to pay. However, our estimate proved to be low and as a result we did not pay out as large a percentage of dividends in the year 1936 as we paid in the year 1935. This error in the estimate resulted in the payment of \$111,000 surtax on a net book profit of \$2,066,000.

Similar statements could be continued indefinitely.

In the light of the evidence, the difficulty can

scarcely be denied, and the reasonableness of the complaint is put on firm ground. The remedy is simple and obvious—an extension of the period within which dividends paid from the profits of the taxable year would be counted as a credit against the tax for that year. The most usual recommendation in the questionnaires is that a ninety-day period be allowed. But since corporations reporting on the calendar year basis are required to make a return on or before March 15, it might be desirable, for administrative reasons, to limit the extension to that date.<sup>5</sup> If so, consideration might be given to allowing the dividend credit for any declaration or distribution of the earnings of the taxable year made within that period. Any such declaration should, of course, be complete in establishing the corporate liability. The payment should be for a definite amount, payable in a definite way, and on a fixed date.

About the only objection that can be urged against the general nature of this proposal is that dividend payments made after the end of the calendar year would not appear in the returns of taxpayers until a year later. Since the undistributed profits tax was enacted to force corporations to pay dividends, which would then become subject to personal income taxation, a provision was inserted requiring the dividend distribution to be within the taxable year. Thus if the corporation did not pay the government, the stockholder would.

This difficulty as to the revenue would, however, appear for one year only. After that the adjust-

<sup>5</sup> If this were done, a corresponding adjustment should be made for corporations reporting on a fiscal year basis.

ment would be made. Moreover, no revenue would be lost. Dividends declared after the turn of the year would simply be reported as taxable income twelve months later than they are now reported. It would seem then that there is no compelling social reason for denying an adjustment, the need for which is clear and the nature of which is reasonable.

### **DEFICIENCY IN THE INCOME REPORTED**

A second criticism levelled by business executives against the undistributed profits tax grows out of the difficulty of determining the income on which the tax is to be computed. The income reported by a corporation for purposes of taxation is not an absolute and easily determinable quantity. It depends largely on the selection or computation of the elements that go into the calculation. These elements in turn depend upon interpretation of the revenue laws and the tax regulations. Thus thousands of disputes arise between tax-paying corporations and officials of the Bureau of Internal Revenue. In the adjustment of these disputes, sometimes a deficiency is found in the corporate report and an additional tax payment is assessed.

The undistributed profits tax raises a new problem in this connection because when the deficiency is found, possibly years later, the time in which a dividend can be declared and a credit received has passed. Thus the corporation must pay not only the normal tax on the deficiency but the undistributed profits tax as well. This situation has given rise to a demand that the corporation be permitted to pay out the additional income to its stockholders and thereby be released from the liability to pay the tax.

The following extracts from various questionnaires explain and illustrate this difficulty.

A representative of a large oil company says :

There have been no unusual delays nor any lawsuits or proceedings before the Board of Tax Appeals, yet our final tax liabilities for the year 1929 to date are as yet not determined. It is my understanding that a similar situation exists with respect to most other oil companies.

A mining company :

This company has never been able to make a tax statement which has been accepted by the Internal Revenue Department without change, and we have been informed by one revenue agent, that he has never examined the books of a company of comparable size to our own company, and arrived at the same tax liability as was stated on the return. This is due to the vast complexity of the law which makes it impossible for two people of ordinary intelligence to take the same set of figures and arrive at the same taxable liability.

Another oil company :

In the case of large corporations, the determination of adjusted net income as defined by the Revenue Act of 1936, for the purpose of determining the amount of undistributed adjusted net income is generally a matter of delay for a number of years. For example, in the case of this company and its predecessor, its statutory net income has not been finally determined by the Commissioner of Internal Revenue for any year from 1923 to date. If this law had been in effect in 1923, we would have had no assurance that all of the adjusted net income for 1923 had been distributed as dividends in 1923. In many cases, these final determinations by the Commissioner of Internal Revenue are not made until many years after the returns are filed, and even after this determination is made, many points must be submitted to the United States Board of Tax Appeals and the courts for final determination. Thus, after the adjusted net income is finally determined it is too late for the corporation to declare dividends equal to any deficiency of income that may be determined, and as a consequence, the corporation is unable to avoid the payment of a penalty for failure to distribute income.

Some provision should be made (also) whereby a taxpayer who may be compelled to pay deficiencies in income taxes for prior years will be entitled to regard such deficiencies in taxes either as reduction of adjusted net income or as dividend credits for the year in which such deficiencies are paid. Under the present law, a corporation may be required to pay a penalty surtax by reason of paying income tax deficiencies into the federal treasury.

That disputes arise as to the income reported is indicated not only by these letters, but by the thousands of determinations pending before the Commissioner of Internal Revenue, the Board of Tax Appeals, and the courts. That no dividend-paid credit against the application of the undistributed profits tax can be received by the corporation for payments made from income determined by higher authority is evident from the provisions of the law. The credit status of the deficiency tax payment itself is not clear. It may be, as the oil corporation executive says, that such a deficiency payment is not a credit, and therefore is subject to the undistributed profits tax.

It might be argued that present provisions should stand as a penalty to corporations transgressing the reporting rules and regulations. But no one familiar with the requirements for reporting income can say seriously that they are of the clarity of broad daylight, and may be followed with certainty.<sup>o</sup> Rather, their meaning must be sought in darkness as well as light and especially in a baffling gray that is compounded of both.

Disputes as to income reported according to rules of unclear meaning are inevitable. Doubtless, attempts are made to cheat the revenue. Undoubtedly also returns are submitted in the hope that they will "get by." But after giving full weight to all returns that are off-color, it remains true that the mere existence of a deficiency in reported income offers not the slightest evidence of any fraudulent intent on the part of the corporation. The reversals that

<sup>o</sup> In this statement, there is no implication of blame. Difficulties of interpretation are in large degree inevitable.

the Board of Tax Appeals has given the findings of the Commissioner of Internal Revenue, and the reversals that the decisions of the courts have given the findings of both the Board and the Commissioner buttress this statement. Besides, in those instances where failure to report income is due to negligence or intentional disregard of rules and regulations, or to fraud, penalties are prescribed. It would seem that these should be sufficient.

A deficiency in reported income could be cared for by providing that any distribution of this income within sixty (or ninety) days after such finding would remove the liability for payment of the undistributed profits tax, and that a credit would be given for payment of the normal corporation income tax.

### **THE NATURE OF THE INCOME TAXED**

In examining the effects of the undistributed profits tax, it is necessary to understand that the net income subject to taxation under this act (and the normal corporation levy as well) is a concept of statute and regulation. It is not cash receipts minus actual expenditures. It does not signify money in the bank. In fact, it conforms not at all to the common man's notion of net income. And it departs also in essential ways from the business man's idea of net income.

Corporation officials were practically unanimous in condemning the rules for determining the net incomes on which their firms are taxed, though some variations appear in the remedies they propose. There are three issues on which their criticisms center: (1) the period for which income is to

be taken; (2) treatment of inventory gains and losses; (3) treatment of capital gains and losses.

1. *The period for which income is taken.* The emphasis in the law is on a one-year period. Losses on the operations of the previous year are not carried forward to offset net income during the current year.<sup>7</sup>

On this point a contracting firm says:

The corporation's business, general contracting, is a hazardous one. In every year, losses are sustained on some contracts. In 1936, a [large] loss, sustained on but one contract, was deducted. In 1931, a [much larger] loss . . . was deducted. The sum of these two losses exceeds the total taxable income reported for the years 1932 to 1936, inclusive. . . . It is unjust to treat each year as a separate period because business is continuous.

An engineering firm:

This company's contracts range in amount from a few dollars to many thousands of dollars; deliveries under the contracts range from shipments "off the shelf" to contracts requiring several years for execution. Even after delivery of a long-time contract, there are contingent obligations, sometimes legal, but always governed by commercial policy, that continue for long periods of time. The annual closing of the books, consequently, indicates to the management of the company little more than an estimate of the profits or loss for the year. Subsequent developments may greatly invade or augment these "profits or losses." To the Internal Revenue examiner, however, these figures indicate a definite amount of money available either for distribution or taxation.

A small iron company:

[It is] customary in blast furnace operations to set aside so much a ton during an operating campaign to take care of repairs when the furnace goes out of blast. This firm has only one furnace. So in good years, with the furnace in operation few repairs can be made, so deductions from taxes are small. But in bad years, the furnace is repaired and the large expenditures do little good in the way of deductions because earnings are too small.

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<sup>7</sup> With few exceptions, the law treats each year as a unit complete in itself. One exception is in the case of a payment of dividends in excess of earnings, where the excess can be carried over—within limits. Another permits the carry-over of prior losses for the determination of accumulated earnings. These exceptions, however, have nothing to do with the taxation of the earnings of a single year.



## A locomotive company :

The division of time into twelve months' periods is quite arbitrary and contrary to the nature of many business undertakings of large size. This is particularly true of such industries as the construction of buildings or other structures and in the fabrication of heavy equipment, much of which takes so much more than a year to build that it is entirely a matter of chance or arbitrary allocation as to which year enjoys profitable income from a particular project.

## A small steamship line :

In foreign trade many ocean rates are made with the large shippers on a contract covering a period of one year. In these times, of increases in labor costs, supplies, and particularly fuel oil, it is more than possible that these contract rates might prove uncompensatory during the year, resulting in a loss one year which might be offset by increased rates in the following year. In the coastwise trade in which we are engaged, where many of the rates are subject to the jurisdiction of the I. C. C., there is difficulty in increasing rates as fast as operating costs increase. We feel that the loss of a prior year should not only be allowed to be carried forward and applied to reduce the net income of the subsequent year for the purpose of the undistributed tax, but also for the income tax itself.

## A paper company :

Inasmuch as business moves in long-term cycles, which apparently have no relation to calendar or fiscal years, we believe that the practice of taxing all annual gains should be partially compensated by carrying losses forward. As a matter of fact, if gains are taxed annually and losses are not carried forward from year to year, this amounts to the imposition in profitable years of a very high rate of tax on total corporation incomes, which, as you probably know, fluctuate within a range which in many instances includes periods of substantial losses as well as periods of excellent profits. The average earnings may be moderate.

What can be said of this testimony? The facts reported cannot be denied. Indeed, they could be extended greatly. The industrial pattern within which corporate profits are earned is of infinite variety. It is subject to the vast upheavals of the business cycle, and to the rising or falling tides of changes in the general price level. Through it run the various cycles of individual industries, each

contributing its quota of disturbance to the mass. And at all times changes small or great appear from all sorts of causes.

In short, whatever the course of industry and trade in the large or in the particular, its movement is always subject to the "jitters." But in their adjustment to the unstable and shifting pattern of the economic order in which they function, corporations do not all fare alike. That fact is elementary. It is no accident that statements by snuff and cigarette manufacturers and by certain large makers of well advertised soft drinks did not come readily to hand when testimony on the matter of prior losses was introduced. Some corporations lead humdrum lives. Each round of the seasons finds that they have made money. The annual footing-up of accounts discloses variations in their earnings but never great changes. There is calm in the executive offices, and the stockholders are seldom exercised by the reports. Other corporations lead a more exciting kind of life. At times, profits come in like a racing tide; at other periods, they ebb so greatly that part of the accumulation of earlier years is taken. There are thrills and "blues" for executives and stockholders alike.

The point of all this, for the matter at issue, is that unless prior losses be taken into account, corporations will not be treated alike under the income tax law, even though taxed at the same rate. Of two concerns making equal total net incomes over a period of years, the one a steady income, the other a fluctuating income with years of gain interspersed with years of loss, the company receiving a variable return will be taxed more than

the other, *unless the years of loss are offset against those which are profitable*. This is a matter of plain arithmetic and may be shown by an example, as follows:

UNDISTRIBUTED PROFITS TAX FOR TWO COMPANIES WITH NET INCOME OF \$45,000 FOR FIVE-YEAR PERIOD

Year	Company A				Company B			
	Net Income <sup>a</sup>	Normal Tax	Undis-tributed Profits Tax	Total Tax	Net Income <sup>a</sup>	Normal Tax	Undis-tributed Profits Tax	Total Tax
First.....	\$10,000	\$1,040	\$1,042	\$2,082	\$10,000	\$1,040	\$1,042	\$2,082
Second.....	(D)50,000	—	—	—	(D)2,000	—	—	—
Third.....	100,000	13,840	17,663	31,503	15,000	1,590	2,017	3,607
Fourth.....	(D)20,000	—	—	—	10,000	1,040	1,042	2,082
Fifth.....	5,000	490	316	806	12,000	1,260	1,417	2,677
Five-year total...	\$45,000	\$15,370	\$19,021	\$34,391	\$45,000	\$4,930	\$5,518	\$10,448

<sup>a</sup> (D) indicates deficit.

This discrimination against industries of variable earnings (in general the "heavy industries") has existed since the carry-over of prior losses was no longer allowed in computing the normal corporation income tax. But it has been sharply accentuated by the undistributed profits tax, for now both taxes are laid on net incomes computed without regard to previous losses.<sup>8</sup>

What should be done? The answer to that question depends upon what is wanted. The analysis just

<sup>8</sup> It is of course recognized that in the absence of remedial treatment there will be a tendency for industries (through price changes) to adjust themselves to such an inequality of tax burdens but only through a painful and lingering process. In so far as variation is due to differences in location, skill in operation, foresight, or other factors of management, this process of adjustment will entail the elimination of less well managed companies, but as between industries some of which are inherently stable and others inherently variable as to their earnings possibilities adjustment will mean that the tax, though borne by the industry at the outset, will eventually be shifted to consumers; that is, the prices of the products of industries of variable earnings will have to be on a higher level than they would be in the absence of this tax.

given was for the purpose of presenting the issue. This issue, however, apart from its larger phases, has an immediate practical bearing on the recovery problem. In an economic situation in which recovery lags largely because the durable goods industries lag, it does not seem wise to discourage these industries further by levelling a discriminatory taxation policy at them.

What *can* be done? The practical difficulty here is that of obtaining adequate revenue. This need not be a fundamental trouble if a compensating adjustment be made elsewhere in the taxation system. But in the absence of such an adjustment, it would seem that losses in excess of income for three years prior to any year in which net income is reported should be deducted for purposes of the undistributed profits tax. This could be done on the theory—though a debatable one—that the normal tax is a business tax, and the undistributed profits tax is levied to compel the disbursement of corporate earnings to stockholders. But however the compromise mentioned be justified, it would seem to be the least that should be done in respect to this issue.

2. *The treatment of inventory gains and losses.* In the computation of net income, gains in the value of inventory are fully taxable and losses fully deductible. This problem is a special and violent phase of the question of prior losses. For clearer exposition of certain ways in which it may depart from the main issue, it is given separate treatment.

Protests on the matter of inventory gains and losses are so general, and the array of fact and argument submitted is so extensive that selection is difficult. An executive of a cotton mill states the prob-

lem so clearly in relation to prior losses that his testimony is given first:

Most businesses today use what we call the "lower of cost or market" method in valuing inventories. At the beginning of a depression period most businesses lose money and at the same time inventory values per unit decline, increasing the net loss still more. At the beginning of a period of prosperity the business makes a profit and at the same time the value per unit of the inventories increases due to the Treasury regulation holding that the "first in, first out" method must be used, therefore, the same quantity of goods in the ending inventory of the first profitable year may be valued at twice what it was at the beginning of the year. This results in a business paying a tax upon a fictitious profit or gain, because the net loss in the prior year, when this same quantity of goods was written down to market, cannot be carried forward as a deduction from gross income. Let us use the following figures to make myself clear as to what I mean:

The first year ending after the start of a depression period shows a net loss based upon inventories at cost of \$100,000. It had an inventory of cotton amounting to 2,000,000 pounds at both the beginning and the end of the year. It was valued at cost at the beginning of the year, or 10 cents a pound, a total of \$200,000. The market is 5 cents at the end of the year, or a total of 100,000.

Net loss or write-down to market	100,000
Total net loss for this year	<u>\$200,000</u>

The next year we will assume was a prosperous year and the value of the last purchase of cotton goes back to a cost of 10 cents (and the market on the date of inventory is even higher than this), and the company still has on hand the same quantity of inventory that it has at the beginning of the year, and further that it shows a profit based upon inventories at the end of the year being priced at the same value as was used per unit at the beginning of the year of \$100,000. Since the price per unit at the beginning of the year was 5 cents and at the end it has increased to 10 cents the increase is 5 cents per unit or a total increase of 100,000.

Net income	<u>\$200,000</u>
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From the foregoing you can readily see that the company lost \$200,000 one year and has made \$200,000 in the other. There-

fore, it has neither actually made or lost money to date, although it is compelled to pay a tax on a net income of \$200,000. The effect also is that it has actually paid a tax upon the write-up of the inventories.

### An economist in the tanning industry:

It is assumed in the law that net taxable income, as determined by present regulations of the Bureau of Internal Revenue, can be distributed or is available for the payment of taxes. That assumption may be correct for the majority of industries. *It is not correct for certain slow turnover industries processing, producing or fabricating basic raw materials, industries with inventories which are always the greatest or a substantial part of total assets.* In these industries the greatest part of income, under present regulations, may consist of nothing more than a change in the value of inventory. Such change in the value of inventory is not realizable income any more than a change in the value of plant or machinery would be. A change in the book value of inventory cannot be distributed; taxes cannot be paid with it. In order to pay dividends or taxes on such unrealizable, fictitious earnings, working capital would have to be dissipated. . . . The problem created for these industries is due to certain fundamental characteristics which distinguish them from the majority of industries.

1. Operating processes are continuous; the nature of these processes makes it difficult or impossible to interrupt or discontinue them.

2. Length of process makes turnover very slow. The process period may range from two to six or seven months. In the tanning industry, for example, turnover is often less than once a year.

3. Because the process is continuous, inventories which are often the greatest part of the assets, must be constantly maintained. In fact, inventories are as essential as fixed assets such as plant or equipment.

4. Raw material costs are the most substantial part of the selling prices.

5. Fluctuations in raw material prices directly affect the value of inventories, under present regulations. A substantial part of income, therefore, may be nothing more than a change in the value of inventory.

Industries of which the above characteristics are typical include: tanning of leather; smelting of non-ferrous metals; production and refining of petroleum.

In the above industries the sale of any material must be immediately replaced because operations are continuous and the basic inventory cannot be impaired. It is fundamental, therefore, in these industries that true taxable profit or loss can only be determined by the *difference between current costs and current sales*. If sales prices do not permit re-purchasing an equivalent

of raw material, then a loss is incurred; if sales prices are sufficient or more than equal to the cost of replacing the equivalent raw material, then a converting profit is earned. The general practice in the processing industries named above is to consider only such profit and loss as true income. . . . This practical and sound method of stating income in the group of processing industries under consideration has not, heretofore, been acceptable to the Treasury Department. It has been necessary for tax purposes to employ methods of inventory valuation wholly inconsistent with the basis upon which business is actually done.

An executive in a meat-packing firm resorts to an analogy:

Let us assume that in a period of rising real estate prices a man buys a home for \$5,000. Later he sells his home for \$8,000 and replaces it with an identical home for \$7,000. The price of real estate continues to rise and he is finally able to sell his property for \$12,000 and to replace it with one costing \$11,000.

If the home owner set up a profit and loss account at this point, his books would show a total "profit" of \$8,000 and he would probably feel elated. His inclination would be to spend more money and to increase his general scale of living. Yet on closer analysis he would find that he has the same kind of home he had originally and cash profit available for spending purposes of only \$2,000. In other words, his reported "profit" of \$8,000, as determined by the rules of accounting, consists of \$2,000 cash and \$6,000 inventory profit.

To carry the illustration one step further:

Suppose the owner failed to make a careful analysis of his actual position and set out to spend the total "profit" of \$8,000 shown on his books. In order to spend this sum of money he would have to borrow \$6,000. This he might be able to do and all might go well for a while. In the end, however, he would have financial difficulties to contend with. When the value of his home had declined—and a period of declining real estate prices has invariably followed one of rising prices—he would find himself saddled with a fixed interest-bearing debt of \$6,000 and a piece of real estate that had become greatly depreciated in value. He would also find that instead of spending "profits" of \$8,000 as contemplated, he had spent \$2,000 cash profits and \$6,000 of borrowed money. His inventory profits never became cash profits at all. They vanished as unexpectedly as they came, leaving only a trail of debt to mark their exit.

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## An executive in another meat-packing company:

I am, let us say, a small business man engaged in manufacturing a single specialty which we can call a "unit." For simplification let us omit all expense factors and detail. At the beginning of an accounting period my balance sheet stands:

	Capital stock	.....	\$100,000
Cash	.....	\$10,000	
Unit inventory	.....	40,000	
Fixed investment	.....	50,000	

We are in the advance of the business cycle and after a time I close my books to see how I stand. My inventory has been turned over at a sales price netting me \$65,000. My closing inventory in the same quantity of units stands \$61,000 due to higher labor and material costs. My accountant shows me an income statement:

Sales	.....	\$65,000	
Cost of sales—computed			
Opening inventory	.....	\$40,000	
Purchases and manufacturing cost	.....	61,000	
		<u>\$101,000</u>	
Less closing inventory	.....	61,000	40,000
Net profit	.....		<u>\$25,000</u>

And my balance sheet now reads:

Cash	.....	\$14,000	Capital stock	.....	\$100,000
Unit inventory	.....	61,000	Surplus	.....	25,000
Fixed investment	.....	50,000			
		<u>\$125,000</u>			<u>\$125,000</u>

Ha! Fine business! And I hasten to pay out \$10,000 in dividends. Of course I have to borrow it at the bank to keep working cash up, but what of that? I have the assets, haven't I—quick assets? Also, if I do not distribute some of this \$25,000 I shall pay the top bracket rate in taxation on the whole \$25,000.

In the next accounting period we swing over the cycle peak and into recession of market levels. And when again a full inventory turn has been completed our accountant hands us a new statement:

Sales	.....	\$52,000	
Cost of sales—computed			
Opening inventory	.....	\$61,000	
Purchases and manufacturing cost	.....	48,000	
		<u>\$109,000</u>	
Less closing inventory	.....	48,000	61,000
Net loss	.....		<u>\$9,000</u>

And my balance sheet:

Cash	\$18,000	Capital stock	\$100,000
Unit inventory	48,000	Notes payable	10,000
Fixed investment	50,000	Surplus	6,000
	<hr/>		<hr/>
	\$116,000		\$116,000

But regardless of cash position I am horror struck by the red income result. I must economize, reduce forces, restrict production. Dividends are out. And I owe the bank for \$10,000 of dividends which I now realize I should not have paid. (Actually the illustration does not take into account the further depletion of cash and surplus by taxes paid.)

Now what really has happened. In the first period I made a true profit—cinched in cash and expendable—of \$4,000 not \$25,000. The \$21,000 of paper profit if considered profit was not expendable *because already spent* for higher priced goods. Only by complete liquidation at that market level could I make good, as a distributable profit, the surplus exhibited.

And in the second period did I really lose \$9,000? No. I sold my goods for \$4,000 more than cost to replace and have the money in the bank to prove it. All that really happened was a \$13,000 shrinkage of former paper profits or reduction of the reserve contained in surplus for that very contingency.

Over the two periods and in net result I have a true and distributable profit net of \$8,000 and the expendable cash shows it. I have another \$8,000 (or would have in that \$16,000 surplus had I not paid any dividends) which still is in reserve as protection against further decline of inventory to the level or base from which we started.

Application to any business in whose profits inventories are a factor is exceedingly simple. . . . It is needed only to re-price the closing inventory on the prices effective at the beginning (the inventory investment base) and the difference in total value, if an increase, is paper profit to be reserved; if a decrease, it is paper loss to be charged against reserve.

These exhibits on the problem of changes in the valuation of inventories could be duplicated manifold—not in quality but in attitude and general drift of argument. While there can be no doubt of the difficulty, the question is: What should be done?

The corporation executive first quoted on this topic implies that the difficulty would be met by allowing prior losses to be carried forward, but the others all favor a change in the handling of inventory in the determination of net income for

taxation. One merely proposes some kind of special treatment of inventories. Another favors taking the difference between the current cost of the inventory item and the current sale price of the product processed from it. The third holds that the inventory at the end of the year should be re-priced as of the beginning, and that the difference between the values at the beginning and the end of the year should if an increase, be placed in a reserve against losses and, if a decrease, be charged to that reserve. The tax would then be laid only on expendable income.

These officials in general clearly have in the forefront of their thinking the situations of the established business where inventories are comparatively stable and where prices of such inventories tend, in spite of short-run fluctuations, to return to a somewhat stable level. We must remember, however, that there are also prices of inventory items which tend to show relatively permanent increases owing to exhaustion of natural resources or increase in production costs, or that show permanent declines owing to lowered costs of production or to substitution of a new product. There are also relatively long-run changes in volume due to speculative building up of inventories when price changes are anticipated and of depleting them when price declines appear to be in prospect.

Profits or losses from these causes are just as real a part of the net earnings of corporations as are those that arise from fabricating or merchandising operations. Rules devised to meet this problem as it appears in the business of the individual proposing them may be quite unsuited for general applica-

tion. Any remedial measure must be of a well-conceived general character. Such a proposal as taking merely the difference between current unit cost of inventory and current sales price of the product would not meet situations in which there are substantial changes in volume of inventory more than seasonal in character. Placing inventory gains in a special reserve account would come closer to the heart of the problem, but the administration of this or any other rule for the special treatment of inventory profit or loss would be rather complicated and present serious difficulties in actual practice. On the other hand, if the law were so amended as to permit the carrying forward of prior losses, this problem would automatically be reduced to manageable proportions. By this approach it would become possible for firms in the industries concerned to be given equal treatment with respect to one another, and for these firms as a class to receive the same treatment as that given firms in other industries. Ultimately, this means equal treatment for the customers of these industries.

The point made by several respondents to the questionnaire to the effect that inventory gains arising from either price advances or increases in volume are not liquid and available for the payment of taxes is valid as a general proposition. However, gains from this source cannot equitably be exempted while operating gains are being taxed. Hence the real issue merges into the general problem of corporate finance or how the necessary funds are to be kept available for the various needs by which corporation management is confronted. Since that question is discussed at some length in

connection with the corporate surplus, we need not pursue it further at this point.

3. *The treatment of capital gains and losses.* The two preceding sections have been concerned primarily with operating profit and loss. It is necessary now to turn to capital gains and losses. There is a question whether in the true economic sense such gains or losses are to be considered as properly falling in the income classification." No position is taken here on that question. The legal classification of capital gain as income is accepted for purposes of this analysis.

The corporation officials without exception, object to the existing treatment of capital gains and losses. The following statement by an executive of a cotton manufacturing company is a good sample of their opinion:

The present undistributed profits statute allows a deduction of capital losses not to exceed \$2,000 but taxes the full amount of the gains. This is neither reasonable nor fair. It results in some cases in taxing a company upon a gain or income when in fact, it may have lost considerable of its capital or surplus. Capital gains should be exempt from all income taxes, especially when held for more than three or five years, and at least from the undistributed profits taxes. If they are to be taxed at all, then the rate ought to be more in line with the old method of 12.5 per cent. If they were taxed at the normal rates only and exempt from excess profits and undistributed profits taxes, then the rate would more than likely be in the top bracket of the normal rates or 15 per cent. I believe even this rate to be too high, especially on assets that have been held for a great number of years, especially for more than ten years. I know for a fact that there would be sales made if the rate was in reason. As it is now the people and the companies cannot afford to sell properties even in order to pay off debts, because the tax would be so

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<sup>o</sup> A few references to the treatments of this issue are: Irving Fisher, "A Practical Schedule for an Income Tax," *The Tax Magazine*, July 1927; E. R. A. Seligman, "Income Tax," *Encyclopedia of the Social Sciences*, pp. 628-31. See also Elmer D. Fagan and C. Ward Macy (editors), *Public Finance*, p. 434.

high as to take most of the sale price, leaving the debt almost as high and the security much lower covering the balance of the loan.

The treatment of capital gains and losses in general presents one of the most intricate problems in the whole field of taxation. It is difficult both from the administrative standpoint and from that of economic principle. The larger aspects of this problem cannot be examined here. One phase only of this difficulty, the question of equal treatment, will be mentioned. Capital gains are taxed in full; capital losses, on the other hand, are deductible only to the extent of capital gains, plus \$2,000. Thus the law attempts a segregation of capital gains and losses from operating gains and losses, though the same rates of taxation, normal and undistributed profits, are applied to both types of income. The effect of this treatment is to introduce inequalities into the taxation of corporations, and under the undistributed profits tax greatly to increase their burden. Of two concerns having equal capital losses in a given year, the one having a capital gain equivalent to its loss, the other having no capital gain, the one may deduct its capital loss in full, the other may deduct \$2,000 only. Of two concerns having equal net incomes from operations over a period of years, the first sustaining no capital loss and receiving no capital gain, the second sustaining capital losses in some years that are just balanced by capital gains received in others, the first concern will pay a smaller income and undistributed profits tax than the second—assuming a similar dividend policy.

The fortunes of business firms in the economic struggle vary in respect to capital gains and losses, precisely as it has been shown that they vary with

respect to operating gains and losses. Some are at posts of hazard where almost anything in the way of capital gain or loss may happen. Others occupy safer positions and, consequently, gain or lose less ground.

A taxation policy that refuses to allow capital losses, save as compensated by capital gains, discriminates against individual corporate misfortune wherever found and, in general, discriminates against variable industries in comparison with stable industries. The economic effects of this discrimination, already given in the discussion of prior losses, will not be repeated. The solution is, admittedly, difficult. But it would seem that any way of taxation chosen ought to give capital losses equivalent treatment to gains. It should be noted that acceptance of this principle entails the carry-over of prior capital losses for the purpose of determining income.

#### **THE CORPORATE SURPLUS AND ITS USE**

Earnings not disbursed by a corporation go to the surplus account. It becomes necessary, therefore, to examine the nature and the uses of the corporate surplus, for clearly the undistributed profits tax is directed particularly to that item. The importance of this problem is emphasized by the fact, disclosed by the survey, that most corporations distributed a larger proportion of their earnings in 1936 than they would have distributed if the undistributed profits tax had not been effective. Of 684 corporate distributions given in the replies, 572 were larger, 110 were the same, and 2 were smaller.

In the balance sheet of a corporation, the surplus



appears on the liabilities side along with the capital stock, the bonded indebtedness, and other items that may be said to indicate what the corporation, considered as a business entity, owes these various interests. Viewed in the broadest sense, the surplus is the difference between the assets and the liabilities. It, or that counterpart of gloom, the deficit, is the residual that brings the two sides of the balance sheet into balance. Assets must equal liabilities, liabilities assets. The surplus (or deficit) makes this requirement of accounting effective.

The significance of the surplus is, however, not that of a residual only. The surplus represents proprietorship fully as much as the capital stock does. From the point of view of the stockholders, there can be no difference between the ownership indicated by the capital stock and that indicated by the surplus. Both stand for capital owned by the stockholders and invested by them directly, or through the agency of the management, for a return.

The things of value that the surplus represents appear, of course, on the assets side. There it may be represented by working capital (cash, negotiable securities, goods in process, inventory, accounts receivable, and the like), patents, trademarks, or good-will, or even by plant and equipment.

This surplus varies greatly in liquidity. When in cash, it is readily expendable and therefore fully flexible as to use. The management may set up special reserves from it, or the whole may be kept as a general reserve out of which provision can be made for each special need that arises. But as these needs are satisfied, cash is expended. Thus as a

lion dollars to finance the purchase of the vessels acquired. The reason for this is that the company, while paying regular annual dividends, has, up to the year 1930, annually put aside an amount necessary for expansion purposes and during this period has incurred debts which they have been able to pay off through earnings in excess of dividends and through the reasonable accumulation of surplus to meet not only the current needs of the business, but also provision for future capital requirements.

### A brewery :

Accumulation and maintenance of an adequate reserve for business expansion should likewise be one of the fundamental policies of this management, particularly in view of the fact that the brewing industry has had its rebirth only a few years ago. . . . The law of life is growth. Corporations which fail to grow from year to year in moderate proportion are doomed to extinction.

### A farm machinery manufacturer :

Every sound and progressive enterprise requires from time to time new fixed and working capital in its business. There is no method of obtaining such new capital which is so sound as the method of retaining earnings. While some enterprises can obtain needed new capital by the sale of additional common shares, their capital structure is weakened for capital cannot be depleted without replacement and every business should set by adequate reserves to meet cyclical and other losses. Also, the added expense involved may be considerable, especially for a small company. If, on the other hand, the enterprise is for any reason unable to sell additional common shares, either because of its own condition or general economic conditions, it may be forced to assume additional fixed charges. This is a factor making for instability in respect to both the enterprise itself and the general economic situation.

### A manufacturer of paper bags :

In the paper industry, as in many others, constant additional investments are required to meet changes in the art of manufacture or the demands of consumers. These additions to or improvements in plant facilities are frequent and costly. The cost must be met out of liquid reserves or current earnings. It appears to be impossible for any manufacturing enterprise to avoid a substantial penalty under this law for the privilege of remaining in business.

You will note that this statement refers solely to the capital expenditures needed to be efficient. The question of increased capacity is a wholly different matter and should be considered separately.

## An evaporated milk company :

The evaporated milk industry is peculiar in that (1) sales have increased by 30 per cent in five years; (2) any increase must be met by building new plants because the production of milk in any community is limited; (3) it is a new industry with improvements being made which cannot be timed but which ought to be put into effect as soon as possible after discovery. Thus a company must either keep reserves on hand or have a choice between borrowing regardless of money market or postponing improvement in the hope of a favorable money market, thereby possibly losing its position in the industry.

2. *Provision for lean years.* The question respecting this provision brought forth 968 replies; 901 of these corporations maintained surplus reserves for use in lean years.

## A building-fixtures company :

It has been the policy of the company for years to set aside a portion of its earnings to provide for the payment of wages and dividends in lean years. The wisdom of this policy was demonstrated during the recent depression. During that period the volume of business decreased 80 per cent. By drawing on its reserves, however, the company maintained its position and its employment was reduced only 50 per cent. During the years of the depression the company actually paid out of its reserve earnings more than \$10,000,000. Without these reserve earnings to draw on the company would have had to greatly decrease its payroll.

The present undistributed profits tax law will of course necessitate drastic changes in the company's policy of setting up such desirable reserves. This will greatly lessen its ability to pay wages and dividends during lean years.

## A clothing manufacturer :

Sound business judgment has always dictated the accumulation of working capital and surplus during periods of prosperity to carry through to lean years which inevitably followed. Organized personnel must be held together, plants maintained, and selling costs continued during these years.

## A manufacturer of machines :

We believe the tax is inconsistent with sound business policy. The machine tool industry fluctuates violently in demand. For example, our sales dropped from more than \$300,000 in 1929 to \$63,000 in 1932, and went back again to the high figure in 1936. It is impossible to make a profit in the lean years. We must

keep our key men, we must pay taxes, heat the plant, etc., and it cannot be done on a volume 16 per cent of normal. Unless the demand for machinery can be levelled, and we don't believe it can be substantially levelled, we must either accumulate reserves in the good years or go out of business in the bad ones. It is not a question of continuing to pay dividends or to maintain employment. If we do not build a reserve by withholding profits in prosperous years we will go into bankruptcy in the lean ones.

In addition to these uses of the surplus, corporation managers point to a great variety of other uses, each depending upon the particular character of the business. These will now be illustrated.

### 3. *General business needs.*

A large retail firm :

The amount of capital required in a retail business varies according to the prices of commodities and general conditions. If the cost of commodities in general goes up or when sales increase, the amount of inventories carried must be increased requiring a larger investment. Also as sales increase, accounts receivable from customers increase, requiring additional capital for this purpose. We naturally have to recognize these forces and make provision to meet them. Furthermore, there are certain months in the year in which our operations are carried on at a loss, and we must be in a position to absorb these losses in order to pass over into the profitable months. Because of the fluctuation in the volume of business during the course of the year, and also in the types of merchandise which must be carried, the amount invested in inventories fluctuates considerably, and we must at all times be in a position to meet peak requirements.

A contracting firm :

Our company has accumulated a reserve of \$250,000 in cash and marketable bonds, for the purpose of carrying out any contract for architectural metal work, however large it might be. In the contracting business, such a reserve is essential. Owners, architects, and general contractors rely on the adequate position of the subcontractor as a guaranty that the subcontractor will carry out his contract.

A bridge company :

We accept and agree to execute contracts for structural steel in all parts of the United States and foreign countries. Some of these contracts run to very considerable sums, and we feel that it is absolutely necessary if we are honorably to agree to complete

a piece of work that we have sufficient financial resources to do so even in the face of very adverse conditions. We are required to put up bonds running sometimes to a good many millions, and our own balance sheet must indicate resources that will justify a bonding company in agreeing to guarantee the performance of the work we contract to do.

### A leather firm :

Seasonal characteristics of our industry require large reserves. Summer calf skins represent the best obtainable raw materials for our product, and it is advisable to purchase these when available and stock up for future use. There are also large price fluctuations, which are hazardous to the business, not only causing a need for larger working capital during prosperous periods but also to provide for losses in periods when prices are falling.

### A distilling concern :

It should be borne in mind that with the inception of repeal and because of the very limited stocks of whiskey available to meet the new demand for alcoholic beverages, we were confronted with the necessity of producing stocks of whiskeys and other alcoholic beverages not for immediate consumption but to be warehoused and properly aged to meet the demands of future years. This naturally required an amount of working capital which could not be used as a basis of determining the amount that might be required in subsequent years after adequate stocks had matured to meet current demands.

## 4. *Research.*

### A printing firm :

Such outstanding developments as the whole synthetic resin industry, most of our chemical industry, and many important developments in the moving picture industry have come about because companies have had adequate reserves to develop and commercialize the developments of their technical staff with plant and personnel. Otherwise, they would have died in the laboratory.

### A naval stores manufacturer :

All during the depression years the company retained its chemical research staff in full. The results of the developments by this staff require the accumulation of a reserve to provide commercial facilities to produce new allied products from present raw material, which products would diversify the company's business and secure its position against economic changes in the industry that affect the selling price of the basic products.

## 5. *Patent protection.*

A firm supplying machine parts :

Business is highly competitive; any person or firm who has developed a new or successful article is always faced with the situation of others who seeing that success in the marketing of an article will pirate or imitate that product, or bring an action against that firm for an alleged infringement of patents, which necessitates said person or firm being amply protected by their own patents, and also to have a reserve sufficient to cover court and legal costs in presenting their case in court, whether this action brought against them is just or not.

Citing our own case, this has happened to us; an action was filed against us by a competitor who was much larger and more powerful financially than we, which complaint was proved in court to have been without just grounds. If at this time we had not had sufficient funds with which to cover costs to successfully present our case in court, we would have had to liquidate all our assets to satisfy claims for alleged damages, which would have put us out of business.

## 6. *Obsolescence.*

Officials from various industries testified on this point.

A cotton mill :

The charges for depreciation, which are at present allowed by the government, take little or no account of the factor of obsolescence, which is a far more formidable enemy to modern industrial equipment than is ordinary wear and tear through usage, and which is ordinarily covered by the factor of depreciation.

A metallurgical corporation :

The act is especially inequitable as applied to businesses where obsolescence is a serious factor. Since obsolescence cannot in all cases be provided by any charge-off similar to depreciation, the only practical method of providing against obsolescence has been by the accumulation of a surplus as a "cushion" against charge-offs to the property account, which must be made from time to time.

A bleaching and finishing firm :

In our business, the obsolescent factor on account of style is an unpredictable element of expense which frequently renders equipment useless before it is worn out.

A canning company :

Inherent in the canning industry are certain migratory characteristics. The production of canned peas in various sections presents

an interesting illustration of this. By comparison with the ten-year average, 1921-1930, Minnesota's production in 1936 was 204 per cent, as contrasted with Wisconsin's 48 per cent and New York's 40 per cent. In 1934 Washington and Oregon produced 5 per cent of the total national pack of canned peas. In 1936 their production was 384 per cent of the 1934 figures and represented approximately 20 per cent of the national pack of this product. Wisconsin produced 52 per cent of the total nation-wide pack of canned peas 1921-1930; in 1936 it produced 24 per cent of the national total. The pack of canned peas in New York State averaged 2,274,000 cases during the ten-year period 1921-1930. The 1936 pack was 899,000 cases.

Only a few years ago this company's predecessor operated a group of four plants in what was then a pea-producing sector of New York State, where it was then believed that peas could be grown and packed economically. In recent years it was necessary to abandon the operation of these plants as economically unpracticable. In other sections of the country . . . as well as other localities in New York State, crop and growing situations in recent years have changed so radically that this company has abandoned expensive plants at all of such locations because such changes prevented their further economical commercial operation.

In 1932 when this company took over the properties of the predecessor corporation it was considered necessary to set up reserves sufficient to write off completely property values at twenty locations representing original aggregate acquisition costs or appraisal values of over 3 million dollars. The company has since disposed of its interest in such properties at thirteen locations for sums representing purely salvage or scrap valuations. Although abandoning properties at certain locations, this company has found it necessary to explore new fields in hitherto untried states, such as Texas and Maine. It becomes evident then that the element of obsolescence affecting canning plants enters strongly into the picture. To insure permanency and soundness of its business the canner should be permitted in years when earnings are available to establish substantial reserves and to absorb the losses on such large investments when the scene shifts and the properties become worthless. Cannery should further provide themselves with reserves for necessary expansion and new construction when it is thus necessary to shift operations from one section to another. Investments of this type in new plants and equipment do not necessarily represent expansion. They may merely represent a new investment of capital to replace production no longer available at previously operated properties and hence necessary if the business is to continue to go on.

### A hotel:

Very few industries indeed have the courage to apply adequate charges for obsolescence as well as depreciation. If properties to

which these charges are applicable have been acquired out of surplus earnings a board of directors' or a stockholders' meeting will adopt a much more liberal policy in this respect than where such plant has been acquired by the sale of securities, whether these securities be stocks or bonds. It is desirable in my opinion that the manager of an industry should have the greatest possible freedom in scrapping plant or equipment, which either by age or changed conditions in industry, has become less efficient than when purchased and this can only be afforded to such a manager if he is free to use the greater proportion of the profit of his industry for that purpose. As a practical matter, regulations of the Treasury Department and the practices of accountancy will not permit adequate reserves for obsolescence and depreciation in any business with which I have been connected and that covers a good deal more than the operation of [this] company. May I take just one concrete instance which appears to me to show very plainly what I have in mind?

When the . . . hotel owned by this company was built there were no telephones in bedrooms. Shortly thereafter old-fashioned wall telephones were installed. Shortly after this the wall telephones were taken out and desk sets installed. Not long after this the old-fashioned desk sets were unsatisfactory and new modern instruments with the receiver and earphone in one piece were put in. At the time each of these changes were made, the existent equipment was just as good as when first installed but it was completely antiquated. The modernization of this equipment did not increase by one per cent the earning capacity of the plant but merely maintained it where it was before. I believe a charge for this sort of work should be made directly against the earnings and should not in any way be capitalized. No one can tell when such improvements are to come and any estimate of the life of such equipment is the purest guesswork. The only safe financial policy for an industry is to have large reserves of earning from which such things can be absorbed without increasing the capital structure.

This account of the uses of surplus reserves in modern business is by no means exhaustive. There are reserves to cover losses on the creation of subsidiaries, to pay taxes, settle court judgments. A considerable number of companies use their surplus to stabilize the sale price of their products.

An official of an export corporation injects a monetary note:

Exchange fluctuations may mean the difference between a successful year and a highly dangerous one. No one will dispute



the necessity for setting aside reserves to meet unforeseen monetary restrictions, devaluations, and other actions unpredictable in the money markets of the world today.

This survey of the uses of reserve or surplus funds has been made for the purpose of showing the manifold problems confronted in the financing of modern business. We turn now to examine the evidence as to the effect which the undistributed profits tax appears to exert in facilitating or impeding a program of sound financing.

### **THE TAX AND THE CORPORATE SURPLUS**

Not all the corporation officials reported that the undistributed profits tax has unfavorable effects on their accumulation of a surplus.

A large bridge and iron company offers this comment :

We are not much affected by the tax on undistributed earnings, but we feel very sorry indeed for our competitors, and for young men who might have the initiative, energy, and courage to try to start a business these days.

A casket maker observes :

To an old, well-established company such as ours, the undistributed profits tax will not probably for many years be a serious handicap, but it will undoubtedly prevent the growth of our small competitors, and in that way it would be a very considerable advantage to us, but in my opinion an absolutely unfair one, and certainly our company has never desired any unfair advantage over competitors.

Paralleling these are many references made by weaker firms to the fortunate situation of competitors fat with surplus accumulation. The overwhelming body of testimony on the effects of the tax relates, as would be expected, to firms that have felt adverse effects. This will be presented under substantially the same headings as those followed in discussing the uses of the corporate surplus.

## 1. *The financing of business expansion.*

### A small electric company :

The financial condition of this company is sound. It has a good earnings record. But the tax has raised a problem with respect to a new plant. If the tax were not in existence, earnings would probably have been used for that purpose and a new plant built. But, as matters stand today, we have not yet decided to build the plant and one of the principal reasons a decision has not yet been reached is because it would appear necessary to raise perhaps a half million dollars of additional cash to carry out the building program by the sale of additional common stock to stockholders, general public, or both. Naturally there is some question about the advisability of increasing the amount of outstanding stock on which the company will need to earn in future years, and also the unfavorable condition of the securities market raises numerous problems even if we decided to make a stock offering.

### A candy firm :

Very substantial plans for the early part of this year in the line of radical improvements and additions in mechanical equipment and the like were abandoned. . . . Our architects, prominent industrial ones . . . told me the other day that their business had fallen off substantially due not to high prices but to the unwillingness of their accounts to proceed with new buildings in the face of the undistributed profits tax.

### A feed manufacturer :

Last year we had intended to build additional storage providing for one million bushels of grain, however, as the cost would have had to come from our surplus earnings, due to the undistributed earnings tax our entire expansion program had to be abandoned. Our only hope to expand will have to come with the relief offered by removal of the burden imposed by this tax or from a reorganization, which of course would cause us a considerable hardship.

### A nut company :

We need to expand our plant badly but we do not feel that we can pay 25 per cent for the privilege of using earnings for this purpose. Therefore, we do not plan to expand our operations until we are able to raise new capital under favorable terms. Formerly we reserved a reasonable part of our earnings to provide for the orderly expansion of our business.

### A brewery :

In the past we have made all improvements, including new buildings and purchase of new equipment, from earnings. It has

been necessary for us, since this tax has become effective, to analyze each new improvement and ascertain whether the returns from such improvement would be sufficient to offset the amount of tax to be paid upon the undistributed earnings applied to such purpose. This has held up an expansion program and as a result thereof we have contracted for no new buildings or no new equipment.

### A manufacturer of glass machinery:

It may interest you to know that just this morning we have had an informal meeting to determine what we should and could do in regard to purchasing considerable new machinery for our plant. Our superintendent and his assistants have made recommendations for the purchase of new machinery to replace some of our older machines and these expenditures call for an investment of approximately five or six times the amount of the annual depreciation charge on machinery as allowed by the Income Tax Bureau. If we purchase this machinery, it means that 80 per cent of the money must come out of our surplus account, or must be retained out of our current year's profits. We hesitate to spend any of our surplus for machinery as we feel that the surplus should be used to carry on the business and to give employment to our men during lean periods. On the other hand, if we retain some of our current year's profits, it means subjecting these profits to the undistributed profits tax, which in reality means that the cost of the machinery is increased by the amount of the undistributed profits tax. So no matter which way we try to turn, we meet with discouragement. The net answer is that our decision this morning was to cut down and reduce the amount that we will appropriate for purchasing new machinery. This is not good business for us, neither is it good business for the machinery manufacturers.

An economic system which over the years produces an enlarging flow of goods and services must be characterized by a growth of production facilities. And it is unthinkable that these additional facilities should be made available solely by new companies. While new concerns will doubtless be launched, it is equally certain that established firms will expand their facilities. The problem of the effect of the undistributed profits tax on the up-building of corporate surplus has special reference to the status of existing enterprises. The wisdom of particular expansions made by these firms may

be questioned; the existence of the surplus from which part of these improvements is financed may be challenged; but there can be no question respecting the economic legitimacy of providing for business expansion in a dynamic industrial society. In this respect, the corporation managers are clearly on solid ground. Whether other sources of such funds are available is a question which will be examined presently.

## 2. *Provision for lean years.*

An engineering and contracting firm says :

The "tools" of this business are its trained technical personnel. This company entered the depression with a comparatively large, and liquid, surplus much of which was spent in maintaining its organization. Unless this company can replenish its surplus during active business periods, it is inevitable that it cannot maintain its organization in depression periods. It appears that WPA, PWA, and similar organizations may get some highly trained engineering specialists during the next down-turn in business.

A manufacturer of machine parts :

The tax is a blow at sound business policies because it prevents us from building up reserves to carry us through depressions, which will work a hardship on our employees, our stockholders, our customers, and our sources of supply. During the depression we made every effort to keep our men employed by sacrificing profits in order to obtain business. We could not have done so if we had not built up reserves. We gave thousands of dollars to our employees who were out of work through no fault of their own; and we could not justify such action under the 1936 law. If a company is not allowed to build up reserves it must sell stock, and it is quite impossible to sell stock at a reasonable price during a depression. For example: our common stock has sold as high as 35 in 1929, and it sold at 29 in 1935. During 1933, it sold as low as \$2 per share, and at times there was practically no offer at any price for the stock on the New York Stock Exchange. Although our preferred stock has an unbroken record of payments since the time of issue, it sold as low as 45. If our company had not built up reserves, it could not possibly have come through the depression without a creditors' agreement or bankruptcy; and the bankruptcy of our company would involve many other companies.

A characteristic demand arising in lean years is

for the maintenance of dividend payments. Of this need, a large publishing house says:

This company's earnings are now below preferred stock dividend requirements. The firm has a reserve from which dividends could be paid but hesitates to use it because of the heavy tax that must be paid in order to replace the reserves used for this purpose. In the past reserves have been used to pay dividends.

#### A chemical company:

This company paid a dividend annually. After the passage of the Revenue Act of 1936, it reduced the payment and finally discontinued it. Nevertheless the Revenue Act was partly responsible for the discontinuance of the dividend. Our directors were unwilling to continue disbursements from surplus when it became apparent that our reserves could not be re-established from anticipated earnings in the future without incurring considerable cost in taxes.

There are two kinds of lean years: those that arise from causes peculiar to individual firms or industries; and those that follow the collapse of the prosperity phase of the business cycle. The legitimacy of providing for the first kind of lean years out of earnings is not to be denied. Unless a firm with variable fortunes provides for the ordinary vicissitudes of its type of business, it can scarcely hope to maintain itself as a going concern. In any event it will be at a serious disadvantage in comparison with firms of stable fortunes. To hold that such provision should not be made for the variable industries is in effect to favor the stable industries. The second phase of this problem—the business cycle—will be touched on later in our consideration of large general issues.

#### 3. *General business needs.*

Provision clearly has to be made for a miscellany of "general business needs." Moreover, owing to a multitude of influences, the activities of a business

enterprise are in a process of continual change, a fact that argues strongly for some flexibility in the provision for financing these activities. This flexibility is now, in considerable degree, provided by the corporate surplus, particularly when it is liquid. The question whether it could be provided by other means awaits examination. It is sufficient here to note that the requirements of modern business call for flexibility of financial provision in respect to general business needs.

Research and obsolescence present a particular case of general business needs, representing the birth and death rates respectively of the techniques of industry. Research is one cost of doing business. Money expended for the research department is treated as other expenditures of a business nature, that is, deducted in the computation of the net income on which the tax is laid. The difficulty then arises in connection with the decision whether to venture profits on undertakings of a research or exploratory nature that lie outside the routine duties of an established division of the enterprise. A corporation official speaks so much to the point of the matter that his testimony is given:

The most destructive effect of such a tax is to completely stifle all progress. Any operator is all the time looking for new markets, or new methods of manufacturing his product, or methods to eliminate waste. Much of this investigation and development takes a good deal of money. Quite often very large amounts of money are spent on developments, the results of which are not profitable. A business man is willing to venture a profit on such development but is afraid very often of venturing capital. If profits are not available for progressive development, a business enterprise is apt to come to pretty much of a standstill.

It would seem also that in the decision on undertaking a costly research venture, the element of

calculation introduced by the tax would come strongly into play. The cost of retaining earnings is high, and the outcome of the project hazardous. On the other hand, the excellent study of the undistributed profits tax made by Willard L. Thorp and Edwin B. George found that a small percentage of concerns increased their expenditures because of the tax.<sup>30</sup> This finding may not apply to the large ventures that the business man quoted had in mind.

In a machine-made economic society, the discovery of the new and its effects upon the old are familiar facts; since such developments cost money, financial provision for them is an unquestionable need of the modern corporate enterprise and a tax which renders provision for these and other growth needs more difficult or expensive can be justified only if benefits in other directions clearly outweigh this burden.

Obsolescence, like research, is a cost of doing business. It is recognized in the income tax regulations as a deductible item. In view of this fact, it is rather difficult to account for the stress laid by the corporation managers on the problem. For if the obsolescence of a machine is fully covered, there should be, assuming profits, a sufficient deduction available to pay any loss from this cause. The problem may, however, arise out of the difficulty of recognizing and determining obsolescence in a situation of rapid technical change. The only opinion expressed here is that obsolescence, being a cost, should be deducted as a cost. The place to allow for it is in the expenses, not in the earnings

<sup>30</sup> "An Appraisal of the Undistributed Profits Tax," *Dun's Review*, September 1937, p. 13. Referred to hereafter as the Dun and Bradstreet survey.

of the business. The allowance should, of course, be adequate.

4. *New industries and weak firms.* All the difficulties of the tax that relate to the corporate surplus are accentuated for companies in new and developing industries, and for those with impaired capital. The testimony of the corporation executives is emphatic on both situations, and particularly voluminous and vehement when treating the problems of firms in a weak financial position or with an impaired capital structure.

An aircraft manufacturer says :

The tax definitely affects us in the solution of the creation of a reserve for business expansion. Without the undistributed profits tax our current profits would go a long way towards providing a reserve for business expansion. With the undistributed profits tax we are forced to pay such a high rate of tax that practically nothing is left for business expansion. As a result we find that new capital is needed from time to time to take care of the rapid expansion and development of our business, and as yet we are not certain whether it is more advantageous to sell additional capital stock and pay the usual commission, or retain our current profits and pay the high rate of tax. Either method is very costly to the company.

A motor vehicle company :

This company lost money in its operations during the years 1930, 1931, 1932, and 1933. In 1934 the company broke about even. We made a little money in 1935, and had a fairly good year in 1936. However, our reserves have been practically wiped out and our books today show that our surplus is only approximately \$41,000.

We do not have an accumulation of any reserve for business expansion, due to losses in prior years and large dividends paid in 1936. Further, under the 1936 Revenue Act we will be unable to accumulate reserve for business expansion in future years, except by withholding payment of dividends and by paying of heavy penalty imposed on such action. All previous reserves were used up in depression years.

A building materials firm :

This firm lost \$500,000 from 1930 to 1934. In 1935, it broke even; in 1936, it made, after depreciation, \$70,000. The working



capital is depleted. But it was required to pay a normal tax of \$9,000 and an undistributed profits tax of \$11,000.

### A maker of stone and metal-working tools :

It seemed ironical to us that after having losses for five continuous years that we were forced in order to save tax payments, to pay a dividend in 1936, the first year which has shown a profit. Therefore it was impossible for us to start during 1936 a reserve for lean years or years of losses. We had to borrow \$5,000 more at the bank in 1936 in order to replenish our working capital after payment of said preferred dividends.

### A small corporation—unidentified as to product :

This company has a [large] deficit. . . . In 1937, based on the first quarter showing, it should earn \$90,000. On this amount a state income tax of \$5,400 is due, leaving a federal basis of \$84,600. The normal tax on this is \$11,530, and the undistributed profits tax \$14,978 or a little over 31 per cent of the net income subject to federal taxes.

The company cannot legally pay a dividend; on this basis five years would be required to wipe out the deficit. During this period, the company would pay about \$75,000 in undistributed profits taxes, and a total of all federal and state income taxes of \$160,000. The money required on investment and equipment needed to meet competitive conditions would not be available.

### A plating concern :

This company, capitalized at \$400,000, at the end of 1935 had a deficit of \$270,000. In 1936 it earned \$170,000. All this amount should have been applied to debt payment, but the tax law required a dividend payment if a heavy penalty was to be avoided. On the other hand, the Delaware law made it illegal to distribute a dividend on the impaired capitalization. The company, therefore, reorganized its capital structure and paid dividends.

### An iron works :

Our company, following the panic of 1929, has lost over half a million dollars. This loss not only wiped out all of our surplus laid up in prosperous years, but has left us badly in debt. Now, due to the fact that we are in debt, on our small net earnings which we made last year for the first time since 1929, we are obliged to pay the government 27 per cent rather than 13.5 per cent, because we were obliged to apply these earnings on our indebtedness and could not distribute these earnings in dividends.

### An electrical manufacturing company :

We have one subsidiary, organized under the laws of Illinois, with an impaired capital, that had fairly substantial earnings in

1936. Under the laws of Illinois, dividends cannot be declared from current earnings if the capital of an Illinois company is impaired. Therefore, this subsidiary was compelled to retain all of its current earnings and pay a federal income and undistributed profits tax thereon at the full combined rate.

One manufacturing company presented detailed figures showing ten years of operation, only one of which yielded a profit, with the company at the end of the period with its surplus dissipated, capital seriously impaired, large arrears of preferred stock dividends, and heavy loans from officers and directors. The unpaid interest on these loans alone amounted to several hundred thousand dollars. The year 1936, however, showed a substantial profit for the company. In view of its back debts "no responsible board of directors would declare a dividend on account of arrears on preferred stock even if there wasn't a big deficit to prevent them from legally doing so." But if the profits of 1936 were not distributed as dividends the undistributed profits tax would claim over \$100,000 (even after taking advantage of a small exemption granted under Section 26(c) relating to contracts restricting payment of dividends) in addition to some \$150,000 of regular corporation income and excess profits taxes. The official of this company concludes :

It has been figured that under the present status the company will be obliged to pay approximately \$600,000 in undistributed profits taxes before its financial condition will permit it to pay a single dollar in dividends to stockholders who have not received dividends for over 12 years.

#### **WHAT IS THE ACTUAL BURDEN OF THE TAX?**

It is obvious that the undistributed profits tax impedes to some extent the customary practices of corporate management in providing for their financial needs in large measure by "plowing earnings

back into the business." But just how drastically it operates in this direction will not be clear unless we bear in mind not only the progressive rates and definitions already set forth on pages 2-3, 9, 12, 15, but also some further details as to credits given and exemptions made. These delimit the actual effects of the tax.

In the computation of the undistributed net income on which the tax is laid, corporations are permitted a deduction in respect to contracts restricting payment of dividends. In addition to this general credit allowed corporations coming under the act, special credits are allowed holding company banking affiliates and national mortgage associations. And, as has been remarked, banks, joint stock land banks, insurance companies, foreign corporations, corporations in bankruptcy under federal law or insolvent and in receivership under state law, China trade corporations, and corporations deriving a large proportion of their gross income from sources within a possession of the United States are exempt.

It will be observed that the application of the tax is broad. Mining, manufacturing, transportation, communication, and trading corporations, both wholesale and retail, are all included, except as they may be bankrupt, or insolvent and in receivership. Indeed, the only important groups of corporations excluded are banks (including joint stock land banks) and insurance companies. Banking affiliates of the type excluded are unimportant; there are only about 35 in the United States.<sup>11</sup> And no

<sup>11</sup> E. C. Alvord, "Current Trends in Federal Finance and Taxation," *The Tax Magazine*, July 1937, p. 318.

national mortgage association comes within the provisions of the act.

The heart of the provision for relief, however, as seen by management, is the credit for contracts restricting payment of dividends. The provision of the law (26c) by which this credit is defined is reproduced below:

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.

(1) PROHIBITION ON PAYMENT OF DIVIDENDS. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) DOUBLE CREDIT NOT ALLOWED. If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

The regulations of the Bureau of Internal Revenue for effectuating these provisions of the law are, of necessity, "tight." Note for example such wording as in (1) "*provision of a written contract*

*executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends*"; and in (2) "*which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt.*" One does not need to be a lawyer to appreciate the restrictive effect of these provisions.

The corporation officials, as would be expected, generally complain that these "relief" provisions afford their companies no relief. One, a manufacturer of paper specialties, sums up the general attitude so effectively that his is the only testimony given:

Section 26 (c) of the Revenue Act of 1936, as interpreted by the present Regulations (94) offers us no relief although we have fixed obligations (bonds) which must be retired annually. As a matter of fact the present requirements of the Treasury Department practically preclude any corporation from obtaining any relief under this section of the law. The Treasury regulations with respect to the payment of dividends, require that the contract (a) must be in writing; (b) must be executed by the corporation; (c) before May 1, 1936; (d) must deal expressly with the payment of dividends; and (e) must restrict the payment of a dividend in some ascertainable amount, and at the same time foreclose the payment of a dividend in any other form. Furthermore, the Treasury has ruled that restrictions upon dividends contained in the charter of a corporation are not effective because the charter is not executed by the corporation. This is an example of the extremely literal interpretation of the statute being followed by the Treasury. Again, the Treasury has held that the contract must expressly prohibit the payment not only of cash dividends but of stock dividends as well. Considering that such contracts must have been executed prior to May 1, 1936, and that at May 1, 1936, stock dividends were considered to be non-taxable (the Koshland case was decided May 18, 1936), it can be readily understood that practically no contracts are in effect that can afford relief on this basis. The typical debtor-creditor contract does not deal with stock dividends by name, and therefore offers no relief under the present regulations. This is illustrated by a ruling of the Bureau of Internal Revenue

published January 18, 1937 (XVI C. B., No. 3, p. 2). That ruling involved a mortgage indenture which was, in part, as follows:

"The company agrees that so long as any of the bonds are issued and outstanding it will not pay or declare dividends on its issued and outstanding capital stock, unless, after such dividends are declared and paid, there shall remain in its treasury sufficient funds over and above all charges and indebtedness of the company to pay all installments of interest and principal on the bonds hereby secured for the period of 12 months after the time fixed for the payment of any such dividend or dividends . . ."

It will be noted that the contract expressly dealt with the payment of dividends, and, as applied to the facts, it prohibited the distribution of any of the company's earnings for the year 1936. Notwithstanding these facts, the Bureau denied a credit for the following reasons:

". . . In other words, it seems clear in the instant case that the basic purpose of the dividend restriction in the indenture is to prevent any distribution which would deplete the assets of the corporation adversely affecting the bondholders. This would apply not only to cash dividends but also to distributions made in property other than in the corporation's own capital stock. Unlike dividends in cash or other property, a stock dividend of the declaring corporation 'takes nothing from the property of the corporation, and in no way depletes its assets.' . . . Therefore, such a dividend in the instant case would not operate injuriously to the bondholders. It is believed, therefore, that the provisions of the bond indenture relating to 'dividends' should be construed as prohibiting payment of all dividends except stock dividends . . ."

Neither is it practical, nor in all cases possible, for a corporation to change its corporate structure so as to permit the payment of taxable stock dividends.

The same situation exists in connection with the credit on account of contracts which require earnings to be applied to the discharge of debts. Such a contract (a) must be in writing; (b) must be executed by the corporation; (c) before May 1, 1936; (d) must expressly deal with the disposition of earnings of the taxable year; and (e) must require the corporation within the taxable year to pay, or irrevocably set aside, a portion of the earnings and profits of the taxable year for the discharge of a debt incurred before May 1, 1936. The Treasury has ruled that no relief is afforded where the contract merely requires the corporation to retire a certain amount of bonds annually or to maintain a sinking fund sufficient to retire all or a percentage of the bonds by maturity or to pay into a sinking fund for the retirement of bonds an amount equal to a certain percentage of gross income or gross sales. In our particular case we have to retire a fixed amount of funds annually and the refusal of the Treasury to consider such an agreement as affording relief from the undistributed profits tax works a distinct hardship on us.

These expressions of corporate sentiment could be multiplied indefinitely. The officials find little relief in these provisions, which presumably are intended to afford relief, and therefore complain. At the moment, however, we are not interested in the problem of relief. That awaits consideration later. For present purposes, it is sufficient to note that the effects of the tax are limited but slightly by the statute and the regulations. They operate over practically the whole area of corporate enterprise.

With the breadth of its application indicated, the specific question arises: Does the undistributed profits tax operate to prevent the satisfaction of the needs which we have already examined and approved? Two possible situations need to be distinguished. If all the earnings of corporations, other than the normal income, capital stock, or excess profits taxes paid to the federal government, can, in practice, be retained upon the payment to stockholders of taxable "paper" dividends; or if the undistributed profits taxes paid to the government can and are readily replaced by money from new capital issues; then clearly the tax can have no effect on the satisfaction of needs now financed by the corporate surplus. There would be a change in the means of financing these needs and in the cost of doing so, not failure to make provision for them. But if capital cannot be obtained to replace earnings paid out in undistributed profits taxes, then a more serious situation is presented. We shall examine this alternative first.

The undistributed profits tax operates to reduce the proportion of net earnings kept by corporations either through payment of the tax to the govern-

ment, or disbursement of the earnings to shareholders. But it may do more; it may operate also to lessen the net earnings reported by corporations. The table on this page (reproduced from the Dun and Bradstreet survey<sup>12</sup>) shows various types of expenditures which a group of corporations reported having increased in 1936 as a result of the undistributed profits tax and an estimate of similar increases which they contemplated making in 1937 for the same reason.

INCREASED EXPENSES ATTRIBUTED TO TAX, BY SIZE OF CONCERN,  
1936 AND 1937

Item	1936				1937 (Expected)			
	All <sup>a</sup>	Small	Medium	Large	All <sup>a</sup>	Small	Medium	Large
Number of concerns...	618	176	210	160	708	186	221	177
Percentage of concerns								
Not reporting increases <sup>b</sup> .....	51	45	48	59	50	43	48	65
Reporting increases <sup>b</sup> .....	49	55	52	41	49	55	51	33
Reporting increases in specific expense items:								
Bonus to officers.....	23	25	30	14	24	29	29	12
Salaries.....	26	30	28	21	30	35	31	20
Bonus to employees....	28	29	34	21	26	30	30	15
Wages.....	23	24	25	24	28	30	29	23
Advertising..	13	18	14	11	18	22	16	12
Maintenance	13	11	17	10	15	16	16	10
Obsolescence	4	6	6	2	5	8	5	1
Research.....	7	7	7	11	10	7	13	10
Other.....	2	1	2	4	4	1	2	6

<sup>a</sup> Small companies, capital and surplus below \$200,000; medium, \$200,000 to \$1,000,000; large, more than \$1,000,000. Includes a small number of concerns not classified by size.

<sup>b</sup> There were 10 concerns which for 1937 reported "don't know," as follows: small, 3; medium, 3; large, 4.

<sup>12</sup> *Dun's Review*, September 1937, p. 13.



Approximately half of these concerns reported increases in their expenditures. Although various items were increased, the chief preferences to higher taxation were centered in wages, salaries, and bonuses. Despite the difficulty of separating increases deriving from the tax from rationalized explanations of such increases, it seems reasonable to suppose that a substantial number of these increases were made because of the tax. How far such increases were in the interest of the corporation, and how far in other interests we shall not inquire. At all events, something new is indicated here in the distribution of corporate income.

Examination of the effect of the tax on the uses to which reported earnings are put may well begin by noting the arithmetic of the situation. The tax, at the maximum, takes 20.5 per cent of the retained earnings of a corporation. Thus at least 79.5 per cent of such earnings remains in the corporate treasury. The tax, therefore, cannot entirely prevent satisfaction of the corporation's needs ordinarily supplied out of surplus. And if the corporation would, without the tax, pay out part of its earnings to shareholders, the effect of the tax, owing to the dividend-paid credit, is less. It is somewhat less, too, for companies with adjusted net incomes of less than \$50,000, because of the specific credit not exceeding \$5,000 allowed these smaller enterprises.

But in noting the percentage of retained earnings taken by the tax, it should be recalled that the corporation must, in addition, pay an income tax, a capital stock tax, and may pay an excess profits tax. The sum of the normal and the undistributed

profits taxes on income absorb, as we have observed (page 5), approximately 32 per cent of the total net income. The undistributed profits levy, therefore, more than doubled the burden on income laid by the normal tax (15 per cent maximum).

Giving due weight to the limitation on the percentage of earnings which may be taken, it still remains true that the charge is heavy, and that in common with all other uniform taxes that bear upon unlike situations, the effect of this tax varies. Recall, for example, the range within which the financial position of corporations fluctuates. At one end of the scale are established concerns, the financial strength of which proved impregnable to the depression; at the other are weak companies that may suffer from under-maintenance of equipment, a low cash position, or even an impaired capital structure. A levy of 20.5 per cent of retained earnings or a total of 32 per cent on all earnings imposed in respect to a company rich in surplus accumulations, especially cash, may, as some officials have testified, exert no cramping effect. Or the result may make for a distribution to stockholders of earnings not needed by the corporation. A similar levy, however, on a weak firm struggling with its problems, all of which cost money to solve, may impose a serious hardship. The testimony of one official on this matter is so much to the point that it is included:

We find that the impact and effect of this tax varies almost entirely in line with the financial condition in which a company happened to be at the time the law was enacted.

For example, a company which on January 1, 1936, had accumulated an adequate surplus and continues to have normal earnings, has not as yet been seriously affected and can continue to meet its capital requirements from such accumulated surplus and

secure its dividend-paid credits by continuing normal distributions from current earnings.

Another company which, although it had no such surplus at the beginning of 1936, is faced with a serious problem by the surtax only to the extent that its plant and equipment require rehabilitation. If its capital needs are nominal, it can usually maintain its plant by a retention of 10 per cent of its distributable earnings at the 7 per cent rate. On the other hand, if its plant was in bad shape at the time the law became effective, it must either rehabilitate the same by the use of current earnings at a large surtax cost or it must go into the financial markets for new capital funds. It must face the same dilemma if it desires to expand or construct new plant facilities.

The third type of corporation is the one most seriously affected by the surtax. This company found itself, on January 1, 1936, with a large capital deficit which had accumulated during the depression years and much of which was actually expended to maintain continued employment for the company's laborers. Under the laws of most states, such a corporation is prevented from declaring dividends from current earnings until such earnings have replenished its deficit position. Plant rehabilitation and expansion are impossible and it must either remain with capital impaired or pay a surtax penalty for retaining current earnings to eliminate its accumulated red deficit.

The corporation managers testified to numerous hardships of various kinds brought on by the tax. In evaluating their statements, it should be recognized that, being opposed to the tax, they would be inclined to interpret the difficulties of their firms as due to it.

Still, it seems impossible wholly to discard the testimony of these officials—recognizing, as one must, that the tax is heavy, and still assuming that the inroads made on earnings by it or the forced dividend distributions can not be repaired by acquisitions of fresh capital. That we have not yet had full recovery from the world depression is obvious. Its effects have not been distributed impartially over the economic system but have borne with particular severity upon building, railroad, and industrial equipment industries and lightly upon

sugar, tobacco, and trade-marked soft drink industries. It has been established beyond a doubt that in general the durable goods industries suffered most in the depression and the consumer goods industries least. This fact entails recognition, under the assumptions made, that the undistributed profits tax is having significant adverse effects over a large and important area.

These effects are severe on companies with an impaired capital structure. The laws of practically all states forbid a distribution of earnings to stockholders when the capital of the corporation is impaired. The officials of such companies are caught between the requirements of federal taxation and of state law. If they pay a dividend, they violate the state law, and become subject to its penalties; if they obey the state law, the tax must be paid to the federal government—and at the maximum rate.

In many instances, and perhaps usually, there is a technical way out. The capital stock may be written down. Thus the deficit, a residual item, is made to disappear from the books, a dividend can be paid, and the tax avoided. No doubt, sometimes the writing down of the capital stock and the resulting erasure of the deficit are justifiable actions irrespective of the undistributed profits tax. But this kind of free bridge is technically free only. It does not follow that such a way out should be used by all companies with impaired capital in order to avoid paying an undistributed profits tax to the federal government. In the first place, the dividend paid, if it actually removes any significant proportion of the tax liability, must be much larger than the tax would be. Thus the capital structure of the

company is likely to be distorted by such tinkering. In the second place, the corporation may have creditors the security of whose loans is being undermined by the policy of paying out all the earnings to stockholders. We need not enlarge upon the effects of such a policy if followed generally in an economic system that functions largely on a credit basis.

Another element in determining the effects of the profits tax concerns the processes of calculation involved. In arriving at net income for purposes of the normal corporation income tax, there are, of course, elements of calculation. But once that income has been determined, the corporation has no further calculation to make. The income tax attaches at a specific rate or rates, and no course of action will avoid it. The only calculations that remain are those of the Bureau of Internal Revenue in checking the accuracy of the reported income.

The difference between the normal tax and the undistributed profits tax in respect to calculation is that upon the determination of the base of the normal tax, all calculations on the part of the management end; and at the same point, for the undistributed profits tax, they begin. Suppose we recall the schedule by which the undistributed profits tax is applied, or perhaps turn to page 2 and study it. If a corporation pays out 90 per cent of its earnings, and keeps only 10 per cent, it pays a tax of but 7 per cent on the amount retained. At the other extreme, if it keeps all its earnings, it must pay 20.5 per cent. Different rates apply by brackets within this range. Thus the second 10 per cent

retained costs 12 per cent; the next 20 per cent, 17 per cent; the 20 per cent after that costs 22 per cent; and for the final 40 per cent, the cost is 27 per cent.

This scale was devised, in accordance with the theory of the tax, to impose increasing charges upon the retention of larger proportions of earnings, thereby assuring that they would be paid to stockholders. Except for such distribution and corresponding dividend-paid credit, this tax would simply be another levy on the income of corporations.

The business man thinks in pecuniary terms. Both his costs and his sales appear in dollars, and the profit (or loss) computation reports the result of his operations in dollars. The imposition of the tax according to a scale of graduation is therefore peculiarly adapted to obtain a response from the mind of the business man. By this means the problem of taxation is put in familiar terms; this tax is not a fixed cost about which nothing can be done; it is a variable charge fluctuating between zero and 20.5 per cent, and the business man has the decision as to what it shall be. Of course there are bounds to the game that must not be exceeded. But this is true also of other variable costs. To decide within the bounds laid down by the rules of the law, the market, or the custom of the community is nothing new to the business man who directs the play.

What effect does this element of calculation have on business decisions? We have already observed its appearance in the testimony of several officials, who said that their firms compared the cost of retaining earnings with the profit to be derived from investing them in plant improvements, and elected

not to make the improvement. If any significant share of earnings is retained, the cost of retention is higher than the usual rate of corporate profit. It may not meet the approval of the stockholders if the earnings of the company are ventured at high cost upon an enterprise that yields small profit. And among the various interests that the decisions of management may serve is its own. On the other side of the question, it may be observed that earnings retained, even at the expense of 20.5 per cent, are held on terms of this cost for one year only. And the profits which they might earn, if invested, could conceivably be received for many years, subject, however, to the effects of the undistributed profits tax. A positive conclusion on this point is not possible but the opinion is ventured that the element of calculation operates to increase the distribution of earnings to stockholders, and therefore to decrease the relative share budgeted to improvements.

The belief, based on the element of calculation and other grounds, that the undistributed profits tax has checked the expansion and improvement of corporate facilities is in agreement with the conclusion arrived at by the Dun and Bradstreet survey:<sup>13</sup>

Since the evidence presented earlier is that payment of dividends increased appreciably in 1936, while the retention of earnings was reduced, we can assume that plant expansion as well as rehabilitation has been slowed down by the new law, as compared with its potential. This is attested by so much evidence from so many other sources that it is hard not to give it credence.

As to the problem of providing for research and obsolescence, some may hold that the element of

<sup>13</sup> *Dun's Review*, September 1937, p. 22.

hazard ought to deter a board of directors from undertaking enterprises of this kind. But that question opens up a large issue; accordingly, it is reserved for consideration later. At this stage of the study, it is sufficient to note the probability, or at least possibility, that the undistributed profits tax operates to discourage large research and exploratory enterprises involving considerable risk.

#### **THE POSSIBILITY OF OBTAINING NEW CAPITAL BY OTHER MEANS**

Having noted the effect of the tax in encouraging the distribution of earnings to stockholders rather than their retention for meeting various financial needs of the corporation, the question arises whether such needs cannot be met as they arise through new financing."

Three ways are open to a corporation seeking additional money for its business: under the 1936 act, earnings may be retained free of the tax upon the payment to stockholders of taxable rights, scrip, or other "paper" dividends; the money may be borrowed from a bank; an offering of securities may be made to stockholders, or to the public.

The general emphasis of the replies is that no one or combination of these ways is satisfactory. The objections begin with the cost and risk involved, and end with the impossibility of retaining or obtaining money by any of these means. Moreover, the practice respecting the payment of dividends in 1936 supports the objections. To the question whether the corporation changed its practice as to

<sup>11</sup> This recognizes, of course, the fact that the management has the decision in the distribution of earnings and that a choice in favor of retention and payment of the tax operates also, though in lesser degree, to reduce surplus earnings.



the type of dividend paid in 1936, a total of 743 of the 860 officials replying said that their corporations had made no change. A few said that a change might be made in the future.

The difficulty of obtaining capital from sources other than surplus earnings is indicated in the following statements by corporation officials.

#### An oil company :

The argument has been put forward in favor of this law that a company can always get temporary working capital by borrowing from the bank, or permanent working capital by an issue of stock. This may possibly be good enough theory, but anyone whose memory recalls conditions in 1930, 1931, and 1932 will know with what success such attempts would have met during the depression.

The law is worse for those industries faced with the dilemma of retaining a fair portion of their earnings in the business, at the cost of paying a punitive and ruinous tax so as to be prepared for a sudden demand for necessary working capital, or avoid the payment of the tax by distributing all their earnings and thereby leave themselves high and dry when the sudden demand for working capital arises. To say that such capital can be provided temporarily by bank loans or permanently by issue of stock is no solution. If the bank loan is resorted to, and is carried over from one year into the next, then the portion of the next year's profit that is applied toward paying off the bank loans is still subject to the tax. A stock issue is likewise unsatisfactory. The market may not be propitious at the time the money is needed, and the cost, time, trouble, and general inconvenience in complying with all the requirements constitute a serious deterrent. Furthermore, an issue of common stock provides permanent capital which may not be needed, whereas an issue of debentures or redeemable preferred stock will entail payment of the undistributed profits tax on any earned profit used to pay off the debt or the preferred stock.

#### A chemical company :

Remember that under our new security laws, it is quite properly very difficult to obtain money from the public for speculative purposes. Also remember that the high surtaxes paid by very wealthy men have eliminated any incentive for these men to finance such new developments.

#### A motor car maker :

The very existence of this tax hinders the securing of new capital in the form of a stock investment and is a definite hindrance

in . . . the securing of funds from banking connections or in borrowing them in the way of bond issues from the public. Public financing of a corporation that has distributed its earnings and impaired its cash position is, at best, extremely difficult.

### A large cigar manufacturer :

Fresh capital through underwriters and public offering is available only to a comparatively limited few corporations. The small or locally known corporation does not have this market for additional capital open to it. Forcing corporations to rely for growth on such public offerings will work to the benefit of the few larger and internationally known corporations and toward putting an effective brake on the growth of all the rest.

### A locomotive maker :

Much can be said with respect to the propriety of capitalizing earnings retained within an enterprise. This is a difficult procedure, however, due to the Supreme Court decisions on the taxability of stock dividends. The Treasury Department rulings have helped to clarify this situation somewhat, but there is still a great deal of doubt as to what dividends paid in capital stock, even when of another kind or grade, are taxable in the hands of the recipient and what are not. Due to the necessity for paying such dividends in capital stock of another kind or grade from that upon which the dividend is payable, it is frequently difficult to create a market for such other capital stock sufficiently active to permit the recipient to sell such stock at a reasonable price for the purpose of raising funds with which to pay his income tax. A further complication is created by the inability to determine the dividend-paid credit allowable to the distributing corporation on a dividend paid in capital stocks, which credit is measured by the fair market value at the time of distribution of the security used for dividend purposes, regardless of its par value or the amount transferred from surplus in respect thereof. In other words, the inability of the recipient to find a ready market for such securities reacts not only upon him but upon the distributing corporation itself, in the determination of the dividend credit to which it is entitled.

Corporations that have obtained new capital by issuing securities also find that this method of obtaining capital has disadvantages.

### A paper specialties manufacturer says :

We had no obligations outstanding before the tax became effective except a small serial note issue, part of which must be paid back regularly each year regardless of taxes. It did, however, affect our plans for new financing after the tax became effective. We had already planned on a considerable expansion which was

necessary. We could have gotten money from a bank to be repaid in five years at a very low interest rate, and we would have gotten it that way except for the undistributed profits tax. This tax would have made it very, very expensive if we had borrowed the money from a bank for five years because the amount necessary to pay back to the bank each year would have been so heavily taxed. We finally decided on preferred stock with no maturity date and no sinking fund provision, the dividend rate of which was considerably higher than the bank rate would have been.

### A motor vehicle firm:

By withholding dividends and retaining the net earnings of the company, which are estimated at \$250,000 for the current year, in the business, its capital requirements could be satisfactorily met, but to do this would involve the payment of approximately \$80,140 undistributed profits tax.

Rather than pay such an exorbitant premium for capital, the directors have decided to secure additional capital by increasing the preferred stock of the company. Under existing conditions the larger stockholders are unwilling to increase their investment in the business and as a consequence, the new stock to the amount of \$300,000 will be sold to brokers at a discount of not less than 10 per cent plus the expense of legal fees, engineers' reports and other incidental expenses.

In one instance the undistributed profits tax is operating to continue a receivership.

### A paper manufacturer says:

Since receivership, the company has experienced a revival in business and a much better market for its product. Having had interest charges lifted and adjusted, it is now making money and should be shortly in position to propose a satisfactory plan of reorganization to its creditors and its stockholders.

The question now arises as to whether it would be advisable to submit a plan of reorganization promptly, or whether it would not be preferable to continue in receivership for a longer time because when reorganization plans are submitted and approved the company would immediately become subject to the undistributed profits tax under the act of 1936, and as these profits could not be distributed they would be lost through the imposition of additional taxes.

It would seem, therefore, to me that a company in our position would have a definite advantage over its competitors in remaining in receivership as long as possible.

Analysis of this problem of obtaining capital from outside sources after earnings have been disbursed

in dividends may well begin with practices of corporations respecting the payment of dividends. We need to know the forms in which dividends were paid in 1936, the first year in which the undistributed profits tax was effective, and what changes in the forms of payment are forecast. The table below gives information on this point.

FORMS OF DIVIDEND PAYMENT BY SIZE OF CONCERN, 1936 AND 1937<sup>a</sup>

Type of Payment	1936				1937 (Expected)			
	All <sup>b</sup>	Small	Medium	Large	All <sup>b</sup>	Small	Medium	Large
Number of concerns...	479	101	175	143	414	100	147	127
Percentage of concerns using specified types of dividend payment:								
Cash only.....	86	80	84	89	80	67	76	92
Cash and other forms.....	9	10	9	10	12	17	14	6
Other forms only..	5	10	7	1	8	16	10	2
Other forms:								
Option.....	2	1	2	3	6	9	5	4
Stock.....	6	9	7	4	9	16	11	2
Obligations....	6	9	7	3	5	7	7	1
Other.....	1	1	2	1	2	1	2	2

<sup>a</sup> *Dun's Review*, September 1937.

<sup>b</sup> Small companies, capital and surplus below \$200,000; medium, \$200,000 to \$1,000,000; large, more than \$1,000,000. Includes some companies not classified by size.

This table indicates that both the small and medium companies pay a smaller percentage of their earnings in cash than do large companies. Moreover, both the small and the medium companies expect to decrease the percentage of their dividends which is paid in cash to total dividends while the large companies expect to increase that percentage.

The change in the type of payment expected may reasonably be explained for small companies by the

ease with which their stockholders can meet and agree to accept dividends in forms other than cash. It is possible that the large companies did not find the distributions given in other forms to be satisfactory, or doubts as to the legality of these substitutes may have assailed the companies. It would be too bad to pay dividends in some form other than cash and then have the Supreme Court hand down a decision years later holding the form chosen to be non-taxable to the stockholder and, therefore, not available to corporations for purposes of a dividend-paid credit.

But whatever explanations may be given for the variations in the table, the important fact, for purposes of this analysis, is that corporations capitalized at more than one million dollars do not find option, stock, or other "paper" dividend payments satisfactory. And this includes practically all the important corporations and by far the greater part of the corporate business of the country. Berle and Means found that in 1930, the 200 largest corporations controlled 38 per cent of the business wealth and 49 per cent of the corporate wealth of the country, other than banking. The smallest of these corporations had gross assets of 90 million dollars.<sup>15</sup> Corporations below one million are relatively small in the business world of today.

It is important to note in this connection that weak companies, whether large or small, would have the greatest difficulty in making a payment of the paper kind on terms at all satisfactory. And these

<sup>15</sup> Adolph Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, p. 32. The comparison between gross assets and the total of capital and surplus is not "on all fours" but sufficiently valid for the purpose.

are the very companies that need most to retain their earnings.

With corporations in general distributing a larger percentage of their earnings because of the tax, and with corporations representing by far the greater part of the corporate wealth of the country planning to pay a larger proportion of their earnings in cash in 1937 than in 1936, it follows that we must examine the accessibility of sources of new capital. Each of three possible sources is to be examined: bank loans, issuance of "rights" to stockholders, and an offering of securities to the general public.

Bank loans may be had by those who have the proper security to offer. But the requirements of security are on the whole strict. Loans are for strong companies, not for weak ones. Moreover, banks prefer loans of a quick turnover, of a commercial nature. Some corporations, particularly mercantile ones, require credit of this kind. But for most corporations, as has been indicated, the range of uses for funds is much wider. It may be said then that bank credit is available as always but on strict terms both as to security and use, and that on the whole these terms do not meet the needs of corporations. Credit from this source, therefore, cannot be substituted to any great extent for earnings paid to stockholders or to the federal government.

In order to obtain information on the practicability of corporations' obtaining additional capital by issuing rights to their stockholders, or securities to the general public, Senator Steiwer sent a questionnaire to a selected number of investment bankers, including some small as well as large firms.

Then the Securities and Exchange Commission, at his request, prepared several tabulations on the cost of issuing securities.

The general problem of issuing rights to stockholders is described by an investment banker.

The procedure incident to financing through rights is as follows: The issuance of such rights necessitates registration of the new securities under the Securities Act of 1933, and also registration under the Securities Act of 1934 if the new securities are to be listed. Preparation of the registration statement and accompanying prospectus necessarily calls for a great deal of time and careful effort on the part of the company's staff and counsel. A period of several weeks is usually necessary to prepare the accounting, financial, and other data required. Balance sheets, income accounts, and detailed accounting information as of a recent date, certified by independent accountants, must be incorporated in the registration statement, which necessitates an audit of the books by the accountants. Ordinarily the rights are underwritten in order to insure that the company will obtain the necessary funds if the stockholders fail to exercise the rights because of unfavorable market fluctuations or other causes during the offering period, and the terms of the underwriting must be negotiated with the underwriters.

Notice must be given to stockholders of the impending financing, in accordance with Stock Exchange procedure, rights prepared and issued, and arrangements made with the transfer agents for the issuance of rights and new securities. There are numerous other matters to be attended to, such as calling of stockholders meetings in some instances, preparation of new securities, filing of charter amendments, etc., all involving a large amount of legal detail.

After the registration statement becomes effective, which is usually twenty days after filing, a prospectus is mailed out to the stockholders, and an additional period of some twenty days is usually allowed to the stockholders in which to exercise the rights. From the time of beginning the draft of the registration statement until the exercise of the rights, a period of from eight to twelve weeks may elapse.

Considerable accounting, legal, and printing expenses are necessarily incurred in the preparation of the registration statement, prospectus, and the various other documents, the amount of which will depend upon the magnitude of the operations of the company. The amount of the financing is not usually the determining factor in the cost of registration. Substantially the same accounting, legal, and printing work would be involved, whether the financing in a given example were \$2,500,000 or \$500,000.

In addition to the registration and issuance expenses, there are also, of course, the underwriting expenses, the amount of which

will depend upon the size of the financing, the attractiveness of the security to be issued, the degree of risk involved, market conditions, and the nature and extent of the obligations incurred by the underwriters.

This account of the procedure in issuing rights, aside from the attention that it gives to the time involved, the state of the market, and other elements, points out the two general types of expense involved: the underwriter's commission (if the issue is to be underwritten); and the legal, accounting, printing, and other costs.

Through the courtesy of a large investment banking house, underwriters' commissions on 18 offerings of common stock by corporations to stockholders were obtained. These commissions on stock subscribed to by warrant holders ranged from 1.5 per cent to 5 per cent of the subscription price of the issue. The range for stock purchased by the underwriters was from 1.70 to 5.88 per cent.

Four other investment banking firms not only provided information on the underwriting commission for offerings to stockholders but gave other expenses as well. For 8 mortgage and debenture issues, this total cost ranged from 1.9 to 5.3 per cent of the offering price; for 29 offerings of common stock, the range was from 3.1 per cent to 16.8 per cent of the subscription price. For both types of securities, the cost of issuance was lower for the large issues than for the small. The smallest debenture issue, \$4,200,000, cost 5.3 per cent; the largest, \$151,500,000, cost 2.3 per cent. The smallest capital stock issue, \$224,000, cost 13.5 per cent; the largest \$32,000,000, cost 3.3 per cent.

Three tables, made available through the courtesy of the Securities and Exchange Commission, give



the cost of public offerings of securities. They are presented on pages 74-79. The first table gives the expenses, other than underwriting commissions, for issuing the principal types of securities. The second table gives the underwriting commissions but does not give the other costs. The third table completes the series by giving the total cost of issuing securities. In it these costs are classified by the security offered and the size of the issue.

The principal cost of issuing securities to the public is the underwriting commission. This cost is higher for preferred stock than for bonds, and higher for common stock than for preferred. During the three years ended June 30, 1937, the underwriting commissions on bond issues of 5 million or more for the various periods ranged from an average of 2.08 to 3.72 per cent; on preferred stock issues of 1 million dollars or more, from an average of 3.97 to 9.78 per cent; and on common stock issues of 1 million or more, the range of average costs was from 13.11 to 19.62 per cent.

The total cost of issuing securities to the public varies with the kind of security offered and with the size of the issue. The cost in relation to these factors is given in the third table.

Turning now to another element in the problem, that of credit rating, we find, from a tabulation prepared by an investment banker, that concerns of low credit rating must pay more for their capital. This expense is particularly large when the offering is small. A tabulation of common stock offerings by such concerns disclosed a cost ranging from 14.67 to 28.58 per cent.

EXPENSES, OTHER THAN UNDERWRITING COMMISSION AND DISCOUNT, OF FLOTATION OF SECURITY ISSUES OF MORE THAN \$1,000,000 IN SIZE OFFERED FOR SALE DURING YEAR ENDED JUNE 30, 1937<sup>a</sup>

Type of Security and of Expense	Expense		
	In Thousands of Dollars	As Percentage of Total Expense	As Percentage of Total Offering Price
<b>Bond, debenture, and note issues (140 issues with public offering price of \$1,813,800,000):</b>			
Registration fees.....	227	1.61	.01
Revenue stamps.....	2,106	14.95	.12
State qualifying fees.....	430	3.05	.02
Transfer agent, registrar, etc....	2,506	17.79	.14
Printing and engraving.....	2,622	18.60	.15
Sub-total.....	7,891	56.00	.44
Legal.....	2,858	20.28	.16
Accounting.....	1,326	9.42	.07
Engineering.....	361	2.56	.02
Other.....	764	5.42	.04
Miscellaneous.....	890	6.32	.05
Sub-total.....	6,199	44.00	.34
Grand total.....	14,090	100.00	.78
<b>Preferred stock issues (61 issues with public offering price of \$382,100,000):</b>			
Registration fees.....	40	1.44	.01
Revenue stamps.....	339	12.23	.09
State qualifying fees.....	183	6.60	.05
Transfer agent, registrar, etc....	144	5.19	.04
Printing and engraving.....	520	18.75	.13
Sub-total.....	1,226	44.21	.32
Legal.....	841	30.33	.22
Accounting.....	326	11.76	.09
Engineering.....	48	1.73	.01
Other.....	70	2.52	.02
Miscellaneous.....	262	9.45	.07
Sub-total.....	1,547	55.79	.41
Grand total.....	2,773	100.00	.73

<sup>a</sup> Prepared by the Securities and Exchange Commission for Senator Steiwer.

EXPENSES, OTHER THAN UNDERWRITING COMMISSION AND DISCOUNT, OF  
 FLOTATION OF SECURITY ISSUES OF MORE THAN \$1,000,000 IN  
 SIZE OFFERED FOR SALE DURING YEAR ENDED JUNE 30, 1937<sup>a</sup>

(Continued)

Type of Security and of Expense	Expense		
	In Thousands of Dollars	As Percent- age of Total Expense	As Percent- age of Total Offering Price
Common stock issues (92 issues with public offering price of \$246,300,000):			
Registration fees.....	27	0.85	.01
Revenue stamps.....	206	6.56	.08
State qualifying fees.....	90	2.86	.04
Transfer agent, registrar, etc....	355	11.30	.14
Printing and engraving.....	473	15.06	.19
Sub-total.....	1,151	36.63	.46
Legal.....	880	28.02	.36
Accounting.....	506	16.10	.21
Engineering.....	62	1.97	.03
Other.....	219	6.97	.09
Miscellaneous.....	324	10.31	.13
Sub-total.....	1,991	63.37	.82
Grand total.....	3,142	100.00	1.28

In view of all this testimony, submitted both by the investment bankers who underwrite issues of securities and by the Securities and Exchange Commission that regulates their issuance, it cannot be doubted that the cost barrier erected by the undistributed profits tax between the corporation and new capital is a most important one. This charge is particularly burdensome on small issues, common stock issues, and issues by concerns having low credit rating. Some corporations have to choose between retaining their earnings and paying a tax of

20.5 per cent for the privilege, or paying out their earnings and obtaining capital to replace this money at an equivalent or greater cost. Moreover, apart from the question of costs, it is difficult, time consuming, and often impossible for many corporations to procure capital in the investment market for their varied requirements.

It is sometimes argued that if the economic system is to be operated with maximum wisdom and efficiency, business enterprisers should be compelled to obtain all their funds in the financial markets. The point is that their own plans for expansion would thus be subjected to the impartial criticism of detached bankers and investors. A partial answer to this lies in the fact that the investment market prefers seasoned securities, especially those of larger corporations. Hence much of the capital required by companies, both large and small, particularly for experimental and developmental work, must come from their own funds if it is to come at all. Moreover, it may well be questioned whether investors and bankers always make more intelligent decisions than the corporate managers. There have been abuses in the corporate management not only of investors' earnings but of the companies' own capital. But it can hardly be said that the record of bankers and investors in guiding the flow of funds into productive enterprise is altogether a recital of intelligent conduct.

The requirement is not that *all* investment money should be directly provided by the corporate managers themselves but only that the proper exercise of individual judgment and the maintenance of necessary flexibility in business enterprise cannot be

GROSS SPREADS ON PUBLIC OFFERINGS DURING THREE YEARS ENDED JUNE 30, 1937<sup>a</sup>

Period	Bond Issues of \$5,000,000 or Over		Preferred Stock Issues of \$1,000,000 or Over		Common Stock Issues of \$1,000,000 or Over	
	Number of Issues	Average Spread (Percentage of public offering price) <sup>b</sup>	Number of Issues	Average Spread (Percentage of public offering price)	Number of Issues	Average Spread (Percentage of public offering price)
July 27, 1933—Dec. 31, 1934.....	7	3.72	..	.....	..	.....
Jan. 1, 1935—June 30, 1935.....	14	2.79	7	6.78	2	19.62
July 1, 1935—Sept. 30, 1935.....	23	2.33	..	.....	..	.....
Oct. 1, 1935—Dec. 31, 1935.....	22	2.45	..	.....	..	.....
Jan. 1, 1936—Mar. 31, 1936.....	15	2.33	4	9.78	11	17.30
Apr. 1, 1936—June 30, 1936.....	32	2.18	12	7.12	11	15.38
July 1, 1936—Sept. 30, 1936.....	19	2.13	4	3.97	16	13.11
Oct. 1, 1936—Dec. 31, 1936.....	33	2.19	13	5.32	10	15.60
Jan. 1, 1937—Mar. 31, 1937.....	14	2.21	12	6.10	12	15.19
Apr. 1, 1937—June 30, 1937.....	10 <sup>c</sup>	2.08	9	5.30	23	13.12

<sup>a</sup> Prepared by the Securities and Exchange Commission for Senator Steiwer.

<sup>b</sup> From July 27, 1933 until March 31, 1937, data for bonds are expressed as percentages of face value, but this basis is roughly similar to public offering price since most bonds are sold at or close to 100 per cent of principal amount.

<sup>c</sup> Including one serial bond issue, with a spread of .87 per cent. Excluding such issue, the average would be 2.22 per cent.

ESTIMATED COST OF ISSUANCE OF SECURITIES TO BE OFFERED FOR CASH SALE, EFFECTIVELY REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION DURING 1935<sup>a</sup>

Type of Security and of Expense	Size of Issues					
	Less than \$500,000	\$500,000 to \$1,000,000	\$1,000,000 to \$5,000,000	\$5,000,000 to \$10,000,000	More than \$10,000,000	All
78 Stocks, certificates of participation, and beneficial interest						
Number of statements.....	101	27	41	6	5	180
Cost of issuance as percentage of public offering price:						
Commission and discount.....	17.7	20.6	9.8	7.8	6.1	9.0
Other expense.....	1.7	1.4	1.0	0.4	0.2	0.7
Total.....	19.4	22.0	10.8	8.2	6.3	9.7
Bonds, notes, and debentures						
Number of statements.....	13	11	29	13	50	116
Cost of issuance as percentage of public offering price:						
Commission and discount.....	3.7	4.0	3.2	2.5	2.2	2.3
Other expense.....	1.4	1.7	1.4	1.2	0.7	0.7
Total.....	5.1	5.7	4.6	3.7	2.9	3.0

Combined stock and bond issues						
Number of statements.....	4	3	1	1	...	9
Cost of issuance as percentage of public offering price:						
Commission and discount.....	4.9	3.8	2.4	3.5	...	3.6
Other expense.....	1.2	4.6	1.7	2.5	...	2.7
Total .....	6.1	8.4	4.1	6.0	...	6.3
All issues						
Number of statements.....	118	41	71	20	55	305
Cost of issuance as percentage of public offering price:						
Commission and discount.....	15.0	14.2	7.0	4.1	2.6	3.3
Other expense.....	1.7	1.7	1.2	1.0	0.6	0.7
Total .....	16.7	15.9	8.2	5.1	3.2	4.0
79 Gross proceeds (in millions of dollars) of issues offered for cash sale.....	27.1	27.9	169.6	131.7	1,728.4	2,084.7

<sup>a</sup> Prepared by the Securities and Exchange Commission for Senator Steiwer.

had if there is complete dependence upon outside sources of funds. Abuses or evils that may arise in the use of large corporate surpluses, or other available corporate funds, should be corrected by other means.

In concluding this phase of the discussion reference may well be made to a report by the Committee on National Debt and Taxation which was presented in 1927 to the Parliament of Great Britain. In that study a distinguished committee explored broad problems of finance and taxation with the aid of testimony by experienced British financiers and industrialists. While the analysis may not be altogether applicable to American conditions, the conclusions reached are nevertheless distinctly pertinent here.

Saving left to the individual takes a certain amount of time; there is apt to be some delay and economic friction before the money reaches its destination. Moreover there is no certainty that it will flow in the direction most desirable from an economic and industrial point of view; it may be wasted on unsound speculation, or, on the other hand, it may concentrate too much on gilt-edged stocks or on foreign or Colonial securities. Industry may not get its proper share, or may have to divert a great deal of its energy in order to do so.

On the other hand, when a company saves by retaining part of its profit, the operation is smooth and simple. In the case of a progressive business the flow of capital is just in the place where it is required; it is at the growing-point of industry, enabling new needs and opportunities to be met without delay as and when they arise. This is true of the new enterprising business, which may as yet be making only small profits, as well as of the established company whose ability to save large sums for development year by year has given proof of efficiency and power of continued expansion. There are cases of course where reserves are accumulated out of caution rather than enterprise, and are invested, e.g., in the preference shares of outside concerns, but generally speaking it is true that the Income Tax, when it falls upon company reserves, entrenches upon a form of saving which is of special value to the community.<sup>16</sup>

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<sup>16</sup> *Report of the Committee on National Debt and Taxation*, Great Britain, 1927, pp. 148-49.



Reviewing the effects of the undistributed profits tax on corporation financing, two conclusions seem inescapable. (1) In the case of large and strong companies the forcing of distribution of profits or, as an alternative, the payment of additional corporation taxes in the amounts called for by the law, would circumscribe the freedom of their financial policies but it would not be ruinous or, for the more fortunately situated, even severely oppressive. (2) For smaller, more local, weak, or new companies the tax is likely to prove crippling in many instances, and no amount of change in definition or procedure seems capable of avoiding this result. In view of the concern for the welfare of small industrial firms manifested by the Administration, this unequal operation of the law deserves most careful consideration. But other aspects of its inequitable effects need also to be considered.

### **DOES THIS TAX PROMOTE ECONOMIC JUSTICE?**

Advocates of the tax on undistributed profits urged the measure as "a matter of fundamental equity." Its aim was "to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners." It was argued that an undue amount of corporate income was deliberately retained in surplus accounts, not for the genuine purpose of better corporate management but as a means of lessening the burden of taxation which it would bear. The logic of the undistributed profits tax was that it would either force the distribution of such income to its individual claimants, who were in general the more well-to-do part of the community and in whose hands it would con-

tribute more liberally to the national revenue or, if retained by the company, it would bear rates of taxation higher than formerly and more compatible with those paid by similar income in the hands of individuals.

The manner in which the tax actually promotes this end of greater justice in taxation can be made clear by a few illustrative figures. Disregarding a few procedural details, it is approximately correct to say that the regular corporation income tax is levied at a maximum rate of 15 per cent, and this maximum is the actual rate for all except relatively small corporations. On the other hand, personal incomes pay a normal tax of 4 per cent, but steeply progressive surtaxes begin at 4 per cent on net incomes between \$4,000 and \$6,000, rise to 58 per cent as net income reaches \$100,000, and reach a maximum of 75 per cent on incomes of 5 million dollars or more. It is easy to see that any individual subject to surtax rates of 25, 50, or 75 per cent might prefer that his share of the earnings of a corporation should remain in the corporate treasury where, prior to the passage of the undistributed profits tax, it bore a rate of only 15 per cent.

Further support for the idea that the undistributed profits tax would promote justice in taxation is derived from consideration of the fact that if an individual should obtain a substantial income from unincorporated business—either an individual enterprise or a partnership—such income would bear the full surtax rates with their maximum of 75 per cent, whereas for a business of the same size and degree of profitableness, if incorporated, the regular tax on corporate income would not exceed 15

per cent. These inequalities of treatment have long been recognized and are readily apparent in their application to large individual incomes.

But to get a fair and comprehensive view of the whole situation we need to examine the tax law in its application also to persons of small means who may pay no income tax, the normal tax only, or the lower surtax rates.

Income recipients in these classes would, as a result of the undistributed profits tax, in effect pay on earnings accruing to them from common stock ownership but retained by the corporation, a higher rate than they had to pay before the imposition of the tax. This is because the rate of tax on the income retained by corporations is raised from 15 per cent to as high as 32 per cent. Thus the extent of the disadvantage will vary according to the tax bracket in which the personal income falls and the percentage of earnings retained by the corporation.

By the same line of analysis, it appears that business enterprises organized on an individual or partnership basis and having large earnings are still at great disadvantage with respect to corporations having the same rate of earnings, though this disadvantage is somewhat smaller than it would be in the absence of the undistributed profits tax. On the other hand, the small individual or partnership enterprise, owing to the low rates for small individual incomes, would have a somewhat greater advantage with respect to comparable corporate enterprises than it had before.

Furthermore, a series of new differentials is created by the undistributed profits tax throughout the whole range of individual and business income situ-

ations. A corporation with variable earnings, as we have shown, is placed at a greater tax disadvantage in relation to a corporation with stable earnings aggregating the same total income over a period of years. A corporation with a weak or an impaired capital structure is at a further disadvantage as compared with one in a sound position. A corporation operating in a new and developing industry is placed at a greater disadvantage with respect to one operating in an old and established industry.<sup>17</sup> And with these differentials in corporate situations, go differentials in the situations of the stockholders concerned, whether they be rich or poor persons.

It is evident that any attempt to determine whether justice in taxation is promoted by the undistributed profits tax presents great difficulty. A sound answer cannot be arrived at without including all changes made by the tax in the relative situations of individuals, rich and poor, and unincorporated enterprises, big and little, as well as those of corporations. It will not do to limit our scrutiny to those changes that tend to diminish the relative advantage enjoyed by the rich man. The problem is not to be solved by a mere count of the instances of injustice removed or lessened and of those in which it is added or increased. Nor is there any measure by which the quantities of injustice removed may be validly compared with the quantities added. It is obvious, however, that the effect of the tax is not 100 per cent remedial in its nature but combines a complex array of changed relative positions, some

<sup>17</sup> A number of corporation officials who replied to the questionnaire commented on the various ways in which the undistributed profits tax operates to the advantage of large corporations as compared with smaller concerns. See, for instance, page 41.

of which would greatly promote the ends sought while others must definitely be entered on the other side of the ledger.

In fact, the problem of justice between individuals is insoluble in its present setting of a business economy conducted through corporations, partnerships, and private enterprises. To obtain equality on the level implied by proponents of this tax a change of venue would be necessary. The nature of this change can be indicated, though with no suggestion that it is possible of attainment. It would involve the abandonment of the taxation of all corporate income as such, separate from and in addition to the taxation of individual incomes. Individuals as the beneficial owners of the earnings of corporations would pay taxes on them, even though withheld, precisely as they would if these earnings were distributed and added to income which the individual derives from other sources. Under such an arrangement no tax advantage would accrue from the withholding of earnings, no difference in tax treatment would exist between incorporated and unincorporated enterprises, and the differentials between rich and poor inherent in the present system would disappear.

It is patent that such a change of venue for the case with reference to justice in taxation would be extremely difficult if not impossible of attainment. The Supreme Court has ruled in a substantial body of decisions that income must be actually received by an individual in order to be taxable in his returns.<sup>19</sup> Unless this situation were changed by a new statutory definition of income subsequently sup-

<sup>19</sup> Roswell Magill, *Taxable Income*, Chap. V.

ported by Supreme Court decisions or unless the Court changed its position and Congress in new tax acts followed the same course, substantial inequities must continue to exist in our interwoven structure of corporate and individual taxation. The undistributed profits tax would not remedy such inequalities. Nor is attack along this line capable of doing so.

Probably more significant than the issue of justice as between "me and thee," which we have just been discussing, is the broader issue as to whether the undistributed profits tax tends to promote social justice in the broadest sense by making for a more prosperous society, larger national income, and a better standard of living for that large part of the population which inevitably is undernourished and ill-clad whenever there are serious maladjustments in trade and industry. Proponents of the undistributed profits tax urged that it would have important effects in preventing business cycles or alleviating their effects. We turn now to the basis on which this argument rests.

#### **THE TAX IN RELATION TO BUSINESS DEPRESSIONS**

Among the issues raised by the undistributed profits tax none is of more interest than that of its relation to the business cycle. On the one hand it is argued that such a tax would at least go far toward preventing depressions; and on the other it is contended that the effects of *inevitable* depressions would be greatly magnified if the surpluses accumulated in prosperous periods were not available as a cushion in lean years.

The argument that the accumulation of surpluses

has been a very important factor in bringing on depression was stated by George C. Haas, director of the Division of Research and Statistics of the Treasury, at the Senate hearings in the following way.<sup>10</sup>

Not only do we now know that the corporate surpluses accumulated in the twenties were not used to any great extent, in the aggregate, to maintain employment during the depression but we also have some ground for suspecting that the accumulation of these very corporate surpluses assisted materially in causing the depression. Thus it has been argued by very respectable economic authority that among the causes of the depression was starving of consumption through the withdrawal of a too large proportion of our funds for corporate capital expenditure. Is it not quite possible that in many instances, important in the aggregate, over-expansion of plant capacity was stimulated by a desire of the controlling stockholders in corporations to reinvest earnings for the purpose of avoiding the taxes that they would have paid if earnings were distributed? It is also held by many that one of the vicious influences contributing to the great stock-market boom of the late twenties was the piling up of corporate surpluses. Stock-market speculation, which had already been stimulated by the mere piling up of such surpluses, was further stimulated by the volume of surplus funds poured into brokers' loans by corporations.

It will be observed that this statement raises three questions: (1) whether there was over-expansion of plant capacity; (2) whether the large volume of funds available for stock market speculation was largely attributable to corporate surpluses; and (3) whether the existence of accumulated surpluses cushioned the shock of depression.

With respect to the first point, the findings of the Brookings Institution in its study, *America's Capacity to Produce*, did not reveal any rapid piling up of unused plant and equipment in the late twenties, the percentage of unused plant and equipment in 1929 being only slightly above the average for the preceding five years. In a few lines, mainly in newly developed industries, there was some over-expan-

<sup>10</sup> 74 Cong. 2 sess., *Revenue Act, 1936*, Hearings on H. R. 12395 before Senate Committee on Finance, p. 59.

sion, but in general the rate of growth of plant capacity was adjusted to the growth of consumptive demand. Moreover, business surpluses were not accumulating in the late twenties at an increasing rate. The amount of business savings or surplus set aside annually from 1915 to 1929 was as follows:<sup>20</sup>

Year	Corporate Surplus (In millions)	Year	Corporate Surplus (In millions)
1915	\$2,117	1923	\$2,432
1916	4,939	1924	1,463
1917	4,732	1925	2,851
1918	1,986	1926	2,223
1919	4,330	1927	996
1920	1,397	1928	2,388
1921	-2,685	1929	2,238
1922	1,676		

The average increase in surplus in the four years 1923 to 1926 inclusive was 2,242 million dollars, as compared with 1,874 millions for the three years 1927 to 1929. It will be observed that the surplus was heavily drawn upon in the depression year 1921.

While some of the business savings made in 1929 found their way into the stock market, available evidence indicates that at best they could have been of but minor influence in the stock market speculation that developed. As compared with 2.2 billions of corporate savings, only a portion of which was available for security purchases, there was something like 15 billions of individual savings; and moreover bank credit expansion contributed to the disequilibrium in the financial markets.<sup>21</sup>

Rather conclusive evidence that the undivided profits tax is not a certain preventive of depressions

<sup>20</sup> Exclusive of life insurance companies, but inclusive of partnerships and individual firms. Maurice Leven, Harold G. Moulton, and Clark Warburton, *America's Capacity to Consume*, p. 109.

<sup>21</sup> See Harold G. Moulton, *The Formation of Capital*, Chap. X.



is afforded by the fact that it did not check the severe recession which began in the summer of 1937.

Consideration may now be given to the significance of the surplus in cushioning the shock of the depression. The view that it was of little significance is derived from the fact that a substantial part of the decrease in accumulated surpluses of business corporations during the depression years merely represented a writing down of assets which were being rendered less valuable by the depression. For the years 1929-33 the assets of all corporations other than financial were reduced as follows: cash, 1.9 billion dollars; notes and accounts receivable, 8.1 billions; inventories, 7.5 billions; investments, 7.4 billions; and capital assets, 7.4 billions—a total of 32.3 billions. On the liabilities side there was a corresponding decrease in notes and accounts payable, bonded debt and mortgage, miscellaneous liabilities, and capital obligations in the form of stock and surplus.<sup>22</sup>

But it does not follow from the fact that a decrease in the surplus often was a mere bookkeeping adjustment that the existence of the surplus did not mitigate the severity of the depression. The truth of the matter is that just as American business enterprises had paid out something less than the amount of income produced during the prosperous years preceding 1930, they paid out more than was produced in the lean years of the depression. The following data compiled by the United States Department of Commerce show, in millions of dollars, the income

<sup>22</sup> These data are from the Dun and Bradstreet survey previously referred to.

produced and the income paid out in the years 1929 to 1935 inclusive:<sup>23</sup>

Year	Income Produced	Income Paid Out	Difference
1929 .....	81,034	78,632	+ 2,402
1930 .....	67,917	72,932	— 5,015
1931 .....	53,584	61,704	— 8,120
1932 .....	39,545	48,362	— 8,817
1933 .....	41,123	44,321	— 3,198
1934 .....	47,008	48,784	— 1,776
1935 .....	51,646	52,274	— 628

In the three acute depression years 1930 to 1932 inclusive, the aggregate income disbursed was in excess of that produced by almost 22 billion dollars. Some of these disbursements went for the maintenance of interest and dividends at a period when they were not being earned, and some portion—it is impossible to say precisely how much—for the maintenance of wages and salaries during the years of operating deficits.

In the absence of accumulated surpluses, it is obvious that the volume of disbursements would have been limited to the actual amount of income produced. It seems reasonable to believe that in this situation corporation managers, seeking frantically to avert bankruptcies, would have sought to cut expenses the more drastically, that business confidence would have been the more completely undermined, and that the volume of unemployment would have been still further increased.

Similarly, it seems reasonable to assume that the process of recovery was accelerated by virtue of the fact that substantial corporate surpluses remained

<sup>23</sup> Robert R. Nathan, "Expansion in the National Income Continued in 1935," *Survey of Current Business*, July 1936. Work-relief payments are excluded.

even at the depth of the depression. As the tide turned, many individual business enterprises were able to begin the process of expansion long before the condition of the financial markets was such as to encourage the flotation of new securities.

Nothing has been said in this study concerning the revenue aspects of the undistributed profits tax. Figures are not yet available to show the direct yield of the tax for the first year of operation, and it is of course impossible to make any precise estimate as to how much additional revenue the government derived indirectly from personal income taxes on profits whose distribution was induced by the tax. It is clear, however, that this measure has the power to augment the federal revenues substantially, whether the returns be paid directly by corporations or indirectly by individuals. Fiscal considerations, however, cannot be accepted as a justification of the tax without considering its effects upon our national economy. If it appears that there are deleterious effects in this direction, they must be duly weighed against the need for national revenue, and this in turn studied in the light of alternative ways of procuring it.

### CONCLUSIONS

The tax on undistributed profits was conceived as a measure which would not only yield an increase in federal revenue but also promote justice and a more smoothly functioning economic system. In the light of our analysis of the theory and practical operation of the tax what conclusions are to be drawn? Has the undistributed profits tax in fact

spread the tax burden more equitably and advanced economic welfare as a whole? Or, if it does not in its present form attain these ends, are its shortcomings due to details of procedure or definition which could readily be remedied by the process of amendment? If so, what changes in the existing law are indicated?

The conclusion reached is unequivocally that the tax should be repealed. The general arguments in its favor pertaining to taxation equity, the distribution of income, and the control of the business cycle do not in the light of analysis weigh heavily as against the adverse effects of the tax in other ways. Its fundamental weakness is that it limits the possibility of prompt and flexible capital developments and handicaps with particular severity a multitude of small and medium sized business enterprises. It bears with particular severity upon new companies or those which are endeavoring to recuperate from a period of misfortune.

Numerous proposals of an ameliorative character have been advanced by corporate executives, writers on fiscal problems, and public officials. Among these the ones most commonly discussed are: (1) exemption of all "debt-ridden" corporations; (2) exemption of earnings expended for improvements; and (3) exemption from the tax of all corporations earning \$5,000 or less. It is our conclusion that none of these amendments would reach to the heart of the problem and that some of them present complicating elements.

The exemption of corporations that are heavily indebted would of course afford relief to such corporations, but it would at the same time introduce

new discriminations as between corporations. Corporations in debt are in any case allowed deductions for interest paid on bonds; and if the money received from the sale of bonds has gone into a depreciable asset the company may deduct depreciation also. Such charges must be allowed if capital, wherever employed, is to have equal treatment. But if corporations in debt were permitted, in addition to these allowances, to deduct payments on their debts, they would then be given a differential advantage over corporations not in debt. Under these circumstances distinct encouragement would be given to the incurring of increased indebtedness. This provision would also be extremely difficult to administer.

Exemption of earnings expended for improvements would likewise involve complications. In the first place, such an exemption would mean an unequal treatment of capital, for companies operating in new and expanding industries would be given an advantage over those operating in old and developed fields, where capital requirements are relatively stable. In the second place, such an exemption would have a tendency to encourage over-expansion of plant capacity. The defining of improvements to be exempted, as pointed out in the *Report of the [British] Committee on National Debt and Taxation* (page 346), would present great practical administrative difficulties.

Corporations earning \$5,000 or less, though numerous, conduct only a minor proportion of the corporate business of the country. Moreover such corporations are now given a special credit against the tax. To give them complete exemption would mean

a discrimination in their favor against the great body of corporations of medium size. Granting such exemption to all corporations earning \$25,000 or less, as has also been suggested, would of course decrease the number discriminated against but at the same time substantially reduce the revenue-yielding powers of the tax.

Our analysis has, however, suggested that if the tax is to be retained, four amendments should be incorporated in the law, namely:

That the period within which a dividend payment be allowed as a credit against the undistributed profits tax for any taxable year should be extended at least 75 days beyond the close of that year. The provision establishing this credit should make it available to all corporations declaring a dividend within this period in such a manner as to establish full liability for payment within the calendar year succeeding the tax year.

That corporations should be relieved of any requirement that they pay undistributed profits tax on deficiencies in income reported. If the Bureau of Internal Revenue, the Board of Tax Appeals, or any court, on examining the corporation's tax returns, decides that there is such a deficiency and the company thereafter distributes this additional profit to stockholders within sixty, or perhaps ninety, days, there should be no tax upon this deficiency as "undistributed profit."

That in computing corporate net income subject to taxation deduction should be allowed for losses incurred during the three preceding years. It is obvious that if this modification were made it would

be equitable to have it apply also to the corporation income tax, the excess profits tax, and the personal income taxes paid by individuals and partnerships.

That the present requirement that capital gains be taxed in full, whereas capital losses are deductible only to the extent of \$2,000 of net capital loss, should be so amended as to give equal treatment to capital gains and losses. This equal treatment should include the carrying forward of "prior losses" of capital over a three-year period, as we have recommended in the case of operating losses.

While these amendments would eliminate some of the most flagrant weaknesses of the law they do not warrant the retention of the tax. The practical difficulties in applying such a levy to the complex and varied organization and operation of American industry are such that equitable and effective administration is impossible.

## APPENDIX A

### QUESTIONNAIRE SENT TO INDUSTRIAL CORPORATIONS

United States Senate  
Committee on Banking and Currency

June 11, 1937

Gentlemen:

It seems important that an effort be made to learn something about the operation and effect of the Revenue Act of 1936 with particular reference to the undistributed profits tax imposed on corporations. I am accordingly writing to a number of companies for the purpose of inquiring concerning the operation of this law. While I recognize merit in the idea of discouraging the unnecessary accumulation of profits in corporate treasuries, I am apprehensive, on the basis of information already obtained, that the ultimate effect of the present law will be disastrous.

It will be greatly appreciated if you will answer the following questions specifically by number and section. Your courtesy in this connection will enable me to analyze and compile the information contained in replies.

1. Has the undistributed profits tax of 1936 brought any change in your practice or policy in respect to
  - (a) the percentage of current earnings paid out in dividends?
  - (b) the kind of dividends paid (cash, stock, or scrip)?
  - (c) the accumulation of a reserve for lean years, or years of losses?
  - (d) the accumulation of a reserve for business expansion?
  - (e) the reduction of the amount of any capital deficit?
  - (f) building up necessary working capital?
  - (g) the time and amount of repayment of company obligations? (Please give reasons for change or non-change.)
2. What percentage of your net income for 1936 did you distribute and what percentage, in your opinion, would you probably have distributed if the Revenue Act of 1936 had not been applicable to your company?
3. If it was not your practice prior to 1936 to distribute substantially all of your current earnings as dividends, was this due to any of the following reasons (or otherwise)?
  - (a) to maintain reserves for use in lean years?
  - (b) because of any seasonal characteristics of your business? (Please explain.)



4. Were reserves needed or used prior to 1936 in order to
  - (a) maintain a consistent policy in paying dividends over a period of years?
  - (b) stabilize the sales prices of your products?
  - (c) continue payrolls without reduction?
  - (d) meet short-term or long-term liabilities? (In this connection, does the present provision in Section 26 (c) of the statute, relating to contracts directly or indirectly restricting payment of dividends, meet your requirements?)
  - (e) protect your company with respect to contingent liabilities? (Please explain.)
  - (f) provide for reasonable expansion or development of your business or plant?
5. Are you of the opinion that the law should be amended to provide a period after the close of the fiscal year for the ascertainment of profits by a corporation and the declaration and payment of dividends? How long a period do you believe is advisable?
6. Do you believe the loss of a prior year should be allowed to be carried forward and applied to reduce the net income of the subsequent year for the purpose of the undistributed profits tax?
7. Do you believe a certain percentage of net income (say 20 or 30%) should be allowed to be retained free of undistributed profits tax in all cases?
8. Do you favor existing exemptions from this tax? Do you favor further exemptions from this tax or any special treatment of any particular industry or group of corporations? (Please give reasons.)
9. Do you believe the imposition of this tax is inconsistent with sound business policies? (Please give reasons.)
10. If this tax is retained, please submit specific recommendations with respect to amendment of existing provisions.

If it happens that no official of your company feels he can speak authoritatively for the company, I hope, nevertheless, some one familiar with the company's business will answer the questions and in that case qualify the statement as being his personal view. If there is any reason why it is desired that I do not disclose the identity of the answering company and if such desire is indicated on the answer, I will be glad to respect the company's wish in that regard.

This matter is so important I feel justified in requesting that you give it your early attention, and that you answer the questions as fully as you think will be helpful in arriving at a sound conclusion concerning the effect of this law.

Very truly yours,

(Signed) Frederick Steiwer

## APPENDIX B

### TABULATION OF 1,438 REPLIES TO SENATOR STEIWER'S QUESTIONNAIRE<sup>a</sup>

Questions	Replies				
	Yes	No	Indefinite	Inapplicable	Total
1. Has the undistributed profits tax of 1936 brought any change in your practice or policy in respect to:					
(a) the percentage of current earnings paid out in dividends?.....	668	296	3	184	1151
(b) the kind of dividends paid (cash, stock or scrip)?.....	110	743	4	3	860
(c) the accumulation of a reserve for lean years, or years of losses?.....	636	202	10	9	857
(d) the accumulation of a reserve for business expansion?.....	604	224	10	10	848
(e) the reduction of the amount of any capital deficit?.....	132	565	5	119	821
(f) building up necessary working capital?.....	558	251	8	18	835
(g) the time of repayment of company obligations?.....	229	513	3	60	805
2. What percentage of your net income for 1936 did you distribute and what percentage, in your opinion, would you probably have distributed if the Revenue Act of 1936 had not been applicable to your company?.....	b	b	b	b	684
3. If it was not your practice prior to 1936 to distribute substantially all of your current earnings as dividends, was this due to any of the following reasons?					
(a) to maintain reserves for use in lean years?.....	901	49	2	16	968
(b) because of any seasonal characteristics of your business?.....	310	382	3	16	711
4. Were reserves needed or used prior to 1936 in order to					
(a) maintain a consistent policy in paying dividends over a period of years?.....	664	240	3	29	936
(b) stabilize the sales prices of your products?.....	235	568	2	28	833
(c) continue payrolls without reduction?.....	743	199	2	12	956

(d) meet short-term or long-term liabilities? (In this connection, does the present provision in Sect. 26 (c) of the statute, relating to contracts directly or indirectly restricting payment of dividends, meet your requirements?)					
liabilities.....	400	355	3	102	860
26 (c).....	10	74	..	13	97
(e) protect your company with respect to contingent liabilities.....	320	446	..	65	831
(f) provide for reasonable expansion or development of your business or plant?.....	866	81	..	10	957
5. Are you of the opinion that the law should be amended to provide a period after the close of the fiscal year for the ascertainment of profits by a corporation and the declaration and payment for dividends?.....	1164	26	5	...	1195
How long a period do you believe is advisable? <sup>c</sup>					
6. Do you believe the loss of a prior year should be allowed to be carried forward and applied to reduce the net income of the subsequent year for the purpose of the undistributed profits tax?.....	1226	4	6	1	1237
8 7. Do you believe a certain percentage of net income (say 20 or 30 per cent) should be allowed to be retained free of undistributed profits tax in all cases? <sup>d</sup> .....	1211	10	8	...	1229
8. Do you favor existing exemptions from this tax?.....	553	151	30	3	737
Do you favor further exemptions from this tax or any special treatment of any particular industry or group of corporations?.....	527	69	3	...	599
9. Do you believe the imposition of this tax is inconsistent with sound business policies?..	1212	13	20	...	1245

<sup>a</sup> Only replies given in specific terms such as "yes" and "no" are tabulated here. This explains why the tabulation includes but 1,438 of the 1,560 replies received.

<sup>b</sup> The replies to this question could not be tabulated according to the column headings of the table. Of the 684 replies, 572 corporations reported a larger distribution, 110 the same distribution, and two a smaller distribution of dividends in 1936 under the undistributed profits tax than they would have made had this tax not been effective.

<sup>c</sup> Of the 1,111 corporations replying to this question, 59 recommended a period of less than two months; 838, a period of 2-3 months; and 214 a period of more than three months.

<sup>d</sup> In answer to this question, 622 corporations mentioned a definite figure: four an allowance less than 20 per cent; 177 an allowance of 20-29.9 per cent; 334 an allowance of 30-49.9 per cent; and 107 an allowance of 50-100 per cent.

## APPENDIX C

### DETAILED COMMENTS FROM THREE COMPANIES

Many brief excerpts from replies to the questionnaire have been presented for illumination of particular points in our discussion. We now present three more extended statements by corporation executives because of the excellent way in which they reveal the workings of the undistributed profits tax with reference to the whole of the corporation's affairs.

A packing company official says:

The "X" Corporation, incorporated on April 26, 1934 . . . with a paid-in cash capital of \$15,000, was organized primarily for the purpose of cold packing fruits. Cold packing has utilized the surplus crop which heretofore has gone to waste, [and] was never done [in this area] until our entry into the field.

During 1934 we cold packed approximately 550,000 pounds of [fruit] and marketed it throughout the northern states. The net result of that year's operations was a loss of \$7,000. No salaries or dividends were paid to the officers or stockholders.

During 1935 we cold packed approximately 660,000 pounds of fruit, out of which only approximately 15 per cent could be marketed, necessitating a carry-over into 1936 of approximately 500,000 pounds. At March 31, 1936, the end of our fiscal year, we inventoried a carry-over at the market value, which was lower than cost and resulted in a loss of approximately \$9,000. The aggregate deficit of this company as a result of its operations in 1934 and 1935 amounted to over \$15,000, wiping out more than the entire capital of the company.

During 1936 this company did not cold pack any fruit. As stated above, we carried an inventory of approximately 500,000 pounds which were actually cold packed in 1935, and as a result of the crop failures in 1936, we were able to market [this fruit] at substantial prices with the result that operations for 1936 show a profit of approximately \$7,000.

We want to make this picture clear and therefore wish to state the facts regarding our 1935 and 1936 operations again in another way. In 1935 we cold packed approximately 660,000 pounds of [fruit] of which out of necessity approximately 500,000 had been

carried over into the second year. As far as our books are concerned, we show a loss in 1935 of \$9,000 and a profit in 1936 of \$7,000. In other words, the actual net results of this one block of merchandise is a net loss of \$2,000.

This company has never paid a dividend nor any salaries to officers, excepting that a provision has been made for a nominal total of \$500 to the secretary and treasurer to be paid at a later date. In spite of the record of our operations we wish to point out that the 1936 profits are subject to income taxes, excess profits taxes, and surtaxes on undivided profits aggregating approximately \$1,700. Let us point out again that this \$1,700 in taxes must be paid on a block of merchandise which we actually handled at a loss of \$2,000 as outlined above.

. . . Our balance sheet as of March 31, 1937 [shows] that we have only \$4,500 in liquid assets for the payment of these taxes and for the operations of the company. Under these circumstances, this company is practically in distress as a result of the unjustness and unfairness of the excess profits taxes and surtaxes on undistributed profits. We must either get out of business or get relief from these unjust taxes which are imposed on small corporations with impaired capital.

## A manufacturer of machinery:

In the first place, let me say that this company is, in my opinion, an excellent example of the type of corporation which is most seriously punished by the undistributed profits tax aforesaid. The total amount of the cash capital obtained by this company through the sale of common stock (there are no other securities) since its beginning in 1895 is about \$630,000. The company repurchased its own stock to the extent of a little over \$100,000 so that the net cash capital obtained by subscriptions in the company today is only a little over \$500,000. Using this capital in the 52 years which have elapsed since its beginning, the company accumulated a plant which could not, I think, be duplicated under a million and a half, and has distributed about a million and a half in dividends, payment of which began in 1903. It seems to me that we, a moderate size concern, are typical of the results of constructive American enterprise, and though not very conspicuous on account of our size, we nevertheless are one unit in an aggregate of thousands of other concerns employing some millions of men and women which represent a considerable section of the backbone of American industry.

Our capital stock (approximately \$900,000 outstanding at par) is, of course, an unlisted security and the holding of this stock is well diversified so that no individual or small group of individuals can be said to control the company.

This company came up to the year 1930 in good condition with not only a sufficient working capital, but with about a quarter of a million of reserve capital in United States securities in its strong

box. At that time the company had no debts whatever except for current purchases.

We are primarily manufacturers of products sold to industry and none of them to the consuming public. It seems hardly necessary to explain therefore that as the result of the industrial depression, this company was one of those which were hardest hit. During the depression industry bought almost nothing, and our losses were correspondingly severe. Nevertheless, by rigid economies, by some wage reductions and by far heavier salary reductions, the company weathered the storm. When business began to return, we were sailing with not much more than bare poles, and the ship had to be reconditioned if we were to be able once more to take care of such new business as accrued to us. It was necessary to restore a heavily depleted inventory, purchase new tools, and there was an obligation upon us to pay back gradually to the banks some of the \$175,000 which we borrowed to keep us going when things were at their worst, and it goes without saying that to accomplish the necessities aforesaid, money was needed.

As we began to earn again, these earnings were all required for rehabilitation of the business and for the reduction of our debt, and the prospect of a dividend was a matter which was indefinitely postponed. The last dividend which the company paid was at the rate of  $\frac{1}{2}$  of 1 per cent in 1930 and the next dividend which the company will pay has just been declared at the rate of 1 per cent, payable July 1 of this year.

Although we have made some progress in putting our affairs in order, we are still short of capital and owe a substantial sum to the banks; and I submit that under good management the opportunities to secure capital for a company of this kind are definitely limited. Because our stock is unlisted, having no ready market, it is almost impossible to contemplate the successful sale of more stock to secure money. After the experience of the last five years, our present stockholders would not be particularly enthusiastic about adding to their present investment and we are not a large enough concern for an underwriting banker to be interested in undertaking the flotation of new company securities. In other words, financing of the aforesaid character is pretty well out of the picture and we are therefore left with two alternatives (other than the application of earnings to working capital or a merger with a stronger concern), namely, the raising of money through a mortgage or by the increase of bank accommodation.

I think it will be evident to you that neither the stockholders nor the directors of this company want to put a mortgage on the plant, and as to bank accommodation it seems to me that the man who does not attempt to *get out of debt* today, if he can do so, is either a fool or a knave.

Under the above circumstances, how then are we going to put this company back into a position where it can weather the next depression, where it can in the meantime purchase modern ma-

chinery, extend its market and operations and employ more of those persons who are now unemployed. The natural method, it seems to me, and the only sound method for a concern situated as we are situated, is to again pursue the old constructive American plan of turning back the majority of the company's earning into the business, while perhaps paying moderate dividends to stockholders who have been so patient for so long. But the United States government in its wisdom has taken the attitude that the creation and upbuilding of private enterprise in the United States, financed largely out of earnings, is hereafter to be discouraged. It says in effect that regardless of the effect upon the financial structure and stability of a company, that company must pay dividends or else pay a penalty and, in order to make a substantial reduction in the said penalty, must pay dividends which represent pretty nearly all the earnings of the company in a given year. One would suppose that the Congress, when it imposed the undistributed profits tax, had looked over the history of American industry and had come to the conclusion that the growth and stability of such industry was something which should be discredited rather than encouraged. And I say to you quite frankly that it is my opinion that it was only on account of the reserves which the company possessed when the depression hit in the fall of 1929 that the company is alive today. Therefore, one cannot help wondering what will be the fate of this company and of many others like it should another depression come along two, three, or four years from now, a contingency which, in my opinion, is almost sure to occur.

### A manufacturer of textiles :

We believe the facts in connection with this company are typical of most textile mills, and we have, therefore, worked up the data with respect to it in order to be able to show exactly what the effect would have been had the 1936 Revenue Act been in effect from November 1, 1924 to August 31, 1936, as well as to show what the actual taxes paid amounted to and the per cent of this tax to the net income. We are attaching hereto Schedule "A" showing for this mill:<sup>24</sup>

1. The taxable net income for each taxable year or period ended October 31, 1924 to August 31, 1936.
2. The tax that would have been payable for each of these years under the Revenue Act of 1936 if it had been in effect, separated as to
  - a. Normal tax.
  - b. Undistributed profits tax.
  - c. Total tax.

---

<sup>24</sup> Publication of these detailed figures has been specifically authorized by the chairman of the board of directors of this company. Similar permission was given in several other instances where more than general statements were involved.

(We have intentionally left out the excess profits tax under the assumption that a declared value would have been used to avoid this tax.)

3. The income tax actually paid for each year under the existing acts.
4. The increase in the tax that would have been payable under the 1936 act over that amount actually paid under the existing acts.
5. The increase in the percentage rate of tax to net income.
6. The cash dividends paid each year.
7. The balance in the surplus account at various dates.

You will observe that the company had a total net income after deducting net losses for the period of 12 years and 10 months of \$289,304.25, out of which it actually paid \$115,229.11 in income taxes, or 39.83 per cent of its net income. And this high percentage was paid even though some of these years losses were permitted to be carried forward against subsequent years' earnings, and, further, the tax rates were only 12.5 to 13.75 per cent. After paying its income taxes it had left only \$174,075.14 available for dividends to its stockholders.

There was outstanding 1.4 million dollars of common stock during this period. The net income available for dividends during the period, then, is only 12.43 per cent. This is less than 1 per cent a year. How can industry be expected to attract capital under these circumstances? How can the government expect industry to absorb the unemployed under these conditions? And remember the tax rates were only 12.5 per cent to 13.75 per cent during these years and furthermore net losses were allowed to be carried forward in some of them, in fact, most of them.

Now, if the 1936 act had been in effect during all of these years, the total tax would have been \$188,988.87 even after taking the dividend credit for the very large dividends paid (mostly out of prior years' earnings). These dividends could not have been paid had the company just started in 1923. Dividends paid were over 300 per cent of the earnings of this period. After deducting the tax of \$188,988.87 from the earnings of \$289,304.25 we have left available for dividends only \$100,315.38, for a period of approximately 13 years, or only 7.16 per cent. Can you imagine a man investing his money for any such return—only .55 per cent a year, and, with a big chance of losing his investment?

Under the provisions of the 1936 act the tax amounts to 65.67 per cent of the net income for the period, even after taking credit for the large amount of dividends paid out of prior years' earnings.

If it had not had a surplus of \$1,576,724.52 (more than the amount of capital stock) at the beginning of this period, where would the company be today? It could neither sell additional capital stock or borrow money on such a record as this during the last 12 years, and especially if the tax rates are as provided in the 1936 act. This brings out very forcibly why corporations



should be permitted to create a surplus in good times. A good surplus permits a company to continue to operate through depressions, even though at a loss, to furnish employment, and to hold its organization together until good times return when it can expect to make a profit in sufficient amount to absorb the losses and still leave a fair return for its stockholders over all the years of operations.

This company owed on notes payable and a mortgage \$850,000 at the beginning of this period which was reduced to \$250,000 at the end, and this had been paid off during the current year ending August 31, 1937. The reduction during this period of \$600,000 in indebtedness plus the dividends paid of \$882,000 is a total of \$1,482,000 that was paid out of the assets during this period when the earnings after income taxes amounted to only \$174,075.14. In other words there was a net reduction in assets of over \$1,300,000.

Let us suppose that this company had just started in business on November 1, 1923, with a paid in capital of 3 million dollars, this being the approximate net worth at the time. What would the results have been if the provisions of the 1936 act had been in effect during the period, and, that no dividends had been paid, because actually under these circumstances the company would have had no business paying dividends. We have prepared Schedule "B" attached hereto for each year:

1. The taxable net income.
2. Tax
  - a. Normal.
  - b. Undistributed profits tax.
  - c. Total tax.
3. Net income after the tax.
4. Surplus or accumulated earnings.
5. Totals of each of the above for the period.

From this schedule it will be noted that the company had total net earnings before income tax of \$289,304.25, and that the total taxes under the 1936 act would have been \$310,971.63, or 107 per cent of the total net income for the period. The stockholders would have received nothing except, possibly, a headache from worrying over their investment being a loss.

The writer is, and has been, familiar with the company's affairs for the last five years and has handled all of its tax matters during this time. He has specialized in tax work since 1918, or for over 19 years, therefore he is familiar with not only the present tax laws but all of the past acts. He realizes that an enormous amount of taxes or revenue must be collected for a great number of years in the future. In order to collect this revenue the laws should be made as equitable as possible. . . .

SCHED-  
HYPOTHETICAL APPLICATION OF TAX

Year Ended	Taxable Net Income <sup>a</sup>	Estimated Tax under 1936 Act			Tax Actually Paid
		Normal	Undistributed Profits Tax	Total	
Aug. 31, 1936..	\$63,954.37	\$8,433.16	.....	\$8,433.16	\$8,793.73
Aug. 31, 1935..	13,988.99	1,718.57	.....	1,718.57	1,923.48
Aug. 31, 1934..	272,074.53	59,651.18	\$28,856.78	66,507.96	37,410.25
Aug. 31, 1933..	18,281.22	2,016.56	3,334.25	5,360.81	1,675.78
Aug. 31, 1932..	(66,918.21)	.....	.....	.....	.....
Total, 5 yrs.	\$301,380.90	\$51,819.47	\$30,191.03	\$82,010.50	\$49,803.24
Aug. 31, 1931..	(\$68,698.53)	.....	.....	.....	.....
Aug. 31, 1930..	(434,921.95)	.....	.....	.....	.....
Total, 7 years	(\$202,239.58)	\$51,819.47	\$30,191.03	\$82,010.50	\$49,803.24
Aug. 31, 1929..	\$133,170.02	\$18,816.85	\$3,446.14	\$22,262.90	\$15,981.48
Aug. 31, 1928..	189,564.93	27,274.74	10,003.68	37,278.42	23,695.59
Aug. 31, 1927..	193,171.27	27,815.69	6,590.10	34,406.79	25,748.80
Total, 10 yrs.	\$313,675.64	\$125,726.75	\$50,230.95	\$175,957.70	\$115,229.11
Aug. 31, 1926 <sup>c</sup> .	\$94,607.80	\$13,031.17	.....	\$13,031.17	.....
Oct. 31, 1925..	(2,439.41)	.....	.....	.....	.....
Oct. 31, 1924..	(116,539.78)	.....	.....	.....	.....
Total, 12 yrs. 10 mos....	\$289,304.25	\$138,757.92	\$50,230.95	\$188,988.87	\$115,229.11

<sup>a</sup> Figures in parentheses represent a *loss*.

<sup>b</sup> Minus numbers represent *decrease* rather than increase.

ULE A

TO ACTUAL EARNINGS SINCE 1924

Amount by which 1936 Act would have Increased Tax <sup>b</sup>	Estimated Tax under 1936 Act, as Percentage of Net Income	Tax Actually Paid, as Percentage of Net Income	Percentage by which 1936 Act would have Increased Tax <sup>b</sup>	Cash Dividends Paid		Surplus
				Amount	As Percentage of Capital Stock	
-\$360.57	13.2	13.8	-.6	\$14,000	1.0	\$928,586.69
-204.91	12.3	13.8	-1.5	84,000	6.0	
29,097.71	24.4	13.8	10.6	77,000	5.5	
3,675.03	29.3	9.2	20.1			
\$32,207.26	27.2	16.5	10.7	\$175,000	12.5	\$872,875.74
				\$84,000	6.0	
\$32,207.26				\$259,000	18.5	\$1,369,016.99
\$6,281.51	16.7	12.0	4.7	\$84,000	6.0	
13,582.83	19.7	12.5	7.2	91,000	6.5	
8,656.99	17.8	13.3	4.5	112,000	8.0	
\$60,728.59	56.1	36.7	19.4	\$546,000	39.0	\$1,305,768.42
\$13,031.17	13.8		13.8	\$112,000	8.0	
				112,000	8.0	
				112,000	8.0	\$1,576,724.52 <sup>d</sup>
\$73,759.76	65.7	39.8	25.9	\$882,000	63.0	

<sup>c</sup> Ten months.

<sup>d</sup> November 1, 1923.

SCHEDULE B

SURPLUS AS IT WOULD HAVE BEEN HAD THE COMPANY STARTED NOVEMBER 1, 1923, AND PAID NO DIVIDENDS

Year Ended	Taxable Net Income <sup>b</sup>	Normal Tax	Undistributed Profits Tax	Total Tax	Net Income after Tax <sup>b</sup>	Surplus <sup>c</sup>
October 31, 1924.....	(\$116,539.78)				(\$116,539.78)	
“ 1925.....	(2,439.41)				(2,439.41)	— 818,979.19
August 31, 1926 <sup>a</sup> .....	94,607.80	\$13,031.17	\$16,723.24	\$29,754.41	64,853.39	— 54,125.80
“ 1927.....	193,171.27	27,815.69	33,897.97	61,713.59	131,457.68	77,331.88
“ 1928.....	189,564.93	27,274.74	33,269.49	60,544.23	129,020.70	206,352.58
“ 1929.....	133,179.02	18,816.85	23,444.24	42,261.09	90,917.93	297,270.51
“ 1930.....	(434,921.95)				(434,921.95)	— 137,651.44
“ 1931.....	(68,698.53)				(68,698.53)	— 204,349.97
“ 1932.....	(66,918.21)				(66,918.21)	— 273,268.18
“ 1933.....	18,281.22	2,016.56	3,334.25	5,350.81	12,930.41	— 260,337.77
“ 1934.....	272,074.53	39,651.18	47,646.78	87,297.96	184,776.57	— 75,561.20
“ 1935.....	13,988.99	1,718.57	2,515.97	4,234.54	9,754.45	— 65,806.75
“ 1936.....	63,954.57	8,433.16	11,381.84	19,815.00	44,139.37	— 21,667.38
Total.....	\$289,304.25	\$138,757.92	\$172,213.71	\$310,971.63	(\$21,667.38)	

<sup>a</sup> Ten months.

<sup>b</sup> Figures in parentheses represent *loss* rather than income.

<sup>c</sup> Minus figures represent *deficit* rather than surplus.

1924  
1925  
1926  
1927  
1928  
1929  
1930  
1931  
1932  
1933  
1934  
1935  
1936