

The Proposed Revision of Corporation Taxes

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THE honor and pleasure of speaking to the Young Democratic Club leads me to put aside the temptation to make the usual political speech and instead to present my personal views of President Roosevelt's proposed revision of the Federal tax on corporations. It is a living and important subject upon which there is much public confusion and not a little loose talking.

Some of the public discussion of Federal taxation indicates misunderstanding of present as well as of proposed laws.

Former President Hoover, speaking to the Life Underwriters Association a few nights ago, said:

"It would seem that when our Federal government and our State governments are endeavoring to build up economic security for the individual through old-age pensions and through unemployment insurance, that this great segment of economic security represented by life insurance might well be free from taxation. I regret that that is not the case. The tax collector has found that it is a fertile field for easy taxes. And such taxes come out of the poor, for only 5,000,000 people pay income taxes, yet 63,000,000 have insurance. It would be just as logical to tax old-age pensions, savings bank deposits or any other provision of economic security."

Whatever may have been intended by this statement, it has been widely accepted as indicating that the former President's concern for the poor led him to make this protest against some step now proposed, or already taken, to tax, in some new form, the life insurance held by those of humble circumstances.

Let it be clearly understood:

First. No kind or type of Federal tax affects life insurance today that was not contained in the revenue laws approved by Mr. Hoover.

Second. The proceeds of life insurance have the same exemptions now as under the State tax law approved by Mr. Hoover. To a beneficiary other than executor \$40,000 is absolutely free of tax. Above that sum it is now subject to estate tax only if the net estate exceeds \$40,000 above the exempt insurance. So \$80,000 may be left to beneficiaries before a tax begins on insurance. It can hardly be said "this tax comes out of the poor."

Third. Mr. Hoover's estimate of five million income taxpayers is an exaggeration of any recent figures. At the end of Mr. Hoover's four years only 1,747,740 reported having enough income so that they were taxable. Happily, that number has now substantially increased and is steadily increasing.

Confronted with the decision of the Supreme Court,

which took processing taxes away from the Government, and by the enactment of the soldiers' bonus law, President Roosevelt invited the Congress to consider a "form a tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes." The changes proposed are in the taxes on corporations.

These proposals have not been well understood, because Federal taxation has long been exceedingly technical and complex. But the principles of the tax reform proposed by the President are not beyond general understanding. Let us first see what was wrong with the old system.

One wrong is that the present corporation tax makes use of the corporation, as a form of business organization, cost too much for the small business man. Income of the corporation is taxed from 12½ percent to 15 percent. A business of small profit, costs less tax, if done by the individual without incorporation. If the net profit of a business is under about \$18,000, it now costs more in taxes to be incorporated than to operate as an individual. A partnership is cheaper in taxes than a corporation, if the share of profits of each partner is less than \$18,000 a year. There is no just reason why the privileges and advantages of incorporation should be limited to those of large incomes. Under the plan proposed by the President, the disadvantage upon small business will be removed.

A second wrong in the present tax law is that the owners of a business with big income would pay less tax by keeping the profits in a corporation than if they took them out and paid the surtax which applies to large individual incomes. As long as profits stay in the corporation they are taxed at only 15% but when they are paid out, the stockholder may have a surtax which would reach 52% for the high brackets on a \$100,000 income. Thus the stockholder with a large income now saves tax by locking up earnings in the corporation instead of paying dividends. His stock is increased in value by the earnings plowed back. If he dies still owning the stock no one would pay income tax on such increase. If he enters a reorganization of his company, by merger or consolidation, he gets the advantage of his increased value tax free. Devices to get the benefit of the profits without paying the surtax on them have been many and too often successful.

For this purpose numberless holding companies were created and are now operated to collect corporate profits and to prevent distribution to individual owners. These "incorporated pocketbooks" have long been used to evade taxes and have long vexed Congress. Various provisions to reach personal holding companies and to prevent unreason-

able accumulations of surplus to avoid taxes have been enacted. None worked well in actual practice. The result is that existing laws permit the rich man to use the corporation to his great tax advantage, while a man of moderate income can not make use of the corporation for legitimate business purposes without paying a penalty in the form of higher tax. That this discrimination against small business has fostered monopolies ought to be obvious.

Not only is existing tax law unfair to small business in competition with big business, but where the great and the small put their savings to work together in one big corporation, there is a conflict of interest in which the small stockholder often suffers loss of his current income to help the big stockholder save his tax. Some of America's most worthy enterprises are possible only by combining the savings of thousands of small stockholders with those of the larger and managing stockholders. Because their interests are small and scattered, small stockholders are helpless and policies are fixed by the management representing large stockholders. They prefer to pay a small dividend, or, in some cases, no dividend at all, and pursue the policy of "plowing the earnings back into the business." This is very well for those with other source of income. It is a hardship to the small investor whose dividends, if paid to him, would help buy comforts of life. Moreover, the policy of withholding dividends often lowers the value of his stock, and he finds that, not only is he deprived of the true earnings of his investment, but he cannot even sell it at a fair price. It is bad enough when men in control of great aggregations of wealth disregard the interests of their less well-to-do investors, but it is intolerable that the Government should actually put a premium on such conduct, as our tax laws now do.

Another disadvantage from the public point of view is that this corporation hoarding policy has caused the concentration of much capital in the control of a few hands and encouraged monopolies. Possessed of earnings, which the big stockholders cannot afford to withdraw as dividends, the natural tendency is to reinvest, to buy out competitors, buy sources of material or otherwise extend control of markets or of resources. For many years our tax laws have encouraged the concentration of capital and stimulated monopolies. Reorganization provisions have permitted the stepping up of wealth through merger and consolidation of companies, with the postponement of all profits tax until the securities taken in the reorganization were sold. If they were held until the death of the owner, they escaped any income tax whatever. One corporation could receive dividends from another without the payment of any income tax thereon, but an individual could not get a dividend without including it in his surtax calculation. This was almost a subsidy to the holding company which brought a train of evils to our economic system. The device of consolidated returns permitted systems of corporations to offset operating profits with paper losses for tax purposes and to build a pyramid of companies in which a little investment would control a vast amount of wealth. The abolition of the privilege of consolidated returns under this Administration, has already produced, as those who administer the revenue laws can see, a tendency to simplify corporate structure. Enactment of the intercorporate dividend tax, though

small, has further stimulated the movement to unscramble complicated corporation structures.

However, this concentration of corporate assets had already proceeded to a startling degree by 1933. Over 53 per cent in value, of all assets owned by corporations in this country was owned by only 618 out of our half million corporations. Five percent of the corporations owned 85 percent of all the wealth owned by corporations in 1932. We find the same concentration of income. Of all net incomes enjoyed by corporations in 1932, over 50 percent went to 201 corporations, which represented only three tenths of one percent of the number of corporations having some net income. There is no evidence that a limit to the continued increase of corporate size has yet been reached, or that any real obstacle, economic or legal, to the continued concentration of corporate wealth has yet been created. Our antiquated tax laws foster the increase, because withholding profits from stockholders and use of them to finance monopolistic practices has played a large part in this unwholesome development.

Another undesirable effect of the present corporation tax law is that it encourages raising of capital by bonds instead of through stock ownership. Interest on a debt is taken as a deduction from income before figuring tax. Dividend payments are not. Hence the corporation saves tax by borrowing money at interest rather than issuing stock and paying dividends. Proper dividends and interest are equally costs of use of capital, and in spite of legalistic distinction between them should, it always seemed to me, have equal tax treatment.

Financing by debt has been too largely indulged in this country. Fixed interest charges have brought many corporations to receivership which would have been unnecessary if more of the capital had been raised by stock. A corporation which has raised its capital by stock ownership may, in a period of depression, be obliged to suspend dividends, but that does not wipe out the stockholders. When the depression is over they participate in the corporation's recovery. If the corporation, however, has raised its capital in part by a bond issue and cannot meet the interest, it cannot suspend interest payments. It is hustled into receivership. Sales at foreclosure or reorganizations are had. The stockholder is entirely wiped out and can never participate in the recovery, and too often the bondholder meets substantially the same fate. Yet our tax laws have for a generation driven corporations in the direction of financing by debt because it was cheaper from a tax point of view for them to raise their capital through fixed interest obligations than through stock issues which impose a more flexible obligation.

This inequality, this pressure to create an unsound capital structure is relieved by the proposal of the President, so that corporations would no longer find it to their advantage to set up capital structures that could not stand days of adversity.

Just what does the President propose? In the language of his tax message, it is "a proper tax on corporate incomes (including dividends from other corporations) which are not distributed as earnings." "The rate on undistributed corporate income should be graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of

stockholders." A simple way of stating the suggestion is that the corporation be permitted to figure its taxable income in the same manner as now, except that it would take credit against its income for dividends paid, as it now takes credit for interest paid. This would leave a dividend paying company with a smaller amount to be taxed. This smaller amount would, of course, be taxed at a higher rate to be fixed to raise adequate revenue and discourage excessive withholding of earnings from stockholders.

What effect should we expect from this?

Stockholders of the great industries know that the first effect is that it eliminates the present 15 percent tax on earnings actually distributed to them. Their earnings now pay a 15 percent tax before they can be distributed. Under the President's proposal the corporation will not have to pay this 15 percent to the Government, if it pays the earnings to those who are entitled to them. Each stockholder will pay his own tax on dividends based on his income.

Any corporation which distributes 60 percent of its total earnings will have no higher tax to pay under the proposed law than it now pays. The corporation that is distributing more than 60 percent may actually have its taxes reduced. The increases will affect only those corporations which withhold an undue share of earnings from those who have invested.

The proposed tax law will make the corporate form of doing business available to the small business man without a tax penalty. It will be available to the big business man even more freely than it is now available to him for the purposes of conducting a legitimate business. But it will not be advantageous, to either large or small business men, to use the corporate organization to freeze out smaller stockholders. That device is by no means confined to Wall Street. I have seen it operate on Main Street. It will prevent the use of corporations for tax evasion and it will encourage corporations to finance through the safe method of stock ownership rather than through the treacherous method of financing by creating excessive debt to avoid taxation.

The question is asked, can corporations get new capital under this plan? I believe they can. As the effects of the law become apparent, receiverships will be less frequent and reorganizations less common. Stockholders will be less frozen out. The return received on the stock will be much nearer the earnings of the corporation. There will be a greater inducement to stock ownership. The corporation that has earnings and is distributing them should have no difficulty in financing itself with stock issues especially with the additional assurance of the tax law that the stockholders will receive what the company actually earns.

The argument made against this proposal, almost the solitary argument, is that corporations should not be taxed on undistributed profits because it will discourage them from laying aside surplus for the "rainy day." Those who are honestly fearful of that effect should remember that those profits—as well as others—are now taxed. Also that under the proposed law any corporation which intends to distribute two-thirds of its earnings will have no larger tax to pay than under the present system. It may, at the same cost as now, lay aside one-third of its earnings for the "rainy day." Those who favor conservative and prudent corporate management—and I am one of those—will find this law no threat. It does not penalize reasonable reserves

—it repeals as much burden as it imposes upon reasonable management.

Besides those who are genuinely fearful that "rainy day" surpluses of corporations might be discouraged, there is another and more noisy group whose fears are just as genuine but not so noble. They have had privileges and advantages in our tax laws so long that they think they are part of the Constitution. It is they who form the leagues to prevent cruelty to millionaires. They are now engaged in trying to show that their corporate surpluses are great umbrellas which they hold over our whole stockholding public when the "rainy day" comes. Let's look at the revenue figures and see who is really under the umbrella.

Of course out of our 120,000,000 population only those who are stockholders can get any protection. While all of the stockholders of all corporations add up to nine million, there are enormous duplications, and it is probable that the number of persons owning corporate stock does not much exceed 2½ million.

In 1933 the 1,740,000 persons who filed income tax returns accounted for receipt of 85 percent of all the dividends paid by domestic corporations. But this confirms the estimate that the benefit of "rainy day" surplus dividends could not, in any degree, reach over 2½ million people. Thus a very small part of our population got even trifling shelter from the umbrella.

Now let us see what this shelter meant to the various groups who did share it. First let us look at the group most in need of income, most affected by unemployment, most certain to put any money they could get into immediate circulation by purchases of necessities—this is the largest group of all—those with net incomes under \$5,000 per year. We find that they earned in wages and salaries 66 per cent of their income, and received only 5.07 per cent of their total income from dividends. Certainly such small income groups are barely under the edge of the umbrella.

Now let us turn to the other extreme. Those with incomes above \$500,000 we find get over 50 per cent of theirs from dividends, they also get large amounts in interest, and actually earn from wages and salaries only about 3 per cent of their total incomes. They are the boys who are really clear in under the umbrella.

I do not deny that corporate surpluses are useful against the rainy day. But I do deny the claim that such surplus is used as a gigantic relief fund for those in need. It no doubt does help many who need it. It could benefit many more. Many who need it most have to sell their stock before the depression gets far, and the greater benefits go to those who give up no necessities and but few luxuries, as a result of the rainy day.

No country has permitted so extensive a concentration of corporate owned wealth as we have, and none has had such a large part of its total wealth locked up in corporate controlled surpluses. Neither has any other country had so intense a depression. This is not enough to prove the point, but it does justify the suspicion, that, if this wealth and purchasing power were better distributed, we might not have so many rainy days.

It is for this reason that many business men, who are engaged in industry and not in tax avoiding, are favoring the President's proposal. It erases old inequalities, encourages sound financing, prevents tax evasion, permits reason-

able surpluses, and removes the obstacle that now stops the distribution of purchasing power.

A letter written in May of 1931 by one of the dominant stockholders of a great American industrial corporation to his son, who was soon to become a director, has been made public in a litigation. He wrote of the large block of stock he was presenting to his son:

"It is not paying any dividends at present as the company is expanding and using its surplus earnings for that purpose; but this course is better in the long run for the stockholders than would be the present receipt of cash dividends."

Here, my friends, is the perfect expression of the doctrine of these corporation paternalists who do not want to pay over earnings to those who have invested. We know these dominant stockholders saved their own surtax by refusing to distribute earnings. But in May, 1931, a depression year, where was the umbrella for the stockholder that we hear about? In that year how many small stockholders sold this stock at depreciated prices because it was paying nothing

to help carry it? How many lost homes for want of a dividend to help meet interest? The distress caused by this policy of regimenting all stockholders, and making them goose-step to the tune of the tax avoiding management can not be fully known.

The new tax proposal would discourage this paternalism by the corporation managements and let the funds move to those who own them.

This proposal will need and will have careful draftsmanship. Even so, it will have defects, but imperfections will be revealed by experience, and amendment will correct them. This is the course of all new legislation. Demands for unjustified exceptions, exemptions and special treatment will have to be resisted.

The principles set out in the President's tax message are capable of becoming the most significant reform in our entire income tax experience. It deserves the studied and aggressive support of all "young" democrats and all who share President Roosevelt's vision of an economic order that rests on a more equitable sharing of the tax burden.