RADIO ADDRESS

UNIVERSITY OF THE AIR

Station WEVD

March 26, 1936

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 has invited the Congress to consider a "form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes". The proposed changes are in the taxes on corporations.

These proposals have not been well understood, because Federal taxation has long been exceedingly technical. 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 the use of the corporation, as a form of business organization, cost too much for the small business man. Income of a corporation is taxed at from 12½ to 15 percent. If the net profit of a business is under about $18,000, it costs less tax 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, this 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 pay less tax by keeping

the profits in a corporation than if they take them out and pay 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 a corporation instead of paying dividends.

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 unreasonable 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 cannot 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 sources 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.

This concentration of corporate assets had already proceeded to a startling degree by 1933. Five percent of the corporations owned 85 percent of all the wealth owned by corpora-

tions in 1932. We find the same concentration of income. Of all net incomes enjoyed by corporations in 1932, over 50 per-cent 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 tax laws encourage the growth of those who are already giants.

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". 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 much smaller amount would, of course, be taxed at a correspondingly higher rate.

What effect should we expect from this?

Stockholders of the great industries should 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.

On the basis of rates so far discussed, a corporation which distributes two-thirds 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 two-thirds 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 all 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 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 fearful of that effect should remember that those profits - as well as all 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.