

Some Common Misconceptions About the Profits Tax

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Over a year has passed since President Roosevelt first "invited the attention of Congress" to the plan of taxing corporations on undistributed profits,¹ in lieu of conventional corporate taxes.² The business community, it will be remembered, reacted to the plan by violent and unanimous protest,³ subsequently echoed on the senate floor;⁴ and as a result, a "compromise" Revenue Act was evolved,⁵ which, it seems, will be continued without change for another year.⁶

Several lawyers, accountants, and other "tax experts" have examined and explained the provisions of law implementing the profits tax in the 1936 Act.⁷ The majority of these commentators have found hardships and inequities to taxpayers in spe-

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¹ The term "profits tax" will be used hereafter as a convenient expression meaning "the graduated tax on undistributed net income of corporations." The term "effective" profits tax hereafter used means a profits tax with rates steeply graduated, leaving corporations no alternative to distribution.

² Including the normal or "flat" rate on corporate income, and the capital stock-excess profits tax.

³ As recorded at the Hearings on the proposed tax bill before House and Senate Committees (Hearings before Committee on Ways and Means, Hearings before Committee on Finance, on H.R. 12395; Gov't Printing Office, 1936); and in periodicals, speeches, etc., March 30-June 30, 1936, summarized in 14-5 Tax Mag. 299 (May, 1936) and monthly issues thereafter. Some protest was undoubtedly due to a *priori* distrust of the Administration, of novel ideas generally, and of novel tax measures particularly.

⁴ See *Congressional Record* beginning with the issue of June 5, 1936, at p. 9179, *et seq.*, Senator Walsh and others.

⁵ The Revenue Act of 1936, P.L. No. 740, 74th Congress, 2nd Session (June 22, 1936); hereafter called the "1936 Act."

⁶ According to three Government press releases, summarized in *New York Herald-Tribune* editorial, May 5, 1937.

⁷ Section 14, entitled "Surtax on Undistributed Profits." Among others, see Hendricks *The Surtax on Undistributed Profits of Corporations*, 46 Yale L.J. 19, at 49; Cochran, *Scientific Tax Reduction* (Funk & Wagnalls, 1937), p. 187; Paul, *Studies in Federal Taxation* (Callaghan, 1937), p. 76; Montgomery, *Federal Income Tax Handbook, 1936-37* (Ronald Press, 1937), preface, p. V, also p. 701, *et seq.*

cific situations, and have thus concluded against the "principle" or "policy" of profits taxation in general. The Treasury Department, on the other hand, has been content to rest its case for the profits tax chiefly on the basis that it would eliminate three minor⁸ hardships and inequities in the conventional tax system. Less casual study shows that imposition of an effective profits tax would have important and far-reaching results not only in shifting tax burdens, but in influencing matters of general economy, social and political policy, and corporate practice. These matters have been touched on,⁹ but not thoroughly explored. It would seem that the Treasury Department, in the first instance, should have taken the laboring oar, in stating the principles and policies involved in profits taxation, and the objectives sought, especially if, as seems probable, new plans for profits taxation will be advocated for 1938.¹⁰ In the absence of such statements, the present negative public reaction based partly on misconception of the issues, is to be expected.

1. *Defining the profits tax idea.*

Montgomery¹¹ and other authorities¹² do not dispel a cur-

⁸ It is intended to suggest that, in comparison with the sweeping nature of the change proposed, and in view of the importance of the income tax in shaping corporate policy, the matters cited for correction (see President's Message, reprinted in H.R. Report No. 2475, 74th Cong., 2nd Session) were of minor importance.

⁹ E.g., a hint from the President in a speech at Boston, October 21, 1936: "We have made it harder for big corporations to retain the huge undistributed profits with which they gobble up small business." (*N. Y. Times*, Oct. 22, 1936, p. 14). The most discerning comments to date are by Prof. Benj. Graham, *op. cit.*, *infra*, note 20; Prof. Donald W. Gilbert, *Should the Undistributed Profits Tax Be Repealed?*, 14-12 *Tax Mag.*, p. 710 (Dec., 1936).

¹⁰ Cf. Arthur H. Kent, Ass't Gen. Counsel, Treas. Dept., 15-4 *Tax Mag.* 204 (April 1937), at p. 246, mentioning the "reduction and perhaps ultimate removal of the present *normal* tax on corporations."

¹¹ Robert A. Montgomery, *Federal Income Tax Handbook, 1936-1937* (Ronald Press, 1936), p. 703; "As (sic) one of the so-called social objectives of the new tax provisions, according to the President, was the forcing of corporate surpluses into the hands of the stockholders." The meaning of this sentence is not clear; it is taken that Montgomery speaks of pre-existing surpluses. It is noted that neither the President nor any other proponent of the tax disclosed any social objectives therefor; particularly, any objective connected with the shift of corporate surplus.

¹² E.g., Godfrey N. Nelson, *The Taxation of Corporate Surplus*, Vol. 15-1, *Tax Mag.* p. 15 (January 1937); also comment in tax column of the

rent notion that the profits tax in some way affects existing corporate surplus. This idea commonly inheres in newspaper characterization of the tax as a "surplus tax," or a "tax on savings," and in statements that the tax effects a "redistribution of wealth"¹³ the government, in drafting specific legislation, sought to create a directly contrary impression, that the tax is laid "on the net income of corporations" (this being the professed subject of the tax) "in an amount *measured by* the undistributed net income."¹⁴ There is, apparently, confusion as to the incidence of the profits tax—the "levy effected thereby—from the economic viewpoint.

Under a profits tax two factors must be present before the corporation is personally liable for tax. The first may be considered a "condition precedent." The corporation must have "realized"¹⁵ net income. Where there is no corporate income, or where there is a loss, there is no liability tax. It is immediately clear that the tax does not fall on corporate surplus, or other capital, from the economic point of view.¹⁶ It may be distinguished, in this respect, from various levies at flat rates *ad valorem* against corporations, such as "excises" on capital stock,¹⁷ and "franchise" taxes measured by capital stock,¹⁸ where mere ownership of capital gives rise to tax.

The second factor in the profits tax may be considered in the *New York Times* (Business and Finance section) Sunday, April 12, 1936: "In effect, the levy on undistributed corporate earnings seeks to impose a tax upon the equity of the shareholders * * *."

¹³ Montgomery, *op. cit.*, *supra*, note 11.

¹⁴ Regulations 94, Art. 14-1, construing section 14 of the 1936 Act.

¹⁵ See Roswell Magill, *Taxable Income* (Ronald Press, 1936), ch. 1. It is meant to emphasize that the profits tax does not necessarily involve a change in the legal concepts of the nature of taxable income.

¹⁶ Nor as a matter of strict accounting, since current income goes first to profit-and-loss, and to surplus at the end of the current period, which presumably coincides with the income tax year.

¹⁷ E.g., The Federal capital stock tax imposed under the 1916 Act, Title IV; and subsequent Acts through 1926. Montgomery, by a process of circular reasoning, has found that this "amounts to an additional income tax," because past earnings often determine present fair value of the corporate property." "1923 Income Tax Procedure," p. 1468.

¹⁸ E.g., McKinney's N. Y. Tax Law, Section 9 A, tax on real estate holding companies.

nature of a "condition subsequent." The tax arises only if the corporation does not distribute its net income during the tax period in which it was "realized."¹⁹ Distributions, of course, need not be made in cash; it is only essential that they be taxable to the stockholders.²⁰ The rate of tax depends on the amount withheld, thus providing a real incentive to distribute; and the profits tax should be clearly distinguished from taxes graduated on the basis of amount of net income, for one reason or another.²¹ Thus, net income, and non-distribution of such income must occur before there is tax liability on any specific corporation. The economic incidence, or levy, of the tax is on the subject "net income not distributed" (withholdings).

This fact appearing, it is certain that the tax is not, by legal or economic definition, an income tax;²² equally, however, it is not a tax on prior accumulations (capital). The correct concept is of a tax on a particular *use* of income, for income used by corporations for reinvestment (expansion of corporate capital) is to be taxed. Since no precedents for such a tax exist, the legal definition of the tax is doubtful; it would seem to be an excise

¹⁹ Another unit of time may be substituted for the income tax year; e.g., period between due-dates of corporate tax returns.

In dealing with this point, an incidental misconception is noted. This concerns the failure to distinguish between (a) allowable deductions in computing corporate net income, and (b) distributions; illustrated in the Cleveland Trust Co. *Business Bulletin*, September 15, 1936, which gives the impression that amounts paid out for operating expenses of the corporation are considered "distributions." Thus, a corporation which spends all its earnings for research and advertising escapes the profit tax, not because of distributions (factor two) but because of lack of net income (factor one).

²⁰ Various methods of withholding cash, while passing on tax, are open; this, of course, is the first method of escaping "harmful" economic effects of the profits tax. See Graham, *The Undistributed Surplus Tax and the Investor*, 46 *Yale L.J.* 1, at p. 5, *et seq.*

²¹ Thus, from graduated "normal" tax on corporations (favoring smaller corporations), and from graduated individual taxes, where income measures ability to pay.

²² Definitions traditionally concern concepts of receipt, accrual, and reduction to possession, and the element of use to which income is put plays no part. Moulton, *The Formation of Capital* (Brookings, 1935), Ch. II; Beale, *Stockholders and the Federal Income Tax*, 37 *Harvard L. R.* 1 (1923); 1 Paul & Mertens *Law of Federal Income Taxation*, Ch. V. Magill, *Taxable Income* (Ronald Press, 1936), p. 17, p. 191, *et seq.*

within Article I, Section 8, of the Constitution, although the Supreme Court might hold it a burden on property, thus a direct tax unapportioned.

2. *The Profits Tax and the Corporate Entity.*

It is clear that corporations will assume a new status under an effective profits tax; the exact nature of the change is commonly misdefined. Thus, a common "newspaper" attitude has been expressed as follows:

At least by indirection this sort of tax amounts to a disregard of the doctrine of corporate entity, which holds that a corporation is a separate and distinctly (sic) legal entity from that of its owners, the stockholders. In effect such a levy would tax stockholders as co-partners are now taxed.²³

Other commentators create an impression that the profits tax springs from certain Civil War income tax legislation,²⁴ under which the gains and profits of "all companies, whether incorporated or partnership," were included in computing the taxable income "of any person entitled to the same, whether divided or otherwise."²⁵

Since the profits tax is levied against the corporation, it is evident that no disregard of the corporate entity is involved. Whether or not the taxation of stockholders on their *pro rata* share of corporate income would better tax equities, the method is today impracticable,²⁶ and probably would be held unconstitutional.²⁷ On the other hand, it is equally clear that the corporate entity is not to be given the conventional income tax status,

²³ Godfrey N. Nelson, in the *New York Times*, Sunday, April 12, 1936.

²⁴ Graham, *op. cit.*, *supra*, note 20; 14-4 Tax Mag. p. 235; Note, *The Corporate Undistributed Profits Tax*, 36 Columbia L. R., p. 1321.

²⁵ Sec. 117, Act of June 30, 1864, set out in *Collector v. Hubbard*, 79 U. S. 1, at p. 2 (1870).

²⁶ A. A. Ballantine, *Corporate Personality in Income Taxation*, 34 Harv. L. R. 573 (1921): "Corporations (have) become so numerous and their stock so widely diffused in ownership and so frequently transferred that the carrying out of such a plan as to all classes of corporations would involve forbidding practical difficulties." The same conclusion was reached by a Committee on Simplification of the Federal Income Tax (Proceedings of the National Tax Association, 1927, pp. 108-167).

²⁷ *Eisner v. Macomber*, 252 U.S. 189 (1920); see T. R. Powell, *Income from Corporate Dividends*, 35 Harv. L. R. 363 (1922).

under an effective profits tax. The theory of the former method has been to treat corporations as entities collecting and owning income, just as individuals. Thus, under the Revenue Act of 1913 (unchanged in theory by later Act):

* * * the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing * * * to every corporation * * * .²⁸

This method of taxation would seem adequate to exact a flat contribution from all business income toward government support. It breaks down, however, as it conflicts with the fundamental principle of the income tax: to tax each individual according to the amount of his income, which measures his ability to pay. Obviously, the principle cannot be applied to the corporation as an income-collecting entity, for in each corporation there are several stockholders, with diverse interests in the corporate income, and diverse abilities to pay. It has, therefore, been necessary to continue taxing corporations at flat²⁹ rates on their income, while exempting stockholders from the normal or flat tax on dividends (income already taxed to the corporation).³⁰

The fundamental conflict between a flat rate of tax on corporate income, and a graduated rate of tax on individual income becomes important, as a practical matter, as large amounts of corporate income never become subject to the individual surtax,³¹ and as surtax rates become so high, that the factor of indi-

²⁸ Ch. 16, 38 Stat. 114, at 172.

²⁹ Recent slight graduations in rates on corporations are for the purpose of favoring small corporations and are immaterial to the matter under discussion.

³⁰ Montgomery, *1923 Income Tax Procedure* (Ronald Press, 1923), says, p. 701: "The fundamental fact (is) that the income tax is primarily a personal tax; the rate imposed upon the net earnings of corporations being, in fact although not in form, a device primarily designed for collecting part of individual shareholder's tax at the time the corporation earns the money rather than when it distributes it in dividends."

³¹ Berle and Means, *The Modern Corporation and Private Property* (Macmillan, 1933), Appendix B, p. 360, show billions of dollars withheld from distribution in each year from 1922-1928 which, for the most part, never became subject to surtax except through the more or less adequate capital gains or loss provisions when stock is sold. Leven, Moulton, and Warburton, *America's Capacity to Consume* (Review of Reviews Ed., 1934), compute on

vidual tax liabilities enters into decisions by corporate managers on the question of dividends.³² Thus the tax problem is one of forcing current corporate income into the hands of individuals; and the profits tax is a method of accomplishing this result, rather than a method of taxing income. The viewpoint on the corporate entity takes a consequent shift; the corporation is no longer considered the ultimate owner of its income, like individuals, but is regarded as a distributor of income—a conduit of current business income to individuals, and non-taxable so long as it accepts this status by distributing its income.

The above analysis indicates the answer to several misconceptions about the effect of the profits tax in adjusting the total tax load borne by business income. First, it is commonly thought that under an effective profits tax, stockholders as a class (vigorous entrepreneurs, willing to risk capital to develop productive capacity) will be discriminated against in favor of the pure *rentier* class (non-producers, often characterized as "parasitical"), with investments in interest bearing obligations.³³ The profits tax will, of course, do nothing of the sort. The gross income of the *rentier* class has always been entirely subject to the recurring levies of the individual income tax,³⁴

a slightly different basis, for the years 1909-1930, and show that the aggregate holdings have increased materially, which is of prime importance to the individual surtax system. (*op. cit.*, pp. 109, *et seq.*). The Treasury estimated that, without a profits tax, four and one-half billions would be withheld, thus not subjected to surtax, in 1936. President's Message, *cit. supra*, note 8.

³² President's Message, *cit. supra*, note 8, as amplified by government testimony in the Hearings before the Committee on Ways and Means on H.R. 12395 (Gov't. Printing Office, 1936), Graham, *op. cit.*, *supra*, note 20, at p. 2. The author of a note, *The Corporate Undistributed Profits Tax*, 36 Columbia L. R. p. 1321, minimizes this factor in such decisions, p. 1323; at all events, it is immaterial to the fact of loss of revenues from the individual surtax, as corporations "save" income which does not ever necessarily appear in individual returns.

³³ Dorothy Thompson, "On the Record," *New York Herald-Tribune*, May 7, 1937.

³⁴ E.g., 1936 Act, Sec. 22(a); except in so far as invested in tax-exempts. The thought that a profits tax will drive capital into tax-exempts (Finance Committee Hearings, p. 56) implicitly admits that stockholders avoid surtaxes under conventional corporate taxes. If a cure is needed, it should be found in removal of *all* exemptions. The psychological problem is well put by

while the gross income beneficially owned by stockholders has, in the manner above indicated, partially escaped the surtax. Second, it is thought that the profits tax will discriminate against income from capital, as distinguished from income from labor; in every-day journalese, "soak-the-rich."³⁵ Not so; if the profits tax causes distributions, gross income from stockholdings and gross income from wages and salaries will become subject to the same provisions of the individual income tax law. Since the profits tax is designed to coerce distribution of income, rather than to tax income, and since amounts of profits tax payable by any corporation are within the control of the managers (thus, ultimately, the stockholders),³⁶ no reason is seen for the suggestion that stockholders should be exempted from tax on income which has, in a prior year, borne a profits tax.

Erroneous conclusions as to the tax equities involved in a profits tax thus usually arise from a misunderstanding as to the nature of the tax, and the nature of the tax problem sought to be solved. Misunderstandings as to the effect of a profits tax on corporate economy are of much greater importance.

3. *Economic and Social Implications of the Profits Tax.*

The gist of the most common, and perhaps the most important, conclusion against the profits tax is contained in a recent newspaper column:³⁷

Paul: "Some taxpayers have reached the point of believing that tax avoidance is one of their inherent rights." *Studies in Federal Taxation* (Callaghan, 1937), p. 76.

³⁵ Montgomery, *op. cit.*, *supra*, note 7, p. 701: "(the profits tax was) obviously advocated as a 'soak the rich' measure * * * ." It should be added that when a profits tax is imposed *in addition* to conventional corporate taxes, the stockholding class is taxed disproportionately.

³⁶ Except in certain specific cases, e.g., where outstanding contracts prohibit dividend payments, which can usually be avoided by the device of stock dividends, and which, in any event, are cared for by specific exemptions.

³⁷ Dorothy Thompson, "On the Record," *New York Herald-Tribune*, May 7, 1937. It is interesting to note that statements against the profits tax, because it encourages monopoly, often emanate from sources which have not heretofore indicated much interest in that problem, e.g., Nat. Chamber of Commerce; Investment Bankers' Assn.; Nat. Assn. of Manufacturers (see testimony at Hearings, *cit supra*, note 3); Herbert Hoover (*cit. infra*, note 53).

The measure discriminates against enterprises which are new or financially weak in favor of those which are entrenched with ample surplus funds and available sources of capital * * * new and unseasoned enterprises, could not accumulate sufficient earnings to attain an adequate capital position. The usual method of developing small enterprises through the plowing in of earnings would be crippled.

Thus, it is commonly held, with little refutation, that an effective profits tax would operate to the economic disadvantage of small and medium-sized corporations, in comparison to its effect on their larger competitors; that new enterprises necessarily grow by "plowing back" profits, thus the tax would stratify corporations at their present size.³⁸ The basic concept which motivates such conclusions is well put by Dewing:³⁹

It is illuminating to look at the life history of a corporate enterprise as consisting of three great periods * * * . There is a period of youth in the history of every corporation; there is a period of maturity; and there is a period of old age and decay. * * * Much if not all of the capital required for this growth must be extracted from the business itself, namely, from the reinvestment of earnings.

This concept of the growth of small, new corporations, useful under conditions of free competition in business, where the older, larger units gradually pass the point of maximum efficiency, does not accord with the realities of today. Conditions of virtual monopoly now exist in most fields of enterprise; consequently, small corporations, by and large, cannot grow in any event. Proponents of a profits tax can perhaps conclude, with cause, that the present essential problem is to prevent further expansion of large corporations, for it is the large corporations which today are rapidly expanding, and this at the expense of

³⁸ Cf. Minority Report of the Ways and Means Committee, Rep. No. 2475, 74th Cong., 2nd Session: "This penalty on earnings 'plowed back' into the business will tend to stifle the growth of small corporations and will repress the development of new enterprises, since they have virtually no other means of obtaining new funds. By 'freezing' small corporations at their present size, and by discouraging new competition, the tax will be conducive to monopoly."

³⁹ *The Financial Policy of Corporations* (Ronald Press, 1920), Vol. IV, p. 168.

the gross wealth left to all other smaller enterprises in the same fields.⁴⁰

The grouping should be emphasized. On the one hand there are the 200-300 largest corporations, marked by wide diffusion of security ownership, and control vested in a small number of individuals whose beneficial interests in the corporation are, proportionately, small.⁴¹ These dominant corporations have tended to acquire more and more economic power, in one or more related fields of enterprise. On the other hand there are the vast numerical majority of corporations, limited to a steadily diminishing field, and at present dividing the smaller portion of the total business income.⁴² On the realities, it would seem that if the profits tax actually operated to stop all corporate growth, the problem of the maintenance of competitive conditions would not be enhanced.

But on the contrary, it would seem that under an effective profits tax, the existing tendency toward centralization of power in the larger corporations will to some extent be counteracted since in general, large corporations will be more hampered in efforts to expand capital than their smaller competitors. At present, large corporations expand by saving income to a much greater extent than smaller corporations.⁴³ This conclusion fol-

⁴⁰ Berle and Means, *The Modern Corporation and Private Property* (Macmillan, 1933), Ch. III, *The Concentration of Economic Power*, esp. p. 36 & 37. At the 1924-1929 rate of growth, it would take only thirty years "for all corporate activity and practically all industrial activity to be absorbed by two hundred giant companies," *op. cit.*, p. 40-41. Although the writer has no up-to-date statistics at hand, the tendency undoubtedly persists; thus Swift & Co. "buys out its 21st little competitor" (*Time Magazine*, Nov. 2, 1936); Mellon corporations inclusively expand by purchasing the Virginian Railroad (*id.*, Feb. 1, 1937).

⁴¹ Berle and Means, *op. cit.*, Ch. V, VI.

⁴² According to 1933 statistics, over 50% of all corporate net income went to 201 corporations. This is in line with the steady percentage increase found by Berle & Means, *op. cit.*, p. 37. The same statistics show 53% of all corporate assets owned by 618 corporations in 1933. 14-4 *Tax Mag.*, p. 236 (April 1936).

⁴³ Berle & Means, *op. cit.*, p. 41-42, Appendix B, p. 360. A specific example is the Aluminum Co. of America, recently sued by the Government under the anti-trust laws: "The complaint related how Alcoa was founded as Pittsburgh Reduction Co. in 1888 with \$20,000 in cash . . . out of

lows from consideration of several practical matters. Large corporations, with widely diffused stock, cannot declare taxable stock dividends, dividends in scrip, or use other means of passing on taxes without cash,⁴⁴ as easily as the smaller corporations. Where there are numerous stockholders, such dividends raise complicated accounting problems, in computation of fractional interests. The use of such dividends is to a large degree a matter of stockholder consent; and stockholders in large corporations, having no personal relationship with the management, would presumably resist a continuous practice of passing on taxes to them, without cash. Flotation of securities to obtain further capital, in the case of larger corporations, necessarily involves a public offering; a time-consuming operation.

The situation as to smaller corporations, generally, is to be contrasted. Here a small, integrated⁴⁵ body of stockholders presumably agree upon expansion policy. Stockholders can redonate dividends to their corporations with scarcely more trouble than transfer by the corporation of earnings to surplus; in both cases, mere book entries serve the purpose.⁴⁶ A policy of purchasing more stock with dividends may be instituted by the stockholders.⁴⁷ In every way the smaller corporations are more flexible and can adjust to new methods of saving income for expansion more easily and quickly than the large corporations.

Finally, and most basic of all, there is a common misconception as to the effect of a profits tax on the formation of produc-

Alcoa's \$175,000,000 in assets, no less than \$155,000,000 represented (undistributed) profits . . ." (to the end of 1934, last date used by the Department of Justice). *Time Magazine*, May 3, 1937, p. 70.

⁴⁴ Note 20, *supra*.

⁴⁵ By common locale and common interest in the corporation; a compact, continuous group.

⁴⁶ Thus the corporation, formally or informally, declares a dividend, and the stockholders, by prior agreement redonate without reducing the dividend to possession.

⁴⁷ Cf. George C. Haas, Testimony before the Senate Committee on Finance, April 30, 1936: "In the case of small corporations with a limited number of stockholders it is almost as easy to pay out earnings in dividends and have all or a part of them resubscribed by the stockholders for additional shares of the corporation's stock, as to-reinvest them directly."

tive capital; it is thought that amounts drained off in dividends (which the corporation would otherwise have used in expanding its plant) will be irrevocably lost and that the productive capacity of the nation will consequently decline. The idea will be treated on the positive side: The profits tax, for the most part, involves a change in prevailing methods and policies of financing business expansion, rather than a change in the economic process of expansion.

The traditional method of corporate growth is summed up by Dewing:⁴⁸

The simplest and most evident method of obtaining capital to meet the expenditures of an expanding business is through the reinvestment of surplus earnings.

Thus, in accounting procedure, the net results of corporate operations are transferred at the close of the fiscal period to the surplus account, and the corporate managers use this capital to purchase new plants, structures, or other expansion. As stated by Gilbert:

It has become an elementary principle of economics taught generally in the classroom that the corporation has made a considerable part of our annual savings automatic. Regularly the board of directors decides what part of the earnings shall be paid out to the owners and what part shall be retained and perhaps invested in new equipment.⁴⁹

Granting that under a profits tax the earnings formerly capitalized will to a large extent be drained off to individual stockholders, the first premise, commonly misperceived, may be established: Most of these earnings will immediately become available for, and presumably will be utilized in, further corporate expansion. The indicated new method for corporations to obtain these earnings will be increased volume of security flotation.

This premise is established by an analysis of the stockholding class, and what they presently do with their income; thus,

⁴⁸ *Op. cit.*, note 39, at page 168.

⁴⁹ *Op. cit.*, note 9, at page 710.

who will receive the extra dividends? Can we predict what they will do with the excess income received?

There are uncontroverted Government predictions as to the first question. On the basis of an effective profits tax:

A class of 16,051,768 taxable individuals would receive a gross income increase of \$4,398,000,000 of which \$4,015,000,000 would be taxable.

A class of 81,977 individuals with incomes of \$25,000 and over would receive \$2,861,000,000 thereof; thus $\frac{1}{2}$ of 1% of taxable individuals would receive 65% of the increase in income distributed by corporations.

A class of 910 individuals with incomes of \$500,000 and over would receive \$887,000,000 thereof; thus, .006 of 1% of taxable individuals would receive 20.1% of the increase in income distributed by corporations.⁵⁰

Even on the basis of conventional income taxes, it appears that most stock is owned by a high-income class. Thus, in 1934, 419,481 individuals with net income (i.e., income after all allowable deductions) of over \$5,000 received over 78% of all dividends declared. A class of 131,303 individuals with net income of over \$10,000 received almost 65% thereof.⁵¹

The division of dividend recipients is fairly obvious. A very large percentage of increased corporate distributions, under an effective profits tax, will go to a very small high income class. Most of the dividends not taken up here will go to a class which will not need to use their increased income for living expenses.

The second question is easily answered: the high-income group (with incomes of over \$5,000 per annum) has in the past saved a very large proportion of its income, and alone contributes almost all of the total volume of savings, which go to form productive capital.⁵² No other factors bearing on the situ-

⁵⁰ As reported in 14-4 Tax Mag. 237 (April, 1936).

⁵¹ As reported in 14-8 Tax Mag. 495 (August, 1936).

⁵² Leven, Moulton, and Warburton, *op. cit.*, note 31, Ch. VIII; Moulton, *Income and Economic Progress* (Brookings, 1935), p. 39-40. As said by Gilbert, *op. cit.*, note 9, stock is mostly held by "a high income group of satiated consumers who save automatically."

ation,⁵³ the very large part of cash dividend increases will automatically become available for investment in corporate securities, and corporate managers, deciding to issue more securities, will by the same token decide, as in the past, how much expansion is desirable. The indicated pathway to expansion is not the "simplest and most evident one," and along the way some savings are lost, as dividends go to individuals (small stockholders, for the most part) who will use them for consumptive purposes, and as individual surtaxes are increased. Sufficient to add that the most noteworthy economic study of the decade establishes almost beyond controversy that present economic maladjustment is largely due to too much saving in comparison to amounts spent for consumption, and that sizeable amounts of income withheld by corporations in prior years have not been used to expand productive capacity, in any event, but have gone for inflation of security prices, or enrichment of corporate "insiders."⁵⁴

Only brief mention will be made of a last important misconception about the profits tax. It is generally concluded that the

⁵³ Except one: the income taxes payable by this group will take a considerable portion of the excess dividends declared under an effective profit tax, which, of course, is the tax aim in the first place. Former President Hoover has an unintentionally amusing plan to exempt reinvestments: "I sometimes wonder if it ever occurred to anybody that one of the important things that makes jobs and increased national assets is expansion or improvement in plant or production. That should surely be our social and economic purpose. In that light it might be a sane thing for the Government to reverse itself . . . (and grant an exemption from any tax for all income used by corporations for expansion of capital and other "savings")." (Address of Sept. 30, 1936, *N. Y. Herald-Tribune*, Oct. 1, 1936, p. 14). It is noted that, for equitable and practical reasons, an exemption for corporate direct expansion of capital would have to be duplicated in similar exemptions for partnerships and individuals. Then corporations and individuals whose incomes went entirely for operating expenses and other consumption (i.e., too poor to save) would bear practically the entire income tax load.

⁵⁴ The writer has not seen any successful attack on the Brookings Institute studies as to these points. These studies thus furnish a basic justification of the profits tax idea. It is there found, *inter alia*, that not insignificant portions of annual corporate savings are absorbed in commissions and other charges, purchase of fraudulent securities, and especially bidding up of prices on outstanding securities. Moulton, *cit. supra*, note 22, p. 151 *et seq.*; Leven, Moulton, and Warburton, *cit. supra*, note 31, p. 99.

tax will discourage the building of corporate surplus, which constitutes a "reserve against depression," and which is in the nature of a corporate bank account against the "rainy day." For all practical purposes, the surplus account is today undistinguishable from the capital stock account; it may just as easily be created by capital contributions from the stockholders, reduction in par value of outstanding stock, or write-up of corporate assets, as through reinvestment of corporate earnings. The corporate surplus account does not reflect the liquid assets of the corporation, readily available for use in times of depression. For the most part, it represents only the value of capital investments in plant or structures in excess of value of capital stock outstanding. Even surplus reserves "for general and operating contingencies":

* * * will generally be represented by assets employed in the business, being often invested in additions to plants.⁵⁵

When notions about the inherent virtues of large surplus accounts are dispelled, it is easily seen that liquid reserves to any necessary amount can be obtained by corporate managers through the security market,⁵⁶ or through redonated dividends.

What has gone before has perhaps indicated that, in general, commentators have not examined the facts before concluding against the idea of a profits tax. Their arguments have largely been on the basis of abstract generalities (concepts) which have no meaning or which are inapplicable, under modern economic, tax, and business conditions. On the contrary various concepts as to the effect of a profits tax would tend to show that its effect

⁵⁵ Fletcher, *Cyclopedia of Private Corporations* (Callaghan, 1933), Vol. 19, p. 503.

⁵⁶ E. I. duPont de Nemours & Co. announces a plan to issue fifty million dollars in no-par value preferred stock, the proceeds of the issue to be placed in the general funds of the company. ". . . the purpose of the financing is to guard against depletion of working capital in the face of contemplated expenditures for increased manufacturing facilities." *New York Times*, financial section, p. 33, Tuesday, May 18, 1937. A commentator there cites the profits tax as the reason for using this method of securing capital. The proceeds of the issue can be divided between capital stock and surplus accounts, as the corporation sees fit. "Corporation Manual, 1937" (U. S. Corporation Co., 1937), p. 267, citing Delaware Code.

would be beneficial; for instance, through the operation of the tax in securing more publicity for corporate affairs. Thus, corporations desiring to float security issues for expansion (being unable to withhold for this purpose) will often be subject to the scrutiny of investment bankers, and of the Securities Commission. The exact purpose of the issue (the kind of expansion contemplated) will almost necessarily be disclosed to the investor, whether in a large or a small corporation, and wasteful or fraudulent disposition of funds, through "inside schemes" and otherwise, will to some extent be curbed.

When examining the merits of specific profits tax legislation, most commentators are on more solid ground. Certainly proponents of the profits tax find it difficult to justify their idea, when it is embodied in a tax bill which no one could understand.⁵⁷ The tentative approach to an effective profits tax, as contained in the 1936 Act (together with conventional corporate taxes) serves to enhance some of the equitable problems which existed under the older Acts, and works several specific economic and tax injustices. It is perhaps not too much to hope, that more skillful draftsmanship will mark the general revision of corporate taxes that may be expected in 1938.

⁵⁷ The profits tax as originally proposed was embodied in H.R. 12395, 74th Cong., 2nd Session. In the writer's opinion, Prof. H. L. Lutz has properly characterized this bill as "the most involved legislation ever recommended to Congress for enactment." The same author has also said: "It would be presumptuous for anyone to attempt a clear resume * * * (of the bill) in view of its obscurity. Any summary undertaken by one who had not been a party to its drafting is likely to be in error, and it may be questioned whether the draft is wholly clear even to those who prepared it." (Proceedings of Conference on Debt, Taxation, and Inflation; Wharton School of Finance and Commerce, Philadelphia, Pa.). Nothing in the nature of the profits tax idea makes it incapable of clear and flexible implementation in specific legislation.