TAXATION OF UNDISTRIBUTED CORPORATE PROFITS

John B. Martin Jr.
Member of the District of Columbia bar
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HISTORICAL BACKGROUND

THE legislation proposed by President Roosevelt in his message of March 3, 1936, to prevent automatic avoidance of taxation by non-distribution of corporate profits, does not represent a new and previously unheard of system of taxation. It embraces, on the contrary, the gist of proposals made by various individuals and organizations extending back as far as the year 1864 when Congress passed a Revenue Act providing that “gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.”† The Revenue Acts since 1913 have also attempted to deal with the closely related problem of purposeful evasion of surtax by the accumulation of surplus beyond the reasonable needs of the business.‡ In July 1917, a bill was submitted to the Senate by its Finance Committee§ containing a section suggested by Senator Jones of New Mexico¶ which levied in addition to normal income tax an additional 15 per cent tax on undistributed net income exempting, however, undistributed profits used for the maintenance of reserves required by law and 20 per cent of net income directly engaged in the production or distribution of commodities or in banking. This bill was sent back to the committee and altered. A subsequent amendment proposed a flat 10 per cent tax on the amount of undis-

*The material which follows has been limited in scope to a consideration of the new tax on undistributed corporate profits levied by the Revenue Act of 1936. Inevitably some mention has also been required of sections 102 and 351 and their counterparts in previous acts. The attempt has been made to view the principle embodied in the new act from the standpoint both of the lawyer and the economist. The technical accounting problems raised by the act have not been dealt with except as corporate accounting necessarily enters into economic analysis.

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§ See note 26, infra.

¶ 55 Cong. Rec. 4631, 4646 (1917); H. R. 4280, § 1206 (2).

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tributed net income retained, but this was modified to apply only to income not retained for actual employment in the reasonable needs of the business.

The statement has often been made that an ideal method would be to tax corporate income as though it belonged to the stockholder whether divided or not. But the decision in 1920 of the United States Supreme Court in *Eisner v. Macomber* seems to make this impossible. A tax on stock dividends was involved in that case. The court expressed itself strongly to the effect that “the stockholder’s share in the accumulated profits of the company is capital, not income” and cannot be taxed directly without apportionment until distributed as dividends other than stock dividends.

In addition to the pronouncement of the Supreme Court, the year 1920 was also fruitful in suggestions from several sources. The National Association of Credit Men in January, 1920, sent out from its Committee on Federal Taxation a proposal that the corporate income and excess profit taxes be repealed, that the dividends from current earnings be made subject to the normal tax in the hands of individuals and that a tax be levied on the undistributed net income. This tax was to be a graduated tax, each additional 10 per cent of undistributed net income paying a higher tax. In line with this proposal an amendment was offered by Senator Jones of New Mexico, but it was not finally made part of the Revenue Act.

In March 1920, Secretary Houston of the United States Treasury suggested to the House Ways and Means Committee that a tax on the annual undistributed profits of corporations would be a desirable

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5 55 Cong. Rec. 6175 (1917).
6 40 Stat. L. 300 at 334, c. 63, § 1206 (2) (1917).
9 Message from the Committee on Federal Taxes of the National Association of Credit Men (January 1920). See remarks of R. G. Elliott, chairman of this committee, in Proc. Nat. Ind. Tax Conf. 64-70 (April 1920), and of Senator Jones of New Mexico, 61 Cong. Rec. 6834, 6841, 6845, 6851 (1921). Note that in the recent House proposal the tax was a percentage of adjusted net income and not of undistributed net income. In the bill as finally passed, the tax is a per cent of undistributed net income, the per cent being determined by the per cent of net income undistributed. In both, however, the ultimate reference is to the amount of net income retained by the corporation.
change in the tax system. The Secretary recognized that this taxed reinvested profits but pointed out that even if unwise economically it was an accepted principle as to sole traders and partnerships, and therefore should be equally applicable to corporations. He felt that if the tax were moderate it would not result in an uneconomic disbursement of dividends.

During the same year the Second National Industrial Tax Conference considered and rejected the idea of a tax on undistributed income “because that . . . would penalize saving, encourage distribution and put an undesirable pressure on the directors of a corporation to pay excessive dividends.” It was suggested that an attempt be made to equalize the tax burden and to tax the undistributed income by increasing the normal income tax and providing for partial abatement of the tax on individual income reinvested. At this same conference the Tax Committee of the National Conference of State Manufacturers’ Associations presented a plan differing in that it proposed a progressive tax upon undistributed net income based upon (a) the amount of invested capital, and (b) the ratio of undistributed net income to invested capital.

By 1923 Dr. T. S. Adams was saying to the National Tax Association in relation to the discrepancy between taxation of partners and corporations: “In consequence, we have all sorts of proposals to lay additional tax on the undistributed profits of corporations. . . . I do not quarrel with this rejection of the proposal to treat corporations like partnerships. . . .” He continued,

11 This suggestion was included in the Annual Report of the Secretary of the Treasury 39-43 (1920). Both flat and graduated taxes were suggested as alternatives. It was also suggested that if a progressive tax was used the total surtax should never exceed 20 per cent of the undistributed profits.


13 In addition it was proposed (1) to attempt no change in the general principle involved under then existing law in taxing individuals (other than stockholders), sole proprietors and partnerships, (2) to withdraw the existing exemption from normal tax on dividends received from corporations, (3) to exempt corporations from any normal income tax. Compare this plan with the House proposal to differentiate between corporations on the basis of the amount of income earned. Roughly, perhaps, the amount of invested capital may be thought to be proportionate to the amount of net income in ordinarily prosperous times. Remarks of J. F. Zoller, Proc. Second Nat. Ind. Tax Conf. 134-139, 187 (Oct. 1920).

14 Former Chairman of the Advisory Tax Board of the Bureau of Internal Revenue. Dr. Adams’ opinion is quoted because there has been considerable controversy as to the position which his long study of tax problems led him to take on the principle of taxation of undistributed corporate earnings. See testimony of G. O. May, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 542 (1936).

CORPORATE SURPLUS TAXATION

"We reject an exact solution of this problem... because when we face the issue squarely we conclude that it would be inadvisable to put a premium on the complete distribution of corporate profits." We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the savings made by corporations... that part of the business income of the country [representing savings] cannot stand surtaxes rising to fifty per cent."  

In 1924 an amendment was again offered by Senator Jones and was accepted by the Senate, 43 to 32, which imposed, in addition to a 9 per cent normal tax on corporate income, a graduated tax on undistributed net income beginning at one-half of one per cent of undistributed net income when the undistributed net income was more than 10 but less than 11 per cent of surtax net income. The taxing framework bore a marked resemblance to that of the recently adopted act. This amendment was eventually eliminated from the bill in conference. 

More recently still the conference of the National Tax Association has fallen in with the suggestion for a tax on undistributed corporate profits. The position was taken that, in view of the practice by which

16 Dr. Adams had changed his earlier position. A U. S. Treasury memorandum entitled, "Treatment of Business Income and of Attempts to Prevent the Escape of Taxes through the Retention of Corporation Earnings," (1936) states that Dr. Adams "as early as 1918 went on record in favor of the taxation of undivided profits at the rates which would apply if such profits were distributed to the shareholders... The same thought was behind his recommendation in 1920 to the Second National Industrial Tax Conference that the corporation income tax be raised from 10% to 16%, and his proposal in substance became a part of the Majority Report of the Conference Board's Tax Committee."

17 In this same address Dr. Adams suggests a progressive tax on spending as the alternative to the principle which he rejects.  

18 It is interesting to compare this amendment with the present Revenue Act. See 65 Cong. Rec. 8032 (1924); H. R. 6715, 68th Cong., 1st sess. (1924) in Senate pp. 85-93.  

1924 AMENDMENT

<table>
<thead>
<tr>
<th>Surtax Net Income:</th>
<th>Adjusted Net Income:</th>
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<tbody>
<tr>
<td>Net income plus interest received from Federal bonds not exempt from surtaxes plus income from other corporations.</td>
<td>Net income less normal tax less interest received on obligations of the United States.</td>
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<th>Undistributed Net Income:</th>
<th>Undistributed Net Income:</th>
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<tr>
<td>Surtax net income less normal tax and cash dividends paid during year.</td>
<td>Adjusted net income (from which the normal tax has been deducted) less credit for dividends paid less credit for contracts restricting dividends.</td>
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1924 AMENDMENT

PRESENT TAX

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<th>Undistributed Net Income:</th>
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sole traders and partners are taxed on their reinvested income, we ought to return "to the idea that a corporation is merely a conduit through which income passes and that the only recipient who should be taxed is the natural person as stockholder, who enjoys the income earned by the corporation." The Association recommended that the tax be a flat 10 per cent of the amount of net income for the year in excess of dividends paid and that it be considered as a premium tax paid by the corporation for its stockholders in exchange for the privilege of retaining the earnings in the business, thereby postponing the normal tax and surtax until a future day. It was pointed out that this "gentle but steady pressure" upon the directors would lead them, as the persons best qualified to judge of the needs of the business, "to pare the surplus down to actual needs and reasonable requirements." The Association takes care to point out that the pressure must be a "gentle" one and the tax "reasonable."

In 1928 the Joint Committee on Internal Revenue Taxation, headed by L. H. Parker, considered the question and, in a report concurred in by the Advisory Committee of which Dr. Adams was a member, rejected an undistributed profits tax. The Committee pointed out, "The most obvious objection to such a tax is the burden which it places on legitimate and proper business expansion. As a business expands not only does its plant and property increase but a larger working capital is required and it is desirable that reasonable accumulation of profits necessary for the expansion and stability of corporations should not be unduly burdened."

That the present plan was in the mind of the President prior to his message of March 3, 1936, is indicated from the recommendations made but not elaborated upon on June 19, 1935, in the President's message to Congress. The President then said, "We should likewise discourage unwieldy and unnecessary corporate surpluses."

To complete the historical picture it is necessary to advert to past legislation by which Congress has sought to prevent the accumulation of surpluses and evasion of taxation. The method first employed disregarded the corporate entity and sought to tax the individual for his

24 Report of Joint Committee on Internal Revenue Taxation 54, 70th Cong., 1st sess. (1927).
pro rata share in corporate income, whether distributed or not, as though it had been distributed, where the corporation was formed or availed of for the purpose of evading taxation through accumulation of gains and profits. 26 This approach to the problem was retained until 1921 when a change in principle was made whereby a penalty tax was assessed against the corporation. In the 1934 act this was made applicable where the corporation is formed or employed for the purpose of preventing the imposition of the surtax upon its shareholders or upon those of any other corporation through the device of allowing gains and profits to accumulate instead of being distributed. 27 It should be noted that the purpose to evade taxation is here of prime importance. Without it no tax is imposed. But the purpose need not be fraudulent. The fact that gains or profits are allowed to accumulate beyond the reasonable needs of the business is made prima facie evidence of purpose to avoid the surtax. 28 This has been interpreted as not preventing ordinary business expansion. 29 Included in reasonable needs of the business are (1) adequate working capital, (2) additions to plant reasonably required, (3) additions to sinking fund for bond retirement. 30 Nor is it unreasonable to take into account in accumulating reserves the hazards of the particular business, its normal rate of expansion, unemployment insurance, or employee benefits. It would also seem reasonable to allow accumulation to offset fluctuations in the wage scale and to cover bad accounts receivable. On the contrary, accumulations for the purpose of buying stock and bonds of other corporations with which the business of the purchasing corporation has no obvious relation is unreasonable accumulation. 31

30 TREAS. REG. 86, art. 102-3.
Two factors are of especial significance in relation to this method of preventing tax avoidance. First, it has been very difficult to enforce because a purpose to avoid the surtax is hard to show either directly or by the prima facie presumption arising from accumulation beyond the reasonable needs of the business. What is reasonable may depend upon dozens of factors, and equally sane men may differ widely on the question as regards any given business. It seems to be generally admitted that the statute has been in many respects a dead letter. Because its penalty is severe, the natural tendency has been to enforce it in extreme cases only. In the last fifteen years not more than ten cases have arisen under this section of the act. The criticism is perhaps justified that this method of dealing with accumulated surplus is "cracking nuts with sledge hammers." Second, it is to be observed that the tendency in enforcing the act has been to avoid encouraging unorthodox business practices. The practice has been to consider every fact which a prudent business man would consider as bearing on the question of reasonable-ness of accumulation.

The problems of proof involved in section 102 led in 1934 to the enactment of section 351 dealing with personal holding companies. This section defines a personal holding company in terms of (1) sources of income, and (2) stock ownership. It levies a surtax upon the undistributed adjusted net income of such companies independent of any questions of reasonable needs of the business or purpose to avoid surtax. It should be noted that though provision is made for the exemption from tax in the hands of the corporation if dividends paid during the year, there is no provision under either section 102 or

65 Cong. Rec. 8014 (1924). Senator Jones of New Mexico remarked, "It is admitted by everybody, and the Secretary of the Treasury in his testimony stated that he had not found a single corporation which had violated that provision of the law."

Revenue Act of 1934, § 102 (a), 48 Stat. L. 702, takes as tax 25 per cent of the adjusted net income not in excess of $100,000 plus 35 per cent of that in excess of $100,000, in addition to the normal corporation income tax running as high as 15 per cent in the 1935 act. For an illustration of the possible burden of this tax, see Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 at 81-82 (1935).


Treas. Reg. 86, art. 351-1.

This applies to corporations under both sections 102 and 351. See Revenue Act of 1934, § 102 (c) and 351 (b) (2) (C), 48 Stat. L. 702, 751.
section 351 for the exemption from a second tax on earnings which have been taxed in the corporation's hands as undistributed and which are subsequently distributed. This may result in very heavy double taxation. It is conceivable that such a result is justified under section 102, where a purpose to avoid taxes is the basis for the penalty, but it is difficult to justify under section 351 where no such purpose need exist. 89 It is true that both sections allow the stockholder to avoid this double tax by reporting his pro rata share of adjusted net income, if all the stockholders in the corporation do likewise. Because the unanimous action of all the stockholders is requisite, 40 this is not a complete solution for the individual stockholder.

It is to be observed that though operating companies may come under the specific definition of section 351 if they have investments, the return on which equals 80 per cent of gross annual income, 41 the section is primarily aimed at holding rather than operating companies. 42 Furthermore, section 102, while applicable to operating companies, has not been enforced against them. 43 These facts have especial meaning in their indication that the economic and legal effects of sections 102 and 351 in their present and earlier forms cannot be regarded as comparable to the effects which may be expected from the Revenue Act of 1936. The former sections in practice have affected only holding companies. The surtax on undistributed profits in the Revenue Act of 1936 is in addition to these sections and purports to affect all operating companies with certain specified exceptions. The argument that the holding company serves no useful economic purpose cannot be made as to the operating company if it should be found that the new law will operate to the harm of the companies taxed.


40 Revenue Act of 1934, § 102 (d), § 351 (d), 48 Stat. L. 702, 752, as amended by Revenue Act of 1935, § 109, 49 Stat. L. 1020. See text, infra, p. 62, regarding an additional obstacle put in the way of such pro rata reporting under the Revenue Act of 1936, § 102 (d) and § 351 (d).

41 361 CCH Federal Tax Service 679E-679L.02, assuming, of course that the requisite stock ownership also exists.


43 Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 at 120 (1935). "The effective enforcement of the statute is practically limited to nonoperating companies such as personal holding or investment companies."
The motives behind the present bill are several. The primary motive is, of course, to raise additional revenue. A related fiscal motive is to prevent tax evasion; the attempts to prevent evasion, under sections 102 and 351, have not been successful.\[44\] Motives which may be termed social and political aim at equalization of the tax burden between sole traders or partners and corporate stockholders\[45\] and at forcing distribution of corporate profits to stockholders.\[46\] It may also be

\[44\] Tax Message of President to Congress, March 3, 1936, 80 Cong. Rec., No. 45, p. 3235 (1936). Testimony of G. T. Helvering, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 22 (1936), showing possibility of evasion either in the payment of dividends in years when other income is small or in the fact that capital gains realized upon sale by reason of increased value of stock due to accumulation of earnings in surplus need be recognized only in part if the stock has been held for more than one year. It is also true that earnings which are now taxed might in the past never have paid a tax if carried to surplus but subsequently dissipated by bad management.

\[45\] Tax Message of President to Congress, March 3, 1936, 80 Cong. Rec., No. 45, p. 3235 (1936). See testimony of Secretary Morgenthau, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 5 (1936); and of G. T. Helvering, ibid., p. 19. See proposal of National Association of Credit Men, 61 Cong. Rec. 6851 (1921). This point appears sound and has the support of tax experts, but the problem cannot be oversimplified. The proposal to tax the corporation on income undistributed at the same rate that such income would be taxed if in the hands of stockholders cannot be achieved by any blanket schedule of rates such as are used in the Revenue Act of 1936. [On this point, see remarks of T. S. Adams, 16 Proc. Nat. Tax Assn. 308 (1923).]

Inevitably, except in fortuitous instances, the rates will result in a tax higher or lower than the particular individual would pay if he received the income in dividends. In general, the result would appear to be that men in the small surtax brackets will suffer most from the undistributed profits tax if the corporation retains any sizable portion of its income. The proposal of the House bill to divide corporations into those making more or less than $10,000 income might have partially reduced this inequity in so far as it can be said that the stockholders in small corporations are more apt to be in the lower surtax brackets. The specific credit of section 14 (c) of the final bill tends in the same direction. The inequality as to poor and rich stockholders of the same corporation remains. A truly equitable system can probably be achieved only by taxing to the corporation an amount equal to the sum of the taxes which would have been paid by the several stockholders on the corporate earnings had these been distributed and holding such undistributed amounts tax free in the case of any subsequent distribution. A method suggested by Dr. Adams as theoretically sound, but rejected by him as economically impractical, is to “put a tentative surtax on corporations high enough to make it to the interest of the corporation and its stockholders to elect ‘voluntarily’ to pay, in lieu of this tentative surtax, the ordinary or regular surtaxes on the stockholders’ respective shares in the undistributed profits of the corporation. In short, make it profitable for the corporation and its stockholders to elect to pay taxes like the partnership and its members.”

\[46\] Interview with the President, N. Y. Times, p. 1:4 (March 3, 1936). One basis for this argument seems to be the conviction that corporations, having obtained the stockholders’ money, are proceeding to play fast and loose with it in disregard of stockhold-
urged that the present tax plan seeks to help small business\textsuperscript{49} and to check corporate bigness.\textsuperscript{48} Finally, it has been suggested by the President that this tax will be of economic benefit in increasing the velocity of monetary circulation.\textsuperscript{49}

**Economic Questions Raised by the Surtax on Undistributed Corporate Profits**

Most witnesses for or against the bill assumed that they knew how it would operate on the policies of companies affected. In general it was taken for granted that larger dividend distributions would result. The clearest fact emerging from testimony taken is that though the bill may be expected with reasonable certainty to raise revenue, since either the corporation or the stockholder will pay additional taxes, it cannot be predicted with any certainty that corporations will or will not distribute more dividends. If the rate of retention in the past has been dictated by prudence rather than by the desire of particular stockholders to avoid the surtax, as may be thought to have been true in the majority of cases,\textsuperscript{50} then it is reasonable to suppose that prudence ers' interests and should be forced to disgorge the full return on the investment. Whether such distributions should be sought for economic reasons is considered in the text, infra.


\textsuperscript{48} See the remarks of the President in discussing the question of corporate taxation in Message to Congress, June 19, 1935, in which he stresses the importance of small business to the national economy, adding that “Size begets monopoly.”\textsuperscript{79} 79 Cong. Rec. 9713 (1935). The storm of criticism leveled at this message seems justified in so far as it attacked the implication that corporate bigness is per se detrimental. From the economic standpoint, the bigger the corporation, assuming a corresponding increase in efficiency and consequent lower cost of production per unit, the greater benefit to the nation as a whole. This does not deny that regulation may be necessary, but it is highly questionable whether such regulation should be through taxation based upon size.

\textsuperscript{49} Note 46, supra. What this means is not at all clear. It was apparently thrown out casually in answer to a reporter’s question. Presumably it has a relation to the prevalent concept that a falling price level is a bad thing and that increased velocity of circulation will produce a rising level of prices. That a falling price level is not necessarily undesirable, see \textit{Durbin, Purchasing Power and Trade Depression} 71-78, 173, 175-176 (1933); \textit{Moulton, Income and Economic Progress} 117-141. Criticizing the President’s reasoning, see Editorial, “Money Velocity,” \textit{N. Y. Times}, p. 14:1 (March 28, 1936).

\textsuperscript{50} No satisfactory evidence has been offered as to the extent of deliberate tax evasion by means of restraining distribution of dividends. The most that can be said
will require the retention of this same amount plus enough to cover the additional tax. Dividends will to this extent be smaller rather than larger. Even if increased dividends are declared by boards of directors which are controlled by large stockholders, the increase will be limited by the fact that stockholders are not likely to urge the payment of any dividends which would have the effect of impairing the very safety of their capital investment. Where such control of directors is lacking, it is difficult to see why past policies of dividend declaration should be materially changed except as suggested above.

The argument urged by the opponents of the act that it will be impossible under the new tax to accumulate surplus does not carry much weight. The House bill was drawn so as to allow the addition of at least 30 per cent of earnings to surplus without subjecting the corporation to a greater tax than had been paid under the then existing act.\(^5\) The corporation could, by refraining from distribution, add considerably more than this to surplus. Under the act as finally adopted, a corporation retaining forty per cent of a $100,000 income will pay approximately eighteen and one half per cent on its total net income. If these several conclusions are correct, much of the argument that the national corporate financial structure will be undermined by the bill is irrelevant. The conclusions apply to the healthy corporations. The effect of the act in certain pathological cases will be referred to subsequently.

It should be noted that statements of Treasury officials in defense of the new act lay stress primarily upon the amount of liquid assets held by the corporations of the country.\(^5\) This position shows at least one fundamental confusion in the minds of the supporters of the bill. It becomes clear from reading the testimony taken that what is really objected to is the accumulation by corporations of large amounts of liquid assets in the form of cash, bank deposits and security investments.\(^5\) The act, however, does not aim at these items alone but at additions to surplus generally. This is highly important because the addition to liquid assets resulting from the earnings of a year’s opera-


\(^{52}\) See text, infra, at notes 58 and 66.

\(^{53}\) Whether such accumulations are detrimental has been to some extent considered in the text, supra.
tions will almost invariably be a totally different figure from the figure for earnings transferred to surplus. Additions to surplus may be $1,000,000, while the increase in liquid assets may be nil or even a minus quantity. To tax additions to surplus as though they were liquid means that the corporation whose liquid capital has not been increased by earnings must borrow, draw down its cash reserves, if any, or liquidate some part of its plant, equipment, or inventory to pay dividends to avoid taxes, or it must pay taxes because of failure to pay sufficient dividends. There does not seem to be any evidence that corporation surpluses, liquid or otherwise, are per se detrimental. In fact, the Treasury has recognized that to some extent at least they are desirable. That liquid assets largely in excess of the needs of the business are undesirable is a possible though not proven economic hypothesis. Assuming its proof, however, if the aim is to do away with these accumulations, the method is not well adapted to the end, including as it does in its penalty, all additions to surplus from earnings.

It is contended by the Government that such a bill will be a check on the severity of booms and depressions in that it will (a) be a brake on excessive expansion, (b) lessen speculation, and (c) maintain purchasing power because money will be distributed to stockholders. The arguments, it should be noted, are based upon a tacit assumption that distribution to stockholders will probably occur. While it is true that cash holdings of corporations increased 5.6 billions between 1926 and 1929, we cannot ignore the conclusions of the Brookings Institution that between 1900 and 1930 the unutilized margin of productive capacity in the United States did not increase in manufacturing, electric power utilities, agriculture, mining (except for the dislocation of the war), and probably also construction and merchandising. Only in

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68 Ibid.
69 "NOURSE, AMERICA'S CAPACITY TO PRODUCE 421 ff. (1934). At p. 425, it is said, "Equipment was being maintained at a rate entirely suitable to the indefinite continuance of operations at the 1929 rate of activity. There was an unutilized margin which, in the perspective of the past, would appear to be about normal."
transportation are there indications of an increasing unproductive margin. A subsequent volume of the Brookings studies concludes that while *individual savings* increased in relation to the aggregate national income, *corporate savings*, through additions to surplus, though increasing in amount of dollars saved, did not constitute “any larger percentage of the national income in 1929 than they did 20 years earlier.” 60 In the light of such findings, the argument that our productive capacity had been over expanded and that this was due to the accumulation of corporate surpluses is of doubtful validity.

That corporation cash reserves did contribute in some degree to the rise of stock prices through the device of brokers’ loans is doubtless true, but any argument that these were solely or even primarily responsible must meet the fact that in 1929, for example, in addition to corporate savings of between two and three billions there were *individual* savings of some thirteen billion dollars available to force security prices upward. It is noteworthy that corporate financing, to increase plant and production through new stock issues, had, for the six years prior to 1929, stood at approximately five billion dollars annually and had in every year been less, by several billions of dollars, than the amount of savings flowing into the market to purchase securities. 61 The normal result of limited supply and heavy demand seems to have occurred as savings in excess of the amount required for the financing of new production were used to bid up stocks. It should also be remembered that corporate earnings in 1928 and 1929 were of a size to justify, at least in some part, the prices for equities then prevailing. The Treasury’s argument as to the effect of corporate reserves upon speculation may therefore be easily overemphasized.

The view that earnings, retained by the corporation and appearing on its books as an addition to surplus at the end of the year, are withdrawn from the industrial economy and represent lost or delayed purchasing power is also doubtful economic theory. In the first place, a large part of such surplus is spent in production and in maintaining plant and equipment. To this extent it flows on down to the worker and increases purchasing power at a rate at least as great as if the same amount were distributed to stockholders who are primarily in a higher income class and therefore more likely to use their money in savings and investment than are wage earners. Nor can it be said that such

60 Leven, Moulton and Warburton, America’s Capacity to Consume 100-108, 110 (1934).
The portion of annual earnings as consists of cash and bank deposits is stagnant. Some part of these funds performs the very necessary economic function of a coverage for contingencies and immediate expenses. The part not so required gives support as bank deposits to the expansion of commercial loans. The economic advantages urged in favor of the bill, therefore, do not appear to stand close inspection.

It has been argued to the contrary that accumulated reserves are available to prevent depressions from being so severe in that they allow the maintenance of some dividends and of employment which would not otherwise exist. To this contention there is some merit if it be assumed that the undistributed profits tax will prevent the accumulation of surplus. As has been previously suggested, this will not necessarily be the result of the tax. If this assumption be made, however, the national corporate structure may suffer to the extent that smaller corporate surpluses might mean more quickly impaired capital in time of depression with a consequent restriction on dividends, and perhaps, a lessened ability to obtain credit. In recent years the surpluses of many firms have been substantially reduced. In some cases capital has been impaired. That the undistributed profits of the last boom were absorbed and existing surpluses heavily trenched upon by corporations as a whole is indicated in the fact that total dividends paid between 1921 and 1933, amounting to $50,700,000,000, exceed net earnings for that period by nearly 10 billion dollars. It must nevertheless be kept in mind that corporate surplus may be almost entirely represented by plant and equipment rather than cash, and the mere fact that a corporation has piled up on its books a large surplus item does not mean that it will have liquid resources on which to draw in time of depression. It may even be forced into receivership with a surplus still recorded on its books. Thus, while a surplus in some instances may prevent the actual impairment of capital, the existence of a surplus on a corporation’s books is no guarantee that the corporation will survive even a mild depression. It cannot be fairly said by opponents of the act that without a surplus a corporation must die in

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62 Moulton, The Formation of Capital 107 (1935), stressing the effect of lending by the commercial banks in allowing the continuance over long periods of simultaneous consumption and saving.


time of depression, leaving it to be implied that with a surplus it would survive. Nor can it be argued that the existence of a surplus means necessarily greater employment in depressed periods. A priori it would appear that corporations with liquid funds would husband them very carefully in time of depression. Statistically this seems correct. The Treasury figures show that disbursements in dividends did not exceed net receipts during the depression and that liquid capital was not drawn down to maintain employment or pay dividends. We may conclude that a large surplus is not indispensable to a corporation’s continued existence even in time of depression, that the liquid part of corporate surpluses has not been used to maintain dividends or employment in depressed periods, but that the presence of a surplus may have had an effect on dividend payments in the case of corporations which could not otherwise have paid dividends because of legal, rather than financial, restrictions on the payment of dividends when capital is impaired. In short, neither the arguments set out by the Treasury in favor of the bill as a force in mitigating the severity of depressions nor the arguments of opponents of the bill as to the importance of having large surplus cushions to soften the depression’s pinch carry very great conviction. The arguments have been pressed far beyond their merits on both sides.

Finally much has been said on the question of hardship on the small corporation. Will the act injure the ability of the small corporation to finance its needs and so injure its owners? In answering this question, it should be remembered that financing for the small corporation has always been somewhat difficult task. It must be agreed

66 The figures cited show cash and investments of all non-financial corporations in 1929 at 32.7 billion dollars and in 1933 at 33.5 billion dollars. Per contra, the Department of Commerce in 14 Survey of Current Business 17 (Feb. 1934), says of 1929-1932:

"in large areas of the economic system, enterprises paid out in wages, dividends, interest, rents and the like, more dollars than they received for the goods and services which they produced. Such withdrawals represent a draft upon previously accumulated surplus and assets which are possibly derived in part from the creation of new debt obligations, which would be in effect a withdrawal currently of anticipated future income. For corporations alone the excess paid out amount to about 7 billion dollars; this was almost three times the net dividends paid and the major portion must, therefore, have gone to sustain other payments, such as salaries and wages and interest."

that for the small corporation to attempt to finance itself through the security markets is out of the question both because of the expense involved and because of the fact that a market could be established only with difficulty for securities of small companies with an essentially local reputation.68 On the other hand, it is urged by the Treasury that the difficulty of obtaining finances for small corporations will not be increased even though the present act should force distribution of earnings and even though resort cannot be had to the security markets. It is contended that the one exception will be the case where stockholders, receiving dividends, refuse to reinvest such funds as are needed by the company and the argument is fairly cogent that since the stockholders are owners of the company, if they refuse to reinvest, it can be no cause for complaint by anyone. The question of business expansion is one which the owners of the business alone may properly determine. In addition it is said that the small corporation does not need the security markets in any event, but will finance its needs, as in the past, by personal and informal negotiation with its stockholders.69 The argument is further adduced that since the principal stockholders of small corporations are generally in lower income brackets than the principal stockholders of large corporations, the former will pay less income tax on the dividends received and, relative to the amounts distributed, will have more to reinvest.70 Whatever these latter points are worth, it seems true that an inability to get the owners of a business to put their earnings back into it cannot be spoken of as "hardship on the corporation" unless the doubtful position is taken that stockholders, once in, have an obligation to play ball, whether they like the game or not, for the benefit of the officers and other stockholders.

One objection, however, may be made to the government's position regarding the way in which corporations should refinance, which applies to both large and small corporations. If the act leads to the retention by corporations of the same amounts as have been withheld from dividends in the past, plus enough to cover the new tax, corporate financing will continue as in the past to come largely from addi-

tions to surplus. Upon the alternative assumption, however, that the act will result in greater dividend distributions, the sale of additional stocks and bonds as a means of financing corporate needs may decrease the stability of the corporate structure as a whole. The method of financing by additions to surplus does not result in increased indebtedness, as must be true if bonds or notes are issued. Nor do such additions to surplus result in an increased capitalization, such as results if stock is sold rather than bonds. During depression a large bonded indebtedness has been found to be a stone around the neck of many corporations, necessitating reorganization. Likewise a high capitalization tends to result in impaired capital in times of stress and, because of the restrictions in most state corporation acts on payment of dividends when capital is impaired, may also have an unsettling effect on the business structure.

THE REVENUE ACT OF 1936

It is worth noting briefly the principal changes as regards the taxation of corporate profits made by the Revenue Act of 1936. The existing normal tax on corporate income is retained though the rate schedule is altered in favor of corporations having smaller incomes. Dividends received by a corporation from other corporations are treated as a credit against net income instead of a deduction from gross income and are free from tax only to the extent of 85 per cent as compared with 90 per cent in the 1935 act. No credit is allowed, however, for dividends received from other corporations in calculating the undistributed net income on which the surtax, discussed below, is based.

A new section levies in addition to the normal corporation tax a surtax upon such part of net income as is undistributed, exempting certain specified corporations. The rates are graduated, beginning at 7 per cent of all undistributed net income which is not in excess of 10 per cent of adjusted net income, and running up to 27 per cent on undistributed net income which is in excess of 60 per cent of adjusted net income. The adjusted net income equals the net income less interest on government obligations and less the normal tax. Undistributed

71 Revenue Act of 1936, §§ 13 and 26 (a) and (b), H. R. 12395, June 22, 1936 (Public No. 740).
72 Revenue Act of 1936, § 14 (b) and (d). The corporations exempted are banks, insurance companies, bankrupt corporations, foreign corporations, corporations deriving the largest part of their income from possessions of the United States, corporations organized under the China Trade Act and Joint Stock Land Banks.
73 Revenue Act of 1936, § 14 (a) (1).
net income equals adjusted net income less a dividends paid credit and less credits arising from contracts restricting payment of dividends. As with the normal tax, the corporation with a small income is favored. This is done in the case of the surtax by the device of a specific credit such that corporations with adjusted net incomes of less than $50,000 pay only 7 per cent upon the first $5000 undistributed, though this is more than 10 per cent of the adjusted net income. The tax under section 14 is distinguished from that levied by section 102 in that it is levied regardless of the purpose or intent with which income is left undistributed.

In the bill as introduced in the House an attempt was made in sections 14, 15 and 16 to lessen the burden of the bill upon corporations with impaired capital, with written contracts restricting the payment of dividends, or with indebtedness evidenced by bank debentures, notes, and mortgages. This material has been to some extent incorporated in section 26 (c) of the present act. Corporations are allowed a credit in figuring their undistributed net income either for such amount of earnings as cannot be distributed without violating a provision which expressly deals with the payment of dividends in a written contract made prior to May 1, 1936, or for amounts required by similar contracts to be paid in discharge of a debt in the taxable year, or to be irrevocably set aside within the taxable year for the discharge of a debt, if these amounts have been so paid or set aside. Thus, contract prohibitions against payment of dividends arising from contracts made prior to May 1, 1936, and certain contracts for payment of debts, directly or by means of a sinking fund, are provided for, but this leaves untouched the problem arising where a corporation has earnings for a particular year but a capital deficit which under existing state law prevents it from paying dividends. Likewise, the act does not take into account the fact that business, as distinguished from personal, reasons may make it unwise for a corporation to pay out any dividends at all under some circumstances, as, for example, where a corporation must rapidly increase its working capital or plant to maintain its competitive position. Nor is any provision made for contract debts which may arise in the future. If the needy corporation is obliged to make

74 Revenue Act of 1936, §§ 14 (a) (2), 26 (c) (1) and 26 (c) (2); and § 27.
75 Revenue Act of 1936, § 14 (c).
such contracts it must apparently bear a tax on the amount devoted to the payment of such debts. The same will be true of future contracts restricting payment of dividends. Further, while section 14 (d) (2) provides for the exemption from surtax of a corporation which is insolvent and in receivership for any portion of the taxable year, no provision is made for any exemption once the receivership has ended. The temptation therefore exists to try to get the receiver appointed just before the beginning and discharged just after the end of a taxable year. It would seem better to have a specific provision in aid of such resurrected but still financially shaken corporations, rather than to tempt them to help themselves by tampering with the processes of justice.

The section in the 1934 Revenue Act dealing with corporations improperly accumulating surplus remains unchanged in its fundamental form in the Revenue Act of 1936. An additional schedule of rates is provided for corporations subject to the surtax on undistributed profits. Some alteration is made in the base on which the tax is figured. The provision allowing stockholders to avoid the tax if all stockholders report as gross income their pro rata share of corporate income retained by the corporation is made even less available than before, by an added requirement that 90 per cent of all income so included in the gross income of stockholders be that of stockholders other than corporations. It is significant that a purpose to evade the act is still a sine qua non of liability under this section. The probabilities are that it will not be any more generally enforced than it has been in the past because of the difficulty of proving an intent to avoid the surtax even with the aid of the statutory prima facie presumption arising from accumulation of surplus beyond the "reasonable" needs of the business.

Finally, the existing section taxing personal holding companies is in some respects changed. The principal change is in rates, these running from 8 per cent to 48 per cent under the Revenue Act of 1936 as compared with a range of 20 per cent to 60 per cent under the amendments of the 1935 act. A change similar to that made in section 102 regarding the pro rata reporting of retained corporate income by stockholders is made in section 351.

79 Testimony of F. Sargent, ibid., p. 486.
Constitutionality of the Tax on Undistributed Profits

There appears to be no reason to doubt the constitutionality of section 14 of the Revenue Act of 1936 imposing a graduated tax upon the undistributed earnings of corporations. "The unconstitutionality of provisions of the income tax law has been constantly urged upon tribunals and almost invariably denied." There have been implications in some cases that a tax might be so extreme as to amount to confiscation and be invalid as in conflict with the Fifth Amendment, but taxes by the Federal Government have not been held bad on this ground thus far, and under the rates of the Revenue Act of 1936 it seems unlikely that the objection could be urged with success. Moreover, the surtax on undistributed profits is probably not unconstitutional as either a direct tax lacking apportionment or an indirect tax without proper uniformity of application. A federal income tax, according to the Brushaber case interpreting the Pollock case and the Sixteenth Amendment, now falls in the class of indirect taxes whatever the source of the income by reason of the fact that the Sixteenth Amendment prevents inquiry into the source of income and hence prevents any conclusion that because of its source there is in effect a direct tax on property. The amendment, impliedly and expressly, does away with the necessity for apportionment but does not create a new object of taxation or new class of tax. The requirement of uniformity therefore attaches, but as this is merely "geographic, not extrinsic" the present tax on undistributed profits does not suffer by the requirement. A graduated tax is not a violation of the uniformity clause of the Constitution nor of the Fifth Amendment.

84 240 U. S. 1, 36 S. Ct. 236 (1916).
86 240 U. S. 1 at 12-19, 36 S. Ct. 236 (1916).
The fact that certain corporations are exempted from the operation of the tax is probably not a valid constitutional objection. Classification which is not arbitrary or unreasonable is an accepted thing in taxation and it is recognized that the difference between kinds of corporations forms a proper basis for classification. Nor does it appear that there is anything unreasonable or arbitrary in using the proportion of undistributed profits as a basis for distinguishing between what shall and what shall not be taxed. There is no specific test by which it can be decided whether a classification is arbitrary or unreasonable, but that the legislature has the power to classify admits of no doubt. It is often stated that classification "must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike." Such a statement, however, is of small assistance in deciding whether a given classification is reasonable or not. On the other side of the picture are those cases which declare that only palpably arbitrary classification will be unconstitutional. The word "palpably" does not really clarify the problem, but it does indicate the reluctance of the courts to hold tax legislation invalid as in conflict with the Fifth Amendment. This reluctance is emphasized in recent cases by the enunciation through Justice Stone of the doctrine that classification in taxation is not bad unless it be of such a kind "as to preclude the assumption that the classification rests upon some rational basis within the knowledge and experience of the legislators." These cases do not deal with the income tax, but there is no reason to believe that the application of the principle will differ as between taxes. The existence of certain dicta in *Bell's Gap R. R. v. Pennsylvania* does not require

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91 *Jackson v. State Board of Tax Commrs.*, (D. C. Ind. 1930) 38 F. (2d) 652 at 656.
93 *Metropolis Theatre Co. v. Chicago*, 228 U. S. 61 at 69-70, 33 S. Ct. 441 (1912); *South Carolina Power Co. v. South Carolina Tax Comm.*, (D. C. S. C. 1931) 52 F. (2d) 515 at 518, where it is said, "it is the duty of the court to sustain it if any state of facts can be conceived of upon which the classification may reasonably rest."
95 134 U. S. 232 at 237, 10 S. Ct. 533 (1890): "clear and hostile discriminations against particular persons and classes, especially such as are of an unusual char-
a revision of the view that the classification of the present act is sufficiently related to the subject matter to be constitutional.

The federal and Supreme Court cases give no answer to the precise question of unreasonableness arising in the present tax bill. We know that constitutional distinctions may be drawn between one corporation and another, between types of income, between income of persons and corporations. We do not know that classification based upon the amount of income retained will be held valid. But under our system prior to the present act, income taxation has been based upon the amount of net rather than gross income, with certain exclusions and deductions allowed and others disallowed. Net taxable income has been subject in large measure to the will of the individual to earn more or less and to use his funds in ways which will, as allowable exclusions and deductions, directly affect the size of gross income and of net income. A tax upon undistributed profits is simply a tax upon net income as figured in the past with some additional deductions, the amount of which will be determined by each corporation. That the tax is graduated upwards as the corporations choose to distribute less to stockholders, and that the tax may be different for two corporations whose net income would be the same if this distribution or failure to distribute were not taken into account, does not make the tax invalid. For this view Bromley v. McCaughn is strong authority:

"It is suggested that the schemes of graduation and exemption in the present statute, by which the tax levied upon donors of the same total amounts may be affected by the size of the gifts to individual donees, are so arbitrary and unreasonable as to deprive the taxpayer of property without due process. But similar features of state death taxes have been held not to infringe the Fourteenth Amendment since they bear such relation to the subject of the tax as not 'to preclude the assumption that the legislature, in enacting the statute, did not act arbitrarily or without the exercise of judgment or discretion which rightfully belongs to it.' . . . No more can they be a basis for holding that the graduation and exemption features of the present statute violate the Fifth Amendment."
A further objection raised to the undistributed corporate profits tax is that it seeks to force the distribution of dividends and is invalid under the AAA decision. The tax cannot be held unconstitutional unless it is shown that it is not a true tax but an attempt under the guise of the taxing power to exercise some other power which Congress is forbidden, expressly or otherwise, to exercise. It is true that in certain cases taxes have been held invalid when it was apparent that the object of the legislation was not taxation, but regulation of some forbidden subject. However, the courts have gone a long way in upholding tax legislation even where the object of revenue was perhaps of relatively minor importance, and where the result would be to destroy the subject of the tax. The two lines of cases cannot be entirely reconciled. The most that can be said is that there is a point where the revenue feature of tax legislation is of such comparative insignificance with some other and forbidden aim of the legislation readily apparent to the Court on the face of the legislation or even perhaps exterior to its face, that the Court has felt itself bound to declare the legislation unconstitutional. The point beyond which tax legislation cannot go seems not to be reached if revenue, rather than forbidden regulation, is a primary aim of the legislation and if the tax is not "a mere incident of such regulation." This is the more true if the object outside the raising of revenue is not apparent on the face of the legislation. With the present act there can be no doubt that the pri-

100 United States v. Butler, 297 U. S. 1, 56 S. Ct. 312 (1936).
104 United States v. Butler, 297 U. S. 1 at 61, 56 S. Ct. 312 (1936). "Taxes are occasionally imposed in the discretion of the legislature on proper subjects with the primary motive of obtaining revenue from them and with the incidental motive of discouraging them by making their continuance onerous. They do not lose their character as taxes because of the incidental motive." Child Labor Tax Case, 259 U. S. 20 at 38, 42 S. Ct. 449 (1922).
105 The requirement that the improper regulation requiring a declaration of unconstitutionality be apparent on the face of the act is stressed throughout the Child Labor Tax Case, 259 U. S. 20 at 38, 41, 42, 43, 42 S. Ct. 449 (1922). The act here involved contained "the detailed specifications of a regulation of a state concern and business with a heavy exaction to promote the efficacy of such regulation." 259 U. S. 20 at 42, italics added. Again in Hill v. Wallace, 259 U. S. 44 at 66, 42 S. Ct.
mary aim is the raising of revenue. The fact cannot be changed by the possibility that the bill may result in action on the part of corporations which the present administration thinks is economically desirable. By Justice Roberts' own definition, "A tax, in the general understanding of the term, and as used in the Constitution, signifies an exaction for the support of the Government." The present tax certainly comes within the limits of this definition. This being so, it is unnecessary to inquire whether, if not a true tax, it is none the less a proper exercise of some other governmental power.

Even if regulation rather than revenue raising were the primary object of this tax bill it would not necessarily be unconstitutional. The suggested purpose of seeking to force distribution is not at all apparent either from specific statements in the act or from the existence of a graduated tax on undistributed profits. The use of a graduated tax might be explained as a device for forcing distribution of corporate earnings, but it may also be explained as an attempted application of the principle of taxation according to ability to pay. Whether, in fact, it is so or not is of minor importance if reasonable legislators could have thought this to be the taxing principle employed. The courts are bound by established principles of constitutional construction to accept that interpretation of two or more possible interpretations which will sustain legislation rather than make it unconstitutional.

**Other Legal Problems**

Certain problems of interpretation are raised by the new act as it deals with surtax on undistributed profits which the regulations may help to clarify but which may remain unsettled by court decisions for some time. Section 14 (d) (1) defining corporations exempt from the surtax on undistributed profits includes banks as defined in section 104. A bank as used in that section is restricted to banks or trust companies "a substantial part of the business of which consists of receiving deposits and making loans and discounts or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended..." There will be some question
in the minds of officers of certain banking institutions as to whether they can qualify under the class of section 104 (b) allowing a flat 15 per cent tax with exemption from surtax.

Section 14 (d) (2) exempts from surtax domestic corporations which “for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.” This section raises several important questions. Does the phrase “any portion of the taxable year” relate only to bankruptcy or does it relate to both bankruptcy and receivership? The phrase was not included in the bill as introduced in the House. It would seem to relate to both, but this does not necessarily follow from the position of the phrase. Of this same phrase it may be asked whether “any portion” means “any substantial portion” or “any portion, however infinitesimal.” The question also occurs as to whether a reorganization proceeding under Section 77B of the Bankruptcy Act is included within the terms “bankruptcy” and “receivership.” It would seem that it is, in view of the fact that Section 77B is a part of the Bankruptcy Act and that it takes the place of the old consent receivership. As to bankruptcy, there is also a problem as to when it ceases. Has bankruptcy ceased during the period after a discharge and before its revocation where the discharge is revoked? Is the discharge effective when refused where it is subsequently granted on appeal? If no application for discharge is made, how long does the corporation remain a bankrupt?

Section 26 (c) provides for certain credits to be deducted from adjusted net income in determining undistributed net income under section 14 (a) (2). Section 26 (c) (1) provides for a credit for the amount of adjusted net income in excess of 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.” Presumably this will cover a provision, for example, that “no dividend shall be paid until $10,000 has been paid to John Doe,” or that “no dividend shall be paid unless the current ratio of the company is 2 to 1 or better.” A query may be made as to whether a provision that “preferred stockholders shall have the privilege of having their stock called at 101 if the current ratio is allowed to fall below 2 to 1,” which may have the same effect as the other provisions mentioned, is within the scope of section 26 (c) (1). Apparently this will
not be true since the statute refers to provisions "expressly" dealing with the payment of dividends.\textsuperscript{108a}

Section 26 (c) (2) allows a credit for obligations paid pursuant to the provisions of a contract which must have been executed prior to May 1, 1936. Suppose that this obligation consists of a note executed on April 1, 1936, for a debt then contracted. If this note requires periodic payments and is to run for two years but for some reason is not paid as agreed, will a renewal of this note constitute the basis for a credit if renewed on April 30, 1938? The answer is not given in the statute.\textsuperscript{108b}

Section 14 (a) (2) also provides for a credit under Section 27 for dividends paid. Section 27 (c) treating dividends in kind allows a credit for dividends "paid in property other than money (including stock of the corporation if held by the corporation as an investment)." This seems to refer to treasury stock. Such stock is not necessarily retired by purchase\textsuperscript{109} and is treated in some jurisdictions as an asset of the corporation.\textsuperscript{110} Sound accounting procedure would dictate that such stock be carried on the equities or liabilities side of the balance sheet and not as an asset.\textsuperscript{111}

\textsuperscript{108a} 70 T. D. 59, Internal Revenue No. 4674, Art. 26-3(b). "The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount."

\textsuperscript{108b} 70 T. D. 61, Internal Revenue No. 4674, Art. 26-3(c). "Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2) of the act. A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. . . . For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2) of the act."

\textsuperscript{109} 11 FLETCHER, CYCLOPEDIA CORPORATIONS, § 5148 (1932).

\textsuperscript{110} 6 FLETCHER, CYCLOPEDIA CORPORATIONS, § 2859 (1932); Pabst v. Goodrich, 133 Wis. 43 at 68, 113 N. W. 398 (1907).

to tell when such stock is "held by the corporation as an investment." Is stock held as an investment where, being issued and fully paid, it is reacquired by the corporation by donation or by purchase but not retired? Would treasury stock represented by "an unissued stock increase paid for out of surplus assets and held in the treasury by formal vote of the stockholders" be held as an investment? Finally, is some oral or written evidence necessary to show an intent to hold such stock for investment purposes?

The problem of what is a taxable stock dividend available as a credit, raised by sections 27(e) and 115(f), is so broad as to require separate treatment; it cannot be dealt with here.

The original aim of the tax bill framers appears to have been to produce a system of taxation which would in effect treat the corporation as "a conduit to income"; this was to be done by taxing income of the corporation in such a way that, whether distributed or not, it would bear the same tax burden as though it had been distributed. The same idea is expressed in saying that the corporate stockholder should be made to bear equal taxes with the sole trader or partnership.

Eisner v. Macomber in its implications stands in the way of a requirement that the stockholder must include in his income the earnings of the corporation whether distributed or not. However, there would probably not be the same objection to a tax on the undistributed earnings of the corporation measured by the tax which the individual stockholders would have had to pay if the retained earnings had been dis-

112 This is the only form of treasury stock recognized by some jurisdictions. FLETCHER, CYCLOPEDIA CORPORATIONS, § 5088, p. 45 (1932).


113a 70 T. D. 66, Internal Revenue No. 4674, Art. 27-3. "As used in this article the term 'property' includes shares of capital stock of the corporation making the dividend distribution if such shares of stock are held by it as an investment. Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment. The term 'property' also includes obligations upon which the corporation making the distribution is liable as a guarantor, endorser, or surety."

114 See on this subject, Magill, "Realization of Income Through Corporate Distributions," 36 Col. L. Rev. 519 (1936).


116 See supra at note 45.

tributed to them.\textsuperscript{118} This would have to be accompanied by a provision that such undistributed earnings, once taxed, could thereafter be distributed to the stockholder exempt from tax.\textsuperscript{119} The original bill as introduced in the House was an attempt to achieve this equality by a blanket schedule of taxes on undistributed profits with no provision for exempting such profits when once taxed. As already indicated, absolute equity cannot be attained in this way.\textsuperscript{120} Nor can it be reached by treating the tax on undistributed profits as a punitive social and economic measure to force distribution of profits rather than as a means to equitable taxation.\textsuperscript{121} The rates used in the original House bill and the testimony of witnesses strongly suggested that the rates were based upon the dubious and wholly undemonstrated economic theory that accumulations above 30 per cent of earnings are undesirable, rather than upon the eminently just taxing principle of equality.\textsuperscript{122} Furthermore, if the “conduit to income” theory is followed, any tax levied on the corporation for corporate income which is distributed, as has been done in the past Revenue Acts and as is still done in the Revenue Act of 1936, should be the basis for a credit against the tax which the stock-

\textsuperscript{118} See note 45, supra. Such a proposal would involve certain practical difficulties in that it would require a cross reference to the tax return of the stockholders before the corporation could know the amount of its tax. It might be necessary to set a later date for the payment of the corporation tax than for the payment of the individual tax. There might also be constitutional difficulties. The tax would be essentially a tax upon corporate income retained, measured by the additional tax which would be paid by the stockholder had this retained income been distributed. The question would be whether this was not arbitrary and unreasonable classification and hence lack of due process. In this regard, see Bromley v. McCaughn, 280 U. S. 124 at 139, 50 S. Ct. 46 (1929), quoted in the text, supra, at note 99.


\textsuperscript{120} See note 45, supra.


\textsuperscript{122} Where 57.5 per cent of adjusted net income was retained the remaining 42.5 per cent was absorbed by the tax. See testimony of G. C. Haas, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 37-49 (1936), the implication of which is that 30 per cent of earnings plowed back as surplus ought to be enough for any corporation unless it wants to pay heavier taxes or go into the open market for funds. See testimony of F. V. Geier, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 495-511 (1936), especially pp. 505-507, regarding the very serious effect which the House Bill would have had on surplus in the machine tool industry if in effect during and subsequent to 1926 even if no dividends had been paid and all earnings not taken by the tax had been invested in the business.
holder pays, a credit equal to the amount of tax already paid by the corporation.\footnote{123} The present revenue act as finally accepted leaves us with a tax system which is even more a hodge-podge than any in the past. It does not attain equality as between corporations and partnerships. It retains all the complications of the former acts and adds one more. It makes additional work for the tax expert and is correspondingly more costly to the taxpayer. In so far as it levies a tax on all corporate income and allows no credit to the taxpayer, it abandons the idea of treating the corporation as a conduit to income for the stockholder. In addition, it must be realized that the act is one to raise revenue and the tax burden upon the stockholder, directly, through the abolition of the normal tax exemption, and indirectly, through an added burden on the corporation, is materially increased. However, the act has certain merits. It is a step in the direction of a more equitable system though the immediate result is the reverse of this. It does not levy as extreme a tax as the originally proposed bill and to that extent should have less tendency to force imprudent dividend distribution. In view of this fact, it may well be looked upon as essentially experimental and tentative. That it should be so is desirable regardless of whether the bill is the fruit of legislative wisdom or legislative compromise.

\footnote{123} Testimony of F. R. Fairchild, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 203 (1936); testimony of J. W. Oliver, ibid., p. 212.