THE UNDISTRIBUTED PROFITS TAX AND THE INVESTOR

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CONGRESS has been concerned for many years with the question of the distribution or retention of corporation profits, insofar as such corporate policies affect the tax revenue.¹ Five Internal Revenue Acts of the Civil War period taxed as income to the stockholder his share of corporate gains, *whether divided or not*.² After a lapse of forty years the Revenue Act of 1913 sought to apply the same principle as a punitive measure in the case of corporations which accumulated surplus "beyond the reasonable needs of the business" for the purpose of preventing the imposition of surtax on their shareholders.³ Similar provisions appear in the 1916⁴ and 1918⁵ tax legislation. In 1917⁶ a special tax of 10% was imposed on corporate profits remaining undistributed six months after the close of the fiscal year and not actually employed in the business, or "retained for employment in the reasonable requirements of the business", or invested in War Loans.

Beginning with the Revenue Act of 1921, a penalty surtax of 25% was levied on the entire net income of corporations "formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of permitting earnings or profits to ac-

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1. For a discussion of the legal phases of the material covered in this article and of the nature of the tax, see Hendricks, *The Surtax on Undistributed Profits of Corporations* (1936) 46 YALE L. J. 19.

2. REVENUE ACT of 1864, 13 STAT. 281 (1864) (did not apply to profits of companies separately taxed); REVENUE ACT of 1865, 13 STAT. 479 (1865), unchanged by amending act 14 STAT. 5 (1866); REVENUE ACTS of 1867 and 1870, 14 STAT. 978, (1867), 16 STAT. 257 (1870). The two latter provisions did not apply to dividends separately taxed.

3. 38 STAT. 166 (1913), (§ IIA (2) subdiv. 2 (3)). Earnings of such companies were subject to individual surtax, but not to normal tax, as if received by the stockholders in dividends.

4. 39 STAT. 758 (1916).

5. 40 STAT. 1072 (1918). But in the latter case imposition of the tax on the shareholders relieved the corporation of its (normal) income tax, but not of excess-profits tax.

6. 40 STAT. 330 (1917). Under certain conditions the rate might be 15%.

accumulate instead of being divided or distributed".⁷ The principle of this tax has been maintained in subsequent revenue acts. In 1924 the rate was raised to 50%; but in 1934 it was reduced to 25% on the first \$100,000 and 35% on the remainder of net income less dividends paid.⁸

For a considerable period this penalty tax seems to have been very much of a dead letter, although it may have exerted a substantial deterrent influence.⁹ In more recent years the Treasury Department has had some success in collecting surtaxes under this provision.¹⁰ But even if it were possible to prevent by this means all "improper" accumulations of surplus—as clearly it was not—there remained a substantial tax advantage to the wealthy stockholders of corporations which could find legitimate ways of reinvesting all or most of their current profits.

In the 1936 Revenue Act Congress extended the idea of the penalty tax to apply to all undistributed earnings regardless of the motive of their retention. The new Surtax on Undistributed Profits¹¹ is imposed

7. 42 STAT. 247 (1921). The Commissioner "may" tax the stockholders on a partnership basis, if they all agree thereto, in lieu of all income and excess-profits taxes imposed on the corporation.

8. See 43 STAT. 277 (1924); 44 STAT. 34 (1926); 45 STAT. 814 (1928); 47 STAT. 195 (1932), amended slightly by § 214, NATIONAL INDUSTRIAL RECOVERY ACT, 48 STAT. 207 (1933); 48 STAT. 702 (1934), 26 U. S. C. A. § 102, unaffected by the 1935 Act, 49 STAT. 1015, 26 U. S. C. A. §§ 13, 141. See also § 102 of REVENUE ACT of 1936, Pub. L. No. 740, § 102, 74th Cong. 2d Sess. (June 22, 1936) (Rates reduced in 1936 to 15% and 25% respectively for corporations subject to the new surtax on undistributed profits.) Beginning with the 1926 Act, penalty may be avoided if all stockholders include, as dividends, their pro rata share of the earnings, whether or not distributed. Under the 1936 provision 90% of the "retained net income" must be applicable to shareholders other than corporations. In the 1934 and 1936 Acts, a similar but alternative tax is imposed on a new category of "Personal Holding Companies". (§ 351 in both laws). The rates and miscellaneous provisions differ from these in § 102 of the 1936 Act.

9. See *Report of Joint Committee on Internal Revenue Taxation*, 69th Cong., (1927) p. 49. "It has been the policy of the Internal Revenue Bureau to regard these provisions as deterrent to unreasonable accumulations rather than as provisions to raise revenue." This report contains also a discussion of the British policy regarding supertax avoidance by incorporation. (*id.* pp. 53-54). Text of the relevant provisions in the British Finance Act, 1922, 12 & 13 Geo. V, c. 17, § 21 (1), is given in Graubard, *Accumulation of Surplus to Evade Surtaxes* (1932) 10 TAX MAG. 460.

10. A memorandum prepared by the Treasury Department for the use of the House Ways & Means Committee, dated March 10th, 1936, (but not made public in the hearings although referred to, see *Hearings before the Committee on Finance on H. R. 12395*, 74th Cong., 2d. Sess. (1936) 263), contains, *inter alia*, the following data: Total collections under these sections to January 11th, 1927 were \$184,000; as of January 11th, 1930 the total had risen to \$5,679,000. For the fiscal year ended June 30th, 1930, collections were \$5,866,000 (evidently duplicating the previous figure in part). For the next four fiscal years, to June 30th, 1934, collections were \$5,182,000.

11. § 14 of 1936 Act, Pub. L. No. 740, 74th Cong., 2d Sess. (June 22, 1936), 26 U. S. C. A. § 14 (Supp. 1936). Hereafter all citations to the 1936 Act shall be merely by Section designation.

on all domestic corporations, except banks, insurance companies, concerns in receivership, and two other minor groups. The tax is levied in brackets, beginning with 7% of the undistributed profits up to 10% of the "adjusted net income" and ending with 27% on all undistributed profits above 60% of the adjusted net income.¹² If no part of the earnings is distributed the total "pressure" or "penalty" tax will amount to 20.5% of the income after the 8% to 15% normal tax, and (in the case of a large corporation) the two taxes together will take about one-third of the income. Corporations subject to the new Surtax on Undistributed Profits may also be subject to the old "Surtax on Corporations Improperly Accumulating Surplus", but at reduced rates, or they may be subject also to the "Surtax on Personal Holding Companies" at rates ranging from 8% to 48% of the undistributed adjusted net income.

It evidently was the purpose, and it undoubtedly will be the effect, of the Revenue Act of 1936 to induce corporations generally to pay out in dividends a larger proportion of their profits than heretofore. If this new fiscal idea is not abandoned as the result of the election, it is bound to have significant effects upon the financial policies of corporations, and upon the welfare of their stockholders, and possibly of their creditors. It is intended in this paper to consider some of the theoretical and practical implications of the new Surtax on Undistributed Profits, as they bear upon the related fields of corporation and investment finance.

THE TAX BURDEN ON CORPORATE PROFITS

From the tax standpoint, the Revenue Act of 1936 unquestionably imposes a heavy additional burden upon stockholders. As conceived by the President and as passed by the House, the Bill originally aimed to tax corporation earnings on exactly the same basis as partnership earnings. To bring this about, it provided for the complete elimination of both the normal corporation tax and the capital stock tax (with its appended excess profits tax provision). On the other hand it subjected dividends to normal individual tax, in the same way that partnership profits are taxed, and it imposed a tax on undistributed earnings designed either to induce the payment of dividends or to collect from the corporation a penalty substantially equal to the personal taxes which the stockholders might save through the non-receipt of dividends.

As finally passed, however, the effect of the Revenue Act is to tax corporate earnings upon *both* a corporation and a partnership basis. If all earnings are distributed in dividends the profits will first bear the

12. 1936 Act, § 14(b). For a discussion of the calculation of the tax see Hendricks, *supra* note 1, at 19.

regular corporation tax of between 8% and 15% and also the capital stock-excess profits combination tax, amounting to not less than 1% of income and certainly averaging nearer 2% of income.¹³ The balance will then be subject to full normal tax and surtax in the hands of the individual stockholders. The penalty imposed on retained earnings will prevent any substantial escape from this double taxation. It cannot be fairly said that the new law removes the inequalities in tax status as between stockholders and members of partnerships. It has indeed very largely eliminated the tax advantage formerly enjoyed by wealthy stockholders, but it has placed all other stockholders at a great tax disadvantage as compared with partners. The smaller the stockholder the greater proportionately is this additional handicap.

This outcome, so disconcerting to stockholders generally, is not without its ironical aspects. The House Bill, which did substantially equalize the tax status of corporations and partnerships, was subjected to violent attack by the business world. The measure was harshly criticized, and with justice, as being complicated, confusing, and full of technical faults. But the chief assault centered on the theory of the Undistributed Profits Tax. This was excoriated as running counter to all sound concepts of corporate policy, as encouraging improvidence, penalizing prudence, and making impossible the necessary accumulation of rainy-day reserves. With what may be regarded as an excess of zeal, the critics insisted both that the new tax would cripple corporations and that it would bring in a disappointingly small revenue. Hence they argued the Government could not afford to give up the time-tried corporation tax for this new experiment. Congress, being impressed by the latter argument, compromised by retaining the old taxes, imposing the new one as well, and abolishing the time-honored exemption of dividends from normal tax. In this case business seems to have talked itself into a higher tax bill.

There is further irony in the fact that what was a *punitive* provision in the 1918 War Revenue Act reappears in the 1936 Act as a concession or privilege grudgingly granted a very limited group of enterprises called "Mutual Investment Companies". In the 1918 legislation the penalty for the improper accumulation of surplus was merely to tax the enterprise on a partnership basis—that is, *waiving* the corporation income tax, but taxing each stockholder on his full pro rata share of the profits.¹⁴ Under the present scheme of taxation such "punishment"

13. If earnings are exactly 10% of the declared value, the capital stock tax becomes 1% of the earnings. If they are either more or less than 10%, the capital-stock-excess-profits tax combination becomes greater than 1% of the earnings.

14. § 220 of the REVENUE ACT of 1918, 40 STAT. 1072. Such corporations were, however, still subject to War-Profits and Excess-Profits Tax, from which partnerships were exempt.

would prove a boon. This boon is in fact graciously accorded to certain "mutual investment companies", provided they meet one general and eight specific conditions.¹⁵ With the progress of taxation, the horrors of war become the blessings of peace.

EFFECT UPON CORPORATE POLICIES

So much for the burden of taxation under the new Revenue Act. Let us now address ourselves to its effect upon the dividend policies of corporations. Will it result in a substantial increase in the percentage of earnings paid out in cash dividends? If so, will this be a bad thing, or possibly a good thing for stockholders generally? Are corporations likely to adopt devices by which they may avoid both the payment of cash dividends and the imposition of the penalty tax? What are these devices, and what will be their effects upon the corporate structure and upon the corporate picture in good times and bad?

Since our inquiry may appear to take a number of devious turns, it might be helpful if at this point we summarized the conclusions to which we are proceeding. We shall conclude that the new law will result in the distribution of nearly all the current earnings of publicly-owned corporations, *but that such distribution will be divided between cash and taxable stock dividends as the managements see fit*. On the whole, cash dividends are likely to be somewhat larger than has been the practice previously, particularly in the case of companies which have a limited field of profitable expansion. As regards other corporations, however, there is not likely to be a striking change in the proportion of current earnings which is reinvested in the business.

If these predictions are well founded, the new penalty tax will not have a profoundly disturbing effect upon significant corporate policies, as distinguished from matters of bookkeeping. But numerous exceptions are likely to occur in the case of companies which are unable or unwilling to adopt the flexible capitalization policies that will be now required. Moreover, there are serious technical defects in the new law which subject to tax, and impel the distribution of, amounts that may not be true earnings at all. These inequities may be highly injurious to some corporations, and, of course, to their stockholders.

As far as the interests of shareholders generally are concerned, the greater liberality of dividend payments is likely to redound to their advantage, especially through curtailing the extent of uneconomic corporate expansion. A more specific responsibility will be placed upon management to justify the "plowing back" of earnings in the property. The advantages frequently gained by insiders through manipulating the

15. §§13 (a) (3), 48 (c).

dividend policy are likely to be less prominent. While it is possible that dividend rates may be more variable than heretofore, they will be kept closely in line with annual earnings. In view of the greater emphasis now given by the stock market to earnings as against the dividend rate, the equalizing of the latter with the former may not create much additional instability of stock prices.

From the standpoint of corporate accounting, the penalty tax will in all probability accentuate the recent blurring of the distinction between capital and surplus, in order to offset the apparent interdiction against building up an *earned surplus* available for the maintenance of dividends during poor years. Reductions in par value and other transfers from book capital to book surplus, already familiar phenomena; will become even more widespread.

Alternatives to Cash Dividends. The criticisms of the Undistributed Profits Tax have for the most part taken it for granted that corporations now have but two alternatives: either to denude themselves of substantially all their earnings or else pay a crushing penalty tax. If this were so, it would undoubtedly work great hardship, although needed additional capital might still be raised in most cases by the private or public sale of securities. But the new law supplies an important third alternative, namely that corporations *may retain but capitalize* any desired portion of their earnings.

Such capitalization of retained earnings may be effected in at least four different ways, namely:

- (1) By the payment of taxable stock dividends;
- (2) By the declaration of optional dividends, payable either in cash or stock, so arranged as to result in the payment of stock only;
- (3) By the declaration of cash dividends accompanied by an attractive right to purchase stock therewith;
- (4) By the use of part-paid shares, and the calling of payments thereon coincident with the declaration of cash dividends.

Under the recent ruling of the United States Supreme Court in the *Koshland* case,¹⁶ dividends upon common stock paid in stock of some other class may be taxable to the stockholder. Apparently dividends on preferred stock paid in stock of either the same or a different class would be similarly taxable.¹⁷ The 1936 Revenue Act provides that such

16. *Koshland v. Helvering*, 56 Sup. Ct. 767 (1936).

17. The Regulations of the Treasury Department relating to the Undistributed Profits Tax, issued August 6, 1936, (T. D. 4674), 70 Treas. Dec. No. 7 at 51, give examples of taxable and non-taxable stock dividends. (The Regulations are still incomplete). Payments on preferred stock made in common are taxable; also payments on common in

stock dividends shall be valued for taxation at their fair market value at the time of payment¹⁸ and shall create a corresponding "dividends paid credit" for the benefit of the corporation.¹⁹ A corporation may presumably adopt the device of declaring a taxable dividend payable in preferred stock which in turn is convertible for a brief period into the common stock on attractive terms.²⁰ The result will be the prompt conversion of the stock dividend into additional common, with a final set-up equivalent to that produced by an ordinary (common) stock dividend. Such taxable dividends may also be paid in obligations of the company, including income bonds and other new-fangled forms of pseudo-debt.

The second of our four methods is provided for specifically in Section 115 (f) (2) of the new Revenue Act. This states that if a dividend may be taken either in cash or stock at any stockholder's option, it shall constitute a taxable dividend in the hands of all stockholders receiving it, regardless of the medium in which it is paid.²¹ Such optional dividends were paid in the past by a number of companies, for example, North American Company in the earlier years of its stock dividend policy.²² Hence, literally construed, Section 115 (f) (2) presents an extremely simple way of enabling corporations to pay ordinary stock dividends which will be "deductible" for the corporation and taxable to the stockholders. It can declare such a dividend accompanied by an option to take an entirely negligible amount of cash. Of course, no shareholder will exercise that nugatory "option". Concretely, a company could declare a dividend payable either in common stock worth \$5 or at the rate of 1 cent in cash. It may be doubted, however, whether on such a state of facts the courts would hold that the ruling in *Eisner v. Macomber* had been successfully circumvented and that the dividend was in essence anything other than a "true stock dividend made lawfully and in good faith", such as is not taxable under the rule of that case.²³

preferred where shares of the latter are previously outstanding. Payments on common in additional common are, of course, non-taxable. The Regulations do not specifically treat of (1) payments on preferred in additional preferred, and (2) payments on common in preferred, where previously there was no preferred stock outstanding.

18. §115 (j).

19. §27 (e). For discussion of §27 see Hendricks, *supra* note 1, at 30-48.

20. Dividends in preferred or "special" stock were paid periodically in past years by several important corporations, notably General Electric and S. H. Kress.

21. See Hendricks, *supra* note 1, at 41, for discussion of the legal implications of this method.

22. There are also preferred issues carrying optional dividends by their terms, but dividends taken thereon in stock would probably be taxable in any event under the *Koshland* decision.

23. 252 U. S. 189, 219 (1920). The English courts have held that such a state of facts presents no real option to the stockholder, and that in effect he is given only a non-taxable stock dividend. See Magill, *Realization of Income Through Corporate Distributions* (1936) 36 COL. L. REV. 519, 535.

A further literal construction of this sub-section would permit the option to take cash to be given to a single stockholder, thus making an ordinary stock dividend taxable to all the stockholders. Whether the courts will uphold such a peculiar method of making taxable stock dividends that are otherwise non-taxable, also remains to be seen. A conflict of interest is likely to develop between corporations and certain of their stockholders on the question whether a given stock dividend is or is not taxable.

The method of offering subscription rights simultaneously with the payment of a cash dividend, and involving the same amount, has also been used not infrequently in the past. By making the subscription price of the additional stock appreciably lower than its market value, the company can make sure that the rights will be exercised and the cash dividend returned to its treasury. In its practical effects this device differs in one respect from that discussed just previously. In the latter case, the taxable and "deductible" value of the dividend would be the market value of the stock on the date received; under this third method such value is restricted to the cash dividend declared, which is presumably less than the market value of the stock ultimately received.

The combination of cash dividends and subscription rights is merely a special manner of selling additional shares to stockholders. If it chooses, a corporation can offer these shares at other times and raise amounts either greater or less than the cash dividends paid. The prohibition against selling stock at less than par formerly constituted a technical obstacle in the way of such stock offerings. With the present vogue of no-par and artificially low par shares, this no longer presents a serious difficulty.

The application of cash dividends to the paying up of part-paid shares is a device perhaps unknown to this country, but not unusual abroad where part-paid shares are far more prevalent than they are here. Theoretically it should be possible to issue such partially paid shares with a charter provision to the effect that demands for further payments thereon may only be made coincidentally with the declaration of an equivalent cash dividend. Under this arrangement a "dividend distribution" will mean merely the transfer of certain dollar amounts from surplus to capital, with no change in the number of shares outstanding, but with an increase in the nominal or paid-in value of each share. Evidently such a payment will be no more than a bookkeeping device to relieve the corporation of the penalty tax by making its income taxable to the individual stockholders. Such a device would seem, however, to be quite legitimate and feasible.

We have dwelt at such length upon these possible media of capitalizing retained earnings because they seem to have been largely over-

looked in the early heated discussions of the new pressure tax. The writer is convinced that they will be widely availed of, so as to permit many corporations to retain pretty much the same proportion of earnings as heretofore without incurring the surtax. Dividend actions taken by publicly-owned corporations from the passage of the 1936 Revenue Act to date would not seem to bear out this prediction, since these devices have not yet been used to any great extent.²⁴ There has, however, been a pronounced expansion in cash dividend payments, for which both the new law and increased earnings have been responsible.²⁵ It may take some little time for corporations generally to familiarize themselves with the lines of procedure just discussed. Many companies are undoubtedly delaying action of this sort pending the outcome of the election, which may promise the repeal of the Surtax on Undistributed Profits.

Effect Upon the Stockholder's Interests. There is reason to believe that stock prices generally will benefit from a more liberal dividend policy in relation to earnings. Wall Street may pay lip-service to the idea that withholding of earnings is beneficial to stockholders, but it pays higher prices for the shares of companies which pay out their earnings.²⁶ Of two substantially similar concerns with the same earnings per share, the one paying the larger dividend will nearly always sell at the higher figure. This preference for dividends rather than for increased book values seems justified by the investor's experience. Where a large proportion of the profits has been retained and reinvested in the business over a period of years it frequently happens that the earning power and the stock price fail to show a proportionate increase, particularly if allowance be made for compound interest on the amounts retained.²⁷

Broadly speaking, it may be said that if additional capital can be profitably employed in the business, the management can always get it

24. Three current examples may be cited: A special stockholders' meeting called for October 5 by Federal Mogul Corp. to amend articles of association to permit directors to declare dividends payable either in stock or cash. Proposed authorization of \$25,000,000 of preferred stock of Caterpillar Tractor Company to be used for payment of common dividends. Proposed dividend of \$1 per share to be paid by Copperweld Steel Co. in new bonds.

25. Total dividends, exclusive of railroads and banks, for the five months May-September, 1936, as reported by the New York Times, aggregated 1371 millions, as against 1043 millions in 1935, 1554 millions in 1929, and 1174 millions in 1923. A few corporations have postponed dividends to get the benefit of such payments in their next fiscal year beginning late in 1936, at which time the penalty tax becomes effective for them.

26. GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 325-338.

27. It has also been suggested that the accumulation of large corporate surpluses "assisted materially in causing the depression", by withholding of sums from consumption, by stimulating over-expansion of plant capacity, and also by pouring corporations' surplus funds into brokers' loans, thus helping along the stock market boom. See testimony of G. C. Haas, Director of Research and Statistics, Treasury Department, *Hearings before Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 59.

from old and new stockholders. As a practical matter, financing in the market is not difficult if the company has been prosperous in the past and has paid liberal dividends. The advantage of retaining earnings rather than selling new stock seems to accrue to the management rather than to the stockholders, in that there does not seem to be the same responsibility for earning an adequate return upon surplus as upon capital funds. This point is illustrated by a remark made some years ago by Judge Gary at an annual meeting of the United States Steel Corporation. To a stockholder arguing for an increased dividend, the Chairman replied that the current \$7 rate was a liberal return on any common stock. But adding the undistributed profits to the common stock issue at par, the dividend figured out at barely 4% on the stockholder's equity—a circumstance which could be glossed over all too easily.²⁸

When the reinvested earnings are represented by a proportionate increase in stated capital, the underlying nature of the financial operation is made clearer to both the stockholders and the management. A more definite responsibility is laid upon the latter to justify the expansion of the business capital by showing a corresponding increase in the earnings and by maintaining the basic cash dividend rate on the additional number of shares. Where there may be good reason to doubt whether the reinvested earnings will be duly productive, this more specific challenge to the management may impel it to decide against such reinvestment and in favor of a cash disbursement. Under the circumstances stated, this would be decidedly in the stockholders' interest.

Summarizing the foregoing argument, we conclude that the Undistributed Profits tax, if continued, will lead to larger cash disbursements by companies with limited opportunities of profitable expansion, and to the issuance of additional stock generally to represent reinvested earnings.²⁹ As far as those particular effects are concerned, we consider them favorable to the stockholders and not inimical to the financial soundness of corporations.³⁰

28. See GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 330, 332.

29. Many corporations are likely to retain small percentages of their earnings without bothering to capitalize them. Retention of 10% of profits involves a penalty tax of but .7% of the total earnings. Saving of individual surtax and other reasons might well induce a company to retain this amount of earnings and pay the extra tax thereon. Earnings retained because of contracts not to pay dividends or to use same to discharge a debt are not subject to the penalty tax, if such contract was executed prior to May 1, 1936. See § 26(c). The Treasury Regulations (T.D. 4674), 70 *Treas. Dec.* No. 7, at 51 (Aug. 6, 1936) limit severely the benefits of these provisions, See Hendricks, *supra* note 1, at 26-28.

30. The new law should particularly improve the position of *non-cumulative* preferred stocks as a class by discouraging the familiar policy of withholding dividends on these issues even when earned, whereupon they are irrevocably lost to the stockholder. This

Certain collateral problems and objections in this connection present themselves. First, how will stockholders find the money to pay income taxes on dividends received in the form of stock? If the enterprise is a close corporation they may not be able to sell their stock at all; in other cases sales to raise money for taxes may seriously depress the market price.

When carefully considered, this question is seen to be part of the general problem of obtaining the cash to pay individual taxes on business earnings. If an individual owner or members of a partnership wish to leave substantially all the profits in the business, they must still pay their taxes thereon and must find the money from some other source. The stockholders of a private corporation are in exactly the same position as a partnership in this respect—except, as we pointed out at the beginning, that the aggregate tax burden on their earnings is substantially greater. In either case a distribution policy will be adopted which seems best suited to the needs of the owners (including their tax bill) on the one hand, and the requirements of the business on the other. In the case of some corporations the owners may decide that the new penalty tax is still less burdensome than their individual surtaxes would be, and retain part of the earnings with this tax saving in view.³¹

In a publicly owned corporation the tax status of the individual shareholders may or may not exert an influence upon the distribution policy. If there are wealthy stockholders who own a controlling interest, their preference as between cash payments, stock payments, and no payments, will no doubt carry due weight with the directors. In most cases the cash distributions will be at least sufficient to take care of the stockholders' tax bill for both the cash and stock dividends combined. It may well be that part of the stock dividends will be sold to meet taxes imposed thereon, but such sales are not likely to be a more serious matter market-wise than sales of such dividends for any other purpose.

The second question relates to the building up of reserves for the purpose of maintaining cash dividends and meeting losses in bad years. This is somewhat different than the matter of finding money for expanding the business. It is argued that surpluses constitute a necessary rainy-day reserve, and that the new tax, by virtually prohibiting the accumulation of a substantial surplus, will make it impossible for corporations

point applies, in lesser degree, to cumulative preferred stocks also. For an opposing view on the effect of the law upon preferred stocks see testimony of R. C. Osgood, *Hearings before Committee on Finance on H. R. 12395, 74th Cong., 2d Sess. (1936) 229-230.*

31. Since this article is concerned with "investors" that is, holders of marketable securities, we shall not consider in any further detail the effect of the surtax on close corporations.

generally and new enterprises in particular to meet the challenge of hard times.

This contention is not so plausible as it sounds, because there is really no close connection between a balance-sheet surplus and surplus cash. A company may have a large accumulated surplus and yet be short of cash—the surplus earnings having gone into other assets or to pay liabilities. For opposite reasons an enterprise may have a very small surplus, or even a profit and loss deficit, and have far more cash than it needs. This condition did in fact exist in many important companies at the height of the depression in 1931-1933. On the whole it does not appear to have been a well-defined policy of leading corporations to build up a substantial *cash reserve* out of the profits of prosperous years. The large cash holdings that have been characteristic of recent years, in the case of industrial companies, were in good part the result of additional stock financing before the crash.

Whether or not this is in fact true, the use of taxable stock dividends will enable corporations to build up their cash holdings almost as freely under the new surtax as previously. The question of maintaining an established cash dividend in depression years involves an additional consideration; for, if there is no accumulated book surplus, the state laws would prohibit dividend payments in excess of current earnings, even though cash holdings were ample for the purpose. On this point two observations suggest themselves. The first is that accumulated surpluses could not be relied upon in the recent depression to assure the continuance of dividends. By the end of 1931 United States Steel had accumulated Undistributed Net Income of about \$1,200,000,000 (of which \$500 millions had been appropriated to write off intangibles). Yet it passed the dividend on its common stock in April 1932, and reduced the dividend on its preferred from \$7 to \$2 in January, 1933. The record of the Atchison Topeka & Santa Fé Railroad is very similar.

The second observation is that under the new accounting techniques the payment of *stock dividends* representing all the earnings above cash dividends may still permit the accumulation of a substantial book surplus. Hence both a cash fund and a statutory surplus may be available to continue cash dividends even when there are no earnings. To illustrate: Company *A* may have common stock selling at \$100 per share, with a stated value (no par) of \$5, or with an artificially low par of \$5. It earns \$8, pays \$3 in cash, and by one of the devices described previously pays a taxable dividend of 5% in common stock, worth \$5 per share. On its books this 5% stock dividend is transferred from surplus to capital at a valuation of only 25 cents per old share outstanding—that is, 5% of \$5 par or stated value. There remains \$4.75 per share in surplus, avail-

able to continue the \$3 cash dividend even if there are no earnings next year.

On the whole, therefore, the Undistributed Profits Tax need not change substantially the aggregate of cash dividends paid by any given corporation over a cycle of good and bad years. If the cash dividend is kept low in the prosperous years, the balance of earnings being "paid out" in stock, it may still be possible to maintain the cash rate in an ensuing depression. If all the earnings are paid out in cash, and there is no previously accumulated surplus, it will of course be impossible to continue dividends when there are losses. Such a policy might well be improvident; but there is no reason why the typical company need follow it, in view of the other alternatives at its command.

Effect upon Creditors. There remains the question of the effect of the new tax upon creditors, particularly bondholders. If the penalty tax will make for improvident corporate policies, creditors as well as stockholders would of course be harmed thereby. Since we have concluded that most corporations will be able to utilize their cash earnings very much as in the past, we do not anticipate any serious impairment of the position of bondholders because of the new pressure to pay dividends. It may be added that the safety of bond investments in general is not measured by or predicated upon the expectation of a substantial reinvestment of future profits in the business. Bonds are bought on the basis of the past earnings record, the present financial status, and the general view as to future prospects. Protection against untoward developments is provided in indentures by various stipulations, affirmatively, by requiring sinking-fund payments and the maintenance of a certain working capital position; negatively, by prohibiting sales of additional bonds or dividends unless stated conditions are met. Only when bonds are issued under conditions of considerable corporate weakness do we find a specific agreement to build up surplus to a certain point before paying dividends.

The new law may seem to interfere with proper sinking fund arrangements for future bond issues, since such sinking fund payments may not be deducted from earnings subject to the pressure tax. Sinking funds of reasonable size are highly desirable features of bond issues; hence the imposition of an extra tax burden on resources used for that purpose would run counter to sound financial principles and be fairly subject to severe criticism. It should be pointed out, however, that the typical bond sinking fund represents the application of sums reserved for depreciation and deducted from earnings before calculating the income subject to tax. From an accounting standpoint moreover, the sinking fund payment itself is not a deduction from earnings at all, since the company's funded debt is decreased in virtually the same amount as the cash expenditure.

Depreciation charges are frequently offset, and even exceeded, by current expenditures for additions and replacements, and hence there may not be cash available from that source for sinking fund payments. But in theory such expenditures are no different from any other new investments in the business, and they may just as properly be capitalized by selling new bonds, paying stock dividends, etc. Whether or not this is true in practice is not necessarily relevant to the question of a special allowance for sinking fund payments, but rather to the more basic issue of whether all sums retained and added to surplus may be considered the equivalent of new capital in their effect upon future earning power. This problem exists, of course, regardless of whether or not there are bond issues with sinking fund provisions. It may be pointed out that the heavier weight of taxes requires an offsetting liberalization of the deductions allowed from income to reflect the very real element of obsolescence, which up to now has been taken care of to a considerable extent in the surplus account.³²

The pressure tax should produce certain changes in the wording of protective covenants in bond indentures. The new law gives corporations an exemption from surtax with respect to earnings withheld in accordance with a written contract not to pay dividends, if executed prior to May 1, 1936.³³ If a *future* bond issue carries such a provision, compliance therewith may subject the company to a heavy penalty tax. To meet this situation such protective prohibitions should apply to cash dividends only, leaving free the payment of dividends in stock; they might even allow the declaration of a cash dividend provided a corresponding amount of cash has been or is to be returned to the treasury through the sale or acceptance of stock. It should be evident that creditors' interests are not adversely affected by the payment of stock dividends. In fact, to the extent that such dividends earmark past earnings as additional capital, they may be said to benefit the creditors.

A conspicuous weakness in most bond indentures is their failure to insist on the maintenance of a minimum amount of stockholders' "junior investment". Theoretically, the typical company with funded debt might, with the approval of stockholders only, reduce its capital to \$1, distribute all of the stockholders' equity in the form of a return of capital, and leave the bondholders without any of that margin of resources over debt on which the purchase of the bonds was largely based. Some of the more recent indentures remedy this weakness by prohibiting or restricting distributions to shareholders through the medium of a return of capital. A provision of this kind should be standard practice; but here again the Undistributed Profits Tax should be kept in mind, and a suit-

32. See p. 16, *infra*.

33. See Hendricks, *supra* note 1, at 24.

able degree of flexibility retained. Transfers from capital to surplus and payments of stock dividends out of the capital so transferred should be permitted, since they will not injure the creditors and may prove to be necessary in order to avoid the penalty surtax.

The effect of the Undistributed Profits Tax on corporate accounting would seem to be concentrated in the area of capital and surplus items. Corporations will desire (a) to retain a flexible cash dividend policy; (b) to escape the penalty tax on undistributed earnings; and (c) to comply with state law. As already indicated, this three-fold objective will be conducive to arbitrarily low par values for both preferred and common stocks (already expedient from the standpoint of transfer taxes, etc.), a low stated value for the issued capital, and hence to liberal transfers from capital to special surplus accounts. Such transfers will be especially necessary to eliminate accumulated deficits on the balance sheet, which in some states prevent payment of dividends out of current earnings.³⁴

The huge write-offs and write-downs occasioned by the depression have already been responsible for widespread transfers from capital to surplus. Hence the manipulations induced by the pressure tax will merely intensify an already pronounced trend. The effect of all this may be misleading to unwary investors. Ultimately we shall grow accustomed to ignore par values, stated values, etc.; renounce the idea that the Profit and Loss Surplus in the balance sheet has a separate historical value; and treat the capital and surplus accounts together as an indivisible entity for purposes of analysis.

SERIOUS INEQUITIES IN THE NEW LAW'S DETAILS

The weight of our argument to this point has been generally favorable to the principle of the Undistributed Profits Tax, and has tended to minimize the predictions of dire consequences which have been uttered on every hand. But there are a number of serious criticisms which can be leveled against the detailed provisions of the 1936 Act, as they affect the interests of corporations, their stockholders, and their bondholders. Chief of these is the point made at the outset, that the burden of taxation on corporate earnings is now excessive as compared with that on unincorporated enterprise. This is particularly true if state corporation taxes are taken into account.

³⁴ The report of International Paper & Power Co. for the first half of 1936 reserved \$3,8226 as provision for possible federal surtax on undistributed profits, explaining that it was not in a position to pay dividends because of its accumulated profit and loss deficit. It is currently reported, however, that the company will recapitalize in order to eliminate the deficit.

The Act is unfair also because it tends to impose heavy taxes on amounts which are not really earned at all. In enterprises of many sorts the factor of obsolescence is a serious one. It has been difficult to provide for this by a charge against earnings similar to depreciation. The actual practice has been to consider the accumulated surplus in part as an obsolescence reserve, by means of which rather heavy charge-offs against property account might be made from time to time as the obsolescence matures. The 1936 Act will not permit such obsolescence to be provided for either by a specific charge against earnings or by accumulating a general surplus. When the loss through obsolescence is actually realized, a deduction therefor may not even be allowed against the current year's earnings if the obsolete property is disposed of by sale at a loss. In effect this means that over a period of years the earnings on which heavy taxes are imposed will be found to have been calculated at a figure considerably in excess of the true profits of the enterprise.

The latter criticism applies also to the general situation where over a period of time there may be both net losses and net profits. Under the older Revenue Acts business losses could be carried forward against the business profits of the succeeding two years.³⁵ This privilege was withdrawn in 1932. The 1936 Act permits a carry-over of *dividends* paid in excess of earnings in calculating the Undistributed Profits Tax.³⁶ But full corporation and individual taxes, or corporation and penalty taxes, must still be paid on the earnings of all profitable years without any credit for net losses in other years.

This inequity is aggravated by virtually ignoring losses on the sale of capital assets, except as offsets against similar profits.³⁷ When such losses could be charged against undistributed profits on the books of the company, the failure to get a tax credit for them meant an extra tax of say 15% of the amount involved. But with all "earnings" now subject to both corporate and individual tax, the failure to allow this credit becomes a far more serious matter.

Earnings without deduction for net capital losses (in excess of \$2,000) must either be distributed or be subject to the penalty tax. If a company has no accumulated surplus it would be prohibited by state law from paying dividends greater than the net earnings minus the capital losses. To escape the penalty provision, a reduction in capital would be necessary to create a surplus out of which to pay dividends not earned under

35. In §204 (b) of the 1918 Act, 40 STAT. 1061, the net loss could be deducted from the previous year's income, and the tax thereon redetermined. Any excess of such net loss over the previous year's income could be subtracted from the next year's income. The two-year's carry-forward began in §204 (b) of the 1921 Act, 42 STAT. 231.

36. §27 (b). This begins only with the first taxable year under the 1936 Act.

37. A net deduction of only \$2,000 is permitted in any year. §117 (d).

any accepted standards of accounting. The alternative imposed—either to pay such an improvident and questionable dividend or to incur a heavy penalty tax—might well be characterized as outrageous.³⁸

Congress has been disturbed by the adverse effect upon the revenue of the permissions previously accorded to carry forward business losses and to deduct capital losses from ordinary profits. However, the combination of the new system of taxation of corporate profits with the withdrawal of these ameliorating privileges creates for the holders of corporate securities a tax status which in many cases may prove to be grotesquely unfair. Both the carry-forward of net losses and the deduction of capital losses should clearly be allowed in calculating liability to the undistributed profits tax—though not, perhaps, in imposing the normal corporation tax.

Companies subject to wide changes in inventory value—especially of raw materials—may easily show a deceptively large profit in a year of rising prices, to be followed by a severe loss when prices recede. Intelligent and reasonable accounting procedures have been developed to reduce these inherently fictitious variations, such as the "base stock" method and the "last in, first out" method. The law should be liberalized to permit companies to follow conservative accounting policies of this sort; for under present rulings a heavy tax is levied on the high cyclical profit, with no adjustment for the almost inevitable losses to follow.³⁹

The plight of the railroads under the new penalty tax has been emphasized in the recent hearings on the proposed reorganization of the Chicago & North Western Railroad. The basic difficulty here is that a good part of the additions and betterments constructed over a period are not productive of additional revenue, but are needed to meet more exacting standards of comfort and appearance. Such non-earning betterments cannot soundly be capitalized, but should be taken care of out of surplus, considering the latter as a sort of "public welfare fund." In effect this means that part of the balance for dividends, as reported under Interstate Commerce Commission regulations, is not really available for dividends, and a good part of the balance sheet surplus is not surplus at all in any true sense. These undoubted facts would well justify placing the railroads in the same class as banks and insurance companies, exempting them entirely from the provisions of surtax on undistributed profits. At the present time the only special privilege accorded the railroads is that of filing consolidated returns.⁴⁰

38. Cf. BRITISH COMPANIES ACT, 1929, 19 & 20 Geo. V, c. 23, Table A, Reg. 91: "No dividends shall be paid otherwise than out of profits."

39. See testimony on this point in *Hearings before Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) passim, in particular Brief of Tanners Council of America, at p. 629-634.

40. § 141.

In order to escape the penalty tax the year's earnings must be disbursed within the taxable year.⁴¹ Since they cannot be accurately computed until after the close of the year, this provision compels the dividend policy to be based in part on estimates which may prove quite unreliable. Congress decided against granting a leeway for payment of dividends after the close of the taxable year, fearing this might mean a full year's postponement of the collection of individual taxes thereon. A compromise provision seems clearly called for, such as one permitting up to 25% of the dividend credit to be taken for distributions made within sixty days after the close of the taxable year.

Finally, the writer ventures to suggest that a general permission should be accorded corporations to avoid the provisions of the surtax on undistributed profits if their stockholders elect to be taxed on their entire pro-rata shares of the net income, whether distributed or not. This election is now accorded to corporations otherwise subject to surtax for "improperly accumulating surplus",⁴² or to surtax on personal holding companies.⁴³ It corresponds to the treatment given to "personal service corporations" under the Acts of 1917, 1918 and 1921, except that the normal corporation tax would be retained. The purpose of this suggestion is to afford equitable relief to companies which find it highly inconvenient or technically impracticable to distribute their profits in full, but whose stockholders are willing to comply with the intention of the pressure tax by accepting tax liability on their share of the entire earnings.⁴⁴

The chief result of the undistributed profits tax will not be the disruption of American business policies but rather the imposition of considerably higher aggregate taxes upon corporations and their stockholders. Shareholders of publicly owned companies will get partial compensation in higher dividends, which will come largely in the form of additional stock. The effect upon stockholder-management relationships is likely to be rather salutary; upon the position of bondholders and other creditors, unfavorable but not disastrously so. The objectionable features of the Revenue Act of 1936 do not reside in the principle of the undistributed profits tax but in numerous unfair details of its application.

41. § 27(a).

42. § 102(d).

43. § 351(d).

44. This suggestion was incorporated by Secretary of the Treasury Houston in his proposal for an undistributed profits tax, made in 1920, and it was included in such a proposal which passed the Senate in 1924, but failed of final acceptance. See *Hearings before the Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 14, 16.