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New Factors in Federal Income Taxation

Vikctor H. Stempf

New Factors in Federal Income Taxation

By Victor H. Stempf

The revenue act of 1936, which was signed by the president on June 22, 1936, is, unlike the 1935 act, complete in itself as it concerns income taxes. Its most important feature is that it introduces a new method of taxing corporations, while retaining, in a modified form, the old corporate income tax. It is the compromise agreed upon by the conference committee to reconcile the house bill, which had given effect to the president's suggestion that the current taxes on corporations should be replaced by a tax on undistributed profits, and the senate revision of the house bill, which had retained the current corporate taxes and had imposed only a small tax on undistributed profits.

History of the Act

It will be recalled that the house of representatives in attempting to give effect to the president's suggestion, which was intended to simplify the corporate tax structure, evolved the most complicated tax measure ever known in the history of this country and that protests against the proposed act and suggestions for raising the required additional revenue were presented at the hearings on the bill before the senate finance committee by many persons and by representatives of professional and trade associations and societies.

The American Institute of Accountants was represented at the hearings by its committee on federal taxation, which submitted a memorandum criticizing the complexity of the corporate tax provisions, questioning the advisability of abandoning a trustworthy revenue in favor of a conjectural one and offering the following recommendations for raising additional revenue:

"(1) That the existing form of corporate income tax be retained, at increased rates, if necessary;

(2) That the existing personal exemptions be reduced in order to broaden the base of the normal tax, or that the same result be obtained by an irrecoverable withholding at the source in respect of fixed or determinable income of the character required to be included in information returns under the existing law;

(3) That the normal tax be increased, and/or the normal tax be applied to dividends, if necessary;

(4) That the principle of taxing undistributed income be applied at a low rate on a fixed base, by subjecting to this form of supertax the excess of 'adjusted net income' over the sum of (a) the corporate income tax on such income and (b) dividends paid during the taxable year.

(5) As an alternative proposal respecting taxation of undistributed income, and as an incentive to increased dividends, the following method should be considered: In conjunction with a higher corporate income-tax rate (applied directly to the fixed or determinable base of 'adjusted net income' as heretofore) a 'drawback' at a fixed rate (applied directly to the amount of dividends paid during the taxable year) may be allowed as a credit against the corporate income tax."

The senate, in its revision of the house bill, adopted some of these recommendations in that it retained the existing corporate taxes, with increased income-tax rates, substituted a surtax at the rate of 7% on undistributed income for the complex undistributed-profits tax contained in the original bill and made dividend income of individual taxpayers subject to normal tax.

The act, as finally approved, retains the existing corporate taxes, but with lower income tax rates than those provided in the senate bill, imposes a surtax at graduated rates on undistributed income and makes dividend income of individual persons subject to normal tax. However, the corporate surtax rates are fixed and are applied directly to the undistributed net income so that the fundamental complexities of the original tax on undistributed profits are avoided, although there remain many vexing problems.

Constitutionality

The actual imposition of a tax on undistributed profits of corporations is new in the history of taxation in this country, although the idea had been proposed prior to 1921. Its validity, therefore, should be considered carefully. The pertinent provisions of the constitution of the United States, from which congress derives its power to levy taxes, are as follows:

Article I, section 8, clause 1:

"The congress shall have power:

To lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and taxes shall be uniform throughout the United States."

Article I, section 2, clause 3:

> "Representatives and direct taxes shall be apportioned among the several states which may be included within this union according to their respective numbers. . . ."

The sixteenth amendment:

> "The congress shall have power to lay and collect taxes on income, from whatever sources derived, without apportionment among the several states, and without regard to any census or enumeration."

It should be noted that the sixteenth amendment, which is generally deemed to be the source of the power to levy income taxes, merely permits the imposition of such taxes without apportionment, the power to impose all taxes being contained in the first of the foregoing quotations.

As the surtax on undistributed profits is imposed on that portion of the income of the taxable year which is not distributed, there appears to be no reasonable doubt that it is an income tax and that there probably is no restriction in the above quotations which would render it unconstitutional. Accordingly, the only basis upon which its constitutionality may be questioned is that it violates the fifth amendment, which provides that no person shall be "deprived of life, liberty or property without due process of law." In Paul and Mertens' *Law of Federal Income Taxation*, it is stated that "a statute is not unconstitutional under the due-process clause unless it is so arbitrary and capricious that it constrains to the conclusion that it is not the exercise of taxation, but a confiscation of property. In other words, a statute is not unconstitutional unless it is so wanting in a basis for classification as to produce a gross and patent inequality." Whether or not the fact that the tax can be avoided by a corporation which has a surplus while a corporation with a deficit but current earnings is helpless, is a sufficiently "gross and patent inequality" to render the tax unconstitutional under the fifth amendment, is a matter of legal opinion. However, corporate taxpayers should not place too much reliance on the possibility that the tax will be held unconstitutional, inasmuch as the supreme court has been loath, in view of the wide taxing powers granted to congress, to hold a taxing statute void.

There is, however, one new provision in the 1936 act which, in the opinion of many attorneys, is of doubtful constitutionality and that is clause 2, the definition of a dividend (section 115 (a)).

This clause provides that any distribution made by a corporation to its shareholders, whether in money or other property, "out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made" is a taxable dividend. Where a deficit exists at the beginning of the taxable year which is not offset by the earnings for the year, any distribution made during the year would be a return of capital and not income, according to the weight of authority as expressed in American decisions. Accordingly, it would seem that a shareholder contesting the taxation of such a distribution would have a fair chance of success. If the distribution were held to be a return of capital, the corporation making it would be denied the credit for the purpose of the undistributed-profits surtax and should, therefore, give careful consideration to this possibility before making such a distribution.

Revenue Act of 1936

Effective date:

The revenue act of 1936 was enacted June 22, 1936, and applies to taxable years beginning after December 31, 1935. As the income-tax provisions of the revenue act of 1935 also applied to taxable years beginning after December 31, 1935, they thus became ineffective and are now superseded by the related provisions of the 1936 act.

Fiscal years:

It should be noted that fiscal years beginning in 1935 and ending in 1936 are not governed by the 1936 act, but by the revenue act of 1934. Hence, a corporation filing its returns on a fiscal year ending November 30th will not be subject to the surtax on undistributed profits until its returns are filed for the fiscal year beginning December 1, 1936, and ending November 30, 1937. This fact has given rise to a vain hope in some quarters that a corporation might avoid the immediate incidence of the surtax on undistributed income by changing its fiscal year to a date falling before December 31, 1936. This is a vain hope because a corporation which previously filed on a calendar-year basis has reported its income up to and including December 31, 1935. Therefore, when it obtains permission to change its fiscal year it does not obtain the privilege of filing an amended return for a portion of a previous fiscal year but starts its new fiscal year, for tax purposes, with the closing date of its previous report, namely, January 1, 1936, and the first new tax period comprises the portion of the calendar year following that date. A taxpayer may never file a return covering a period of more than twelve calendar months, although the taxpayer under appropriate conditions may file a return for a period shorter than twelve months, e. g., for the initial period of operations from the date of inception to the close of the first fiscal year, or in the case of a change in the fiscal year.

Individual income taxes:

The tax rates on citizens and resident aliens are the same as those provided in the 1935 act. The major innovation is that dividends received from domestic corporations are now subject to normal tax as well as surtax, in the hands of individual persons. This is an important change to the owners of personal holding corporations.

The taxation of non-resident alien persons not having a place of business in the United States has been completely revised and will be discussed later in conjunction with the taxation of foreign corporations.

Corporation income taxes:

The taxable income of domestic corporations is subject (in addition to the excess-profits tax) to a normal tax and the new surtax on undistributed profits. The normal tax on corporations begins at 8% on the first $2,000, increases to 11% on the next $13,000 and to 13% on taxable income from $15,000 to $40,000, with a rate of 15% applicable to all taxable income in excess of $40,000. These rates supersede those ranging from 12½% to 15% provided by the 1935 act.

Banks, trust companies and insurance companies are taxed at a flat 15% rate and are not subject to the surtax. Foreign corporations are taxed at special rates which will be discussed later.

Domestic corporations are allowed to deduct the excess-profits tax as an expense. Fifteen per cent. of the dividends received from domestic companies is subject to normal income tax and excess-profits tax, but no part of such dividends is exempt in the calculation of the surtax on undistributed profits. Charitable contributions are allowable deductions up to 5% of taxable net income.

The foregoing covers, briefly, the changes in the normal tax, and presents no difficulties in interpretation.

The surtax on undistributed profits, however, provides much food for thought. Its enactment was prompted, no doubt, by the expectation that such a tax, if sufficiently high, would encourage (or compel) the distribution of corporate earnings to shareholders and perhaps thus subject such earnings to the individual normal and surtax rates. Its effect may well prove to be socially punitive rather than purely fiscal.

Surtax on Undistributed Profits

Accounting difficulties:

The final determination of net income (which will plague management, cumulatively, for periods of two or three years, or more, in respect of the tax liability relative to each fiscal year) will have a vital bearing, not alone upon the amount of direct income tax, as heretofore, but also upon the amount of earnings available for distribution and, therefore, an equally important relationship to the amount of dividends to be distributed to minimize the tax on undistributed profits. Subsequent revision of taxable net income by the treasury department may have a fatal effect upon the financial condition of a corporation by reason of irrevocable actions as to dividends or otherwise, taken in good faith by directors on the basis of taxable income originally determined.

The provision regarding dividends as it now stands makes it incumbent upon management to estimate earnings for the year, to determine the amount of dividend to be distributed within the taxable year. From an accounting standpoint this creates a more vexing problem than is apparent and likewise poses a financial dilemma which may even involve corporate directors in personal liability for the illegal distribution of dividends. As to accounting difficulties, one may exemplify the point by stating that in the great majority of businesses the ascertainment of earnings depends upon the fair determination of inventories at the close of the year, and such determination can not be made in the average case (even upon the basis of perpetual-inventory records) until after the close of the year. Furthermore, there are other important adjustments of deferred income, reserves and accruals, having a material bearing upon earnings, which, likewise, can not be made accurately until after the close of the year. To ignore these factors is contrary to the tenets of sound management.

Accordingly, it should be urged upon corporate taxpayers that the immediate preparation of a sound forecast of the results of operations for the year 1936 and the constant revision thereof until the end of the year are essential if they wish to avoid unnecessarily heavy taxes. This budgeting should relate not alone to book income but also to taxable income and due allowance should be made in the latter case for any disputed items of past years which may repeat in the current year and also for new doubtful factors. Taxpayers will find that the expenditure of the time and money for this purpose will be amply justified.

Surtax rates:

The rates of surtax on undistributed profits range from 7% to 27%, and the entire 100% of undistributed profits is taxable on the basis of the relationship of undistributed net income to adjusted net income, as follows:

The first	10%	of adjusted net income undistributed is taxed at	7%
The next	10%	of adjusted net income undistributed is taxed at	12%
The next	20%	of adjusted net income undistributed is taxed at	17%
The next	20%	of adjusted net income undistributed is taxed at	22%
The next	40%	of adjusted net income undistributed is taxed at	27%
	100%		

Effective rates of surtax:

The effective rate of tax, in relation to adjusted net income, may be expressed as follows:

Undistributed	Dividends	Effective rate
None	100%	None
10%	90	.7%
20	80	1.9
40	60	5.3
60	40	9.7
100	None	20.5

Thus, when dividends of 90% of the adjusted net income have been paid and only 10% remains undistributed the undistributed-profits tax takes .7% of the adjusted net income; if dividends of 80% have been paid leaving 20% undistributed the tax takes 1.9%; if dividends of 60% have been paid leaving 40% undistributed the tax takes 5.3% of the adjusted net income; if dividends of 40% have been paid leaving 60% undistributed, the tax takes 9.7% of the adjusted net income; but when no dividends have been paid and adjusted net income and undistributed net income are equal, the tax would take 20.5% of adjusted net income.

Determination of the base of the surtax:

The calculation begins, as heretofore, with the elements of taxable income, in which there is now included 15% of dividends received from domestic corporations, followed by allowable deductions now including charitable donations up to 5% of the net income exclusive of such contributions, and also including as a deduction the excess-profits tax, if any. From the residual, net figure, there is then deducted the credit relative to interest received on obligations of the United States and its instrumentalities. The remaining balance is subject to normal tax. Proceeding to the determination of the surtax on undistributed profits, the net income subject to normal tax serves as the starting point. This figure must be adjusted (a) by adding back the 85% of domestic dividends received (which are exempt from normal but are subject to surtax) and (b) by deducting the amount of normal tax. The resulting figure ("adjusted net income") is then subject to two other deductions (1) the credit for dividends paid by the taxpayer corporation and (2) the credit relating to contracts restricting dividends. The remaining balance represents the undistributed net income upon which the surtax is calculated.

Specific credit:

When the adjusted net income which measures the surtax is less than $50,000, a specific credit is provided to the extent of the excess of (a) $5,000 or (b) the total of undistributed net income, whichever is less, over 10% of the adjusted net income, and is to be deducted from the undistributed net income before computing the surtax. This credit is not, however, exempt from tax, but is subject to the 7% rate. The specific credit may not be more than $5,000 and to the extent that it exceeds 10% of adjusted net income it reduces the base subject to the higher surtax. The net effect of the provision for the specific credit (when adjusted net income is less than $50,000) is to subject the first $5,000 to the surtax of 7%, the balance of the undistributed net income being subject to the higher rates.

An alternative interpretation of the specific credit provision holds that the amount is the less of $5,000 or the undistributed net income, less 10% of the adjusted net income. Under this interpretation, the credit is much larger than under the former, official interpretation and results in a greater reduction in tax. For example, take the case of a corporation having adjusted net income of $40,000 and undistributed net income of $20,000. Under the official interpretation, the specific credit would be $1,000 ($5,000 minus 10% of $40,000) while under the alternative interpretation, the specific credit would be $5,000; $5,000 being less than $16,000 ($20,000 minus 10% of $40,000). In this particular case, the reduction in surtax would amount to $550. Accordingly, it is likely that the question will be tested in the courts.

Dividend-paid credit:

The dividend-paid credit is the amount of dividends paid during the taxable year. Dividends declared during the taxable year but not paid until the following year are allowed as a credit in the year of payment and not in the year of declaration. Also, if more dividends are paid within the year than are necessary to avoid the surtax, such excess may be carried forward to the two following years. Dividends paid are applied in the following order:

1. The amount paid within the current year.
2. Any carry-over from the second preceding year which was not applied in the next preceding year.
3. Any carry-over from the immediately preceding year.

Thus, if $100,000 of income in 1936 were subject to surtax except for the fact that $150,000 of dividends had been paid in 1936, $50,000 of such dividends would be carried forward. If in 1937, $30,000 of income were subject to dividends-paid credit and $50,000 of dividends were paid in that year, then $20,000 of 1937 dividends and $50,000 of 1936 dividends would carry-over to 1938. If in 1938 only $10,000 of income were subject to the dividends-paid credit, then $40,000 of the 1936 dividends would be lost irrevocably as a dividends-paid credit. On the other hand, if $100,000 were earned in 1938 subject to the dividends-paid credit and no dividend were paid in 1938, then $50,000 of the 1936 dividend and $20,000 of the 1937 dividend would be applied as an offset, and if in 1938 dividends of $40,000 were paid, the $50,000 of 1936 dividends and $10,000 of the 1937 dividends would be applied, and the remaining unapplied $10,000 of 1937 dividends would carry-over to 1939.

CHARACTER OF DIVIDENDS ALLOWABLE

Concerning dividends paid there are other matters of general interest which deserve mention. The subject of dividend carry-over has been discussed. All that need be added is that no credit is allowable for dividends paid by a corporation prior to its first taxable year under the 1936 act.

Definition:

Basically, the term dividend (for purposes of the act) means a distribution out of earnings of the taxable year or accumulated since February 28, 1913. Income earned prior to that date is not subject to federal income tax, and, similarly, profits or losses relating to the sale of assets acquired prior to that date are determined on the basis of the fair value of such assets at that date.

Stock dividends and stock rights:

Prior revenue acts stated that a stock dividend was not subject to tax. Section 115 (f) (1) states that a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the sixteenth amendment to the constitution. The law does not state what stock dividends or stock rights do not constitute income within the meaning of the sixteenth amendment to the constitution. In *Eisner* v. *Macomber*, 252 U. S. 189, the United States supreme court held that a dividend paid by a corporation on its common stock by issuing to its stockholders additional common stock was not income within the meaning of the sixteenth amendment and therefore not taxable. In *Koshland* v. *Helvering*, 56 S. Ct. 767, the supreme court held that where preferred stockholders received a dividend in common stock they received income which could be taxed under the sixteenth amendment, the court stating that, "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented, he receives income." Under the *Koshland* decision it may be inferred that any stock dividend in shares materially different from those held constitutes income under the sixteenth amendment.

In *Miles* v. *Safe Deposit & Trust Co. of Baltimore* (259 U. S. 247), the United States supreme court held that the right of stockholders to subscribe for new stock is analogous to a stock dividend, and not gain, profit or income. Whether rights to subscribe to stock of a class different to that in respect of which the rights are issued can be taxed has not been definitely settled but on the basis of the *Koshland* decision they probably will be held taxable to the extent of their fair market value.

Method of payment:

"A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands," and a dividend-paid credit in respect of the corporate surtax on undistributed income will not be allowed unless the shareholder does actually receive the dividend within the taxable year for which the credit is claimed. The significance of these governing factors is self-evident. It should be emphasized that the existing dates and methods of paying dividends should be carefully reviewed to avoid the possibility of challenge by a tax examiner. The disallowance of a dividend-paid credit resulting in a revision of undistributed net income may have a disastrous effect upon the amount of surtax payable. The regulations say:

"If a dividend is paid by cheque and the cheque bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the dividend would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year."

In small or closely held corporations, dividends are sometimes credited to shareholders' accounts. This practice usually is adopted in the case of subsidiaries, dividends being credited to inter-company accounts. Perhaps, therefore, it would be advisable to avoid trouble by changing to a payment in cash. In the case of subsidiary companies, they may, if necessary, be supplied with funds with which to make the distribution. It should be borne in mind that the credit for dividends paid will not be allowed unless it be demonstrated to the satisfaction of the commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year. Likewise, in the case of a taxable stock dividend, delivery of new shares and an entry registered on the books of the corporation, both within the taxable year, are required as evidence of the distribution within that year.

Preferential distributions:

Distributions which are preferential or unequal in amount will be disallowed as dividend-paid credits to the extent of the entire amount of the distribution and not merely a part of such distribution, regardless of whether or not such inequality or preference has been exercised with the full consent of stockholders and regardless also of whether or not the amounts received by shareholders are taxable to them.

Dividends paid in obligations of the corporation:

Dividends paid in obligations of the corporation, which are taxable to the distributee, are allowable as dividend-paid credits, limited to the less of the face value or fair market value of such obligations as of the date of payment. At the time of reacquisition, retirement or redemption of such obligations by the corporation, a further dividend-paid credit will be allowed, provided the amount at which the obligations are redeemed exceeds the amount previously taken as a dividend-paid credit; subject to the further restriction that this excess shall be diminished by any amounts allowable as deductions (for amortization of bond discount or expense, allocable to the obligations redeemed) in computing net income of the corporation for any taxable year. The word obligation means any legal liability to pay a fixed or determinable sum of money evidenced in writing signed by the corporation.

Redemption of stock:

It is interesting to observe that when a corporation redeems its own stock, in a manner which makes the redemption in whole or in part essentially equivalent to the distribution of earnings, to that extent the amount becomes a dividend-paid credit. As the payment of a premium upon the redemption of a preferred stock becomes a charge against earnings or surplus it appears that such premium ordinarily would constitute a dividend-paid credit in the year in which disbursed.

Dividends in kind:

The act imposes limitations upon the extent to which distributions of property may be recognized as dividend-paid credits.

Such credits can not exceed the less of the fair market value of the property at the time of distribution or the adjusted basis of the property in the hands of the corporation. The latter ordinarily means cost but may involve other complications if such property was acquired by the corporation incident to a reorganization or liquidation, by gift, or incident to a tax-free exchange, etc. Thus, if the corporation were to purchase stock of Y for $100 and subsequently received a tax-free distribution of $10 and then distributed such stock as a dividend at a time when it had a market value of $70, the adjusted base would be $90 as against fair market value of $70, and the dividend-paid credit accordingly would be limited to $70.

Dividends in stock of corporation:

In the case of a stock dividend or a stock right which is a taxable dividend in the hands of shareholders because such stock dividend or stock right is in shares or in rights to subscribe to shares materially different from those held, the dividend-paid credit with respect thereto is the fair market value of the stock dividend or stock right at the time of payment. Furthermore, whenever a distribution by a corporation is, at the election of any of the shareholders, payable either in a non-taxable form (such as a true stock dividend) or in a taxable form (such as money), then the distribution constitutes a taxable dividend to all shareholders, regardless of the medium in which paid, and a dividend-paid credit for the purpose of the corporation surtax on undistributed profits.

Source of distributions:

One more phase of dividends requires to be considered. Distributions by a corporation are regarded as having been made (for tax purposes) out of the most recently accumulated earnings to the extent available—first, earnings of the taxable year; second, other earnings accumulated after February 28, 1913; third, earnings accumulated prior to March 1, 1913; and, fourth, from sources other than earnings only after earnings have been exhausted. The question which remains unanswered is whether these accumulated earnings are statutory earnings representing the sum of taxable net income and non-taxable income, less allowable deductions and unallowable deductions and, finally, less distributions, or whether earnings are those determined on the basis of accounting regularly employed by the taxpayer. This is a serious matter in the determination of the dividend-paid credit in certain cases. It may be found that distributions, purporting to have been made out of book earnings accumulated after February 28, 1913, have been made out of accumulations prior to March 1, 1913 (from the viewpoint of the treasury department), or vice versa, thereby seriously affecting the calculation of surtax on undistributed profits.

Obstacles to the payment of dividends:

The application of the dividends-paid credit is simple, but earnings alone do not determine the ability of a corporation to pay dividends or the advisability of doing so. There may be a deficit accumulated through losses in prior years which the current earnings may not wipe out; or even though there be a surplus, that fact alone would not justify a distribution.

It is a fundamental concept of corporate law that dividends may be paid only out of the excess of net assets over liabilities and capital (in other words, surplus), although some states permit the payment of dividends out of current earnings despite the existence of a net book deficit. Sound financial management, however, ordinarily precludes recourse to such unsound practice.

For many reasons which govern conservative management it may be impolitic, if not indeed dangerous, to pay dividends. Substantial sums may have been frozen in fixed assets or in the acquisition of the stock of subsidiaries. The net quick-asset position may be jeopardized by such dividends, thereby hampering credit otherwise available. Interest rates in respect of such credit may be affected adversely, and unsecured lines may be thrown back into secured loans by credit grantors. Profitable extension of operations of most businesses is immediately retarded by the distribution of surplus.

Beyond the practical operating problems which confront executives every day, there may be contractual obstacles to the payment of dividends which remove any discretion in the matter. The corporate charter may provide (a) that no dividends may be paid unless the net quick assets exceed a given amount after such payment, or (b) that a prescribed current ratio shall not be impaired by the payment of dividends, or (c) that a fixed amount or proportion of net income shall be applied to the retirement of preferred stock or fixed debt. There may be similar provisions in the indentures of preference stocks, bonds or debentures issued under enabling provisions of the charter when the charter itself contains no such restrictions. Similarly, large borrowings may contain such contractual restrictions. These facts were urged at the hearings on the bill before the house and senate committees, but congressional complacence all but ignored the warning. A sop or two has been thrown into the act, which gives scant relief, and the regulations only aggravate the just objection to these provisions which ignore even the most elementary precepts of finance.

No provision whatever is made in the act for the relief of corporations having a net deficit, which legally, therefore, can not pay dividends and conservatively should not do so in any event. The act does not say that dividends must be paid. One may choose to pay the surtax and retain the earnings. The surtax amounts to a maximum of 20½% of adjusted net income in such event.

Possible remedies:

Companies having deficits should forthwith consider ways and means of correcting the situation. Perhaps the capital structure may be adjusted by scaling down the capital stock sufficiently to eliminate such deficits. Legal advisers and accountants should be consulted concerning methods of eliminating this basic obstacle. The cost of doing so probably will be materially less than the surtax which may be avoided by such action, unless there are other practical difficulties blocking distributions.

Relative to the sections dealing with contracts limiting dividends, the regulations say:

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c) of act" (relative to contracts restricting the payment of dividends).

Every business man looks upon a corporate charter as a contract between the corporation and the state, and eminent attorneys have said that this provision of the regulations will not stand court test; but a champion must be awaited to pursue the test. Charter provisions which restrain dividend payments usually have emanated from protective provisions in the indentures of preferred stocks or bonds issued at the inception of certain corporations. The refunding of such issues by the substitution of other securities, from which these provisions may be eliminated, perhaps offers a solution of the problem if coupled with the necessary stockholders' action amending the charter. Obviously, there are other practical considerations affecting such proposals. The refunding may involve a public offering of securities requiring registration with the securities and exchange commission and the filing of listing applications with stock exchanges. Stockholder resistance to this refunding may be evident, due to dissatisfaction as to prior operating results or otherwise. Such conditions must be weighed in planning a program of this kind. Obviously, one may not sit by passively and "take it on the chin." Capable management always has found ways of fighting for survival.

Contracts Limiting Dividends

Relative to contracts, generally, which restrict the payment of dividends, it should be noted that no relief may be obtained in the case of such contracts executed after April 30, 1936, or relating to debts incurred after that date. Furthermore, a specific credit may be obtained only in respect of one such provision. No double credit will be allowed, and when there are more than one of such provisions only the largest of the credits shall be allowed.

Contracts which restrict the payment of dividends fall into two classes under the act:

(1) Those which prohibit to a specified extent the payment of dividends, and

(2) Those which relate to the application of a portion of the earnings for the year to the discharge of a debt incurred on or before April 30, 1936.

In any event the provisions are applicable only in respect of written agreements executed prior to May 1, 1936.

Determination of credit:

The credit allowable as to provisions prohibiting the payment of dividends is an amount equal to the excess of adjusted net income over the aggregate of the amounts which can be distributed without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends. The regulations go on to say that earnings may be distributable without violating the provisions of such a contract if an amount can be distributed within the taxable year in one form (as for example, in stock or bonds of the corporation) without violating the contract, although the payment of such a dividend in cash would violate the contract. This ruling has the net effect of subjecting to surtax earnings which are not legally distributable.

Application of prior surplus:

On the other hand, in the judgment of the treasury department, "sauce for the goose is not sauce for the gander." The regulations which ignore prior deficits, specifically provide that surplus at the beginning of the year shall be considered in calculating the credit provided in respect of contracts restricting dividends. The effect of this ruling is to add to the earnings of the taxable year the amount of surplus at the beginning of the year. From the sum of the two there is then deducted the amount which can not be distributed as dividends, and, if the remainder equal or exceed the adjusted net income, no credit shall be allowed. This is not relief but a mere gesture. The regulations construe harshly the intent of congress relative to the so-called relief provisions, and certainly do not comply with the demand for relief voiced repeatedly in the congressional hearings. On the basis of the calculations provided in the regulations no substantial benefit will be obtained by any corporations in respect of such limitations on the distribution of dividends. The exclusion of prior deficits and the inclusion of prior surplus in these calculations are neither equitable nor consistent.

Definite reference to limitation of dividends:

Further inequity is present in the regulations providing that contracts which simply state that current assets shall not be reduced below a specific amount while bonds are outstanding or merely specify that there shall be set aside periodically a sum to retire bonds do not come within the relief provisions of the act. Such provisions must be coupled with a definite reference to the limitation of dividends.

Disposition of current earnings:

In relation to the second type of contracts (dealing with the disposition of current earnings in the discharge of debt) it is not enough for contracts to require (a) periodic sinking-fund contributions, (b) periodic retirement of a stated amount or proportion of bonds, or (c) sinking-fund payments in proportion to gross income or in proportion to quantity of natural resources consumed in operations. Nor are shareholders creditors. The act, therefore, does not include in the relief provisions obligations to shareholders to retire preferred stock. However, the working of the act relative to the disposition of earnings of the year applicable to the discharge of debt is unmistakably clear, and the specific credit in such case is unqualifiedly the full amount of the portion of such earnings expressly required to be applied to such use.

Liquidation of Controlled Subsidiaries

Recognition of gain:

The elimination of consolidated returns of corporations (excepting railroads) and the congressional inquisition suffered by holding companies have developed temporarily an apparent opportunity to liquidate controlled subsidiary companies without immediate gain or loss. Under the 1934 act, gain or loss was recognized upon liquidation of a controlled subsidiary. The 1935 act provided that no gain or loss would be recognized upon the receipt of property other than money in such liquidation. Under this provision the basis of the property received (provided no cash were involved) would be the amount of the parent's investment in the subsidiary. Under the 1936 act, no gain or loss is recognized in such a case (whether or not cash is received as part of the liquidation) and the basis of the property in the hands of the parent is the same as it was to the subsidiary.

This 1936 provision in many cases should enable a parent to dissolve a subsidiary in order to offset losses of the subsidiary against earnings of the parent, or vice versa, and thereby reduce taxes. It also affords the opportunity to dissolve the profitable subsidiaries of a profitable parent to avoid the partial tax on inter-company dividends. Such steps have been taken by a number of parent companies. It is interesting to observe that the congressional hearings record repeated objections to the dissolution of subsidiaries by representative taxpayers because of the inherent tax difficulties. The treasury department, obviously, was loath to relax the rules governing distributions in liquidation, but the senate finance committee, it appears, considered the complete liquidation of subsidiaries more important than potential taxes relative to such liquidations.

Complete liquidations:

Under the act as it was finally issued, in order to be tax-free, liquidations must be complete, including any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock, in accordance with a bona-fide plan of liquidation, under which the transfer of the property in liquidation is to be completed within a time specified in the plan, not exceeding three years. The crux of such procedure lies in a careful consideration of the form and substance of the agreement under which complete liquidation is contemplated. If the liquidation can be effected in one (lock-stock-and-barrel) transfer of property, and other conditions of the law are met, there can be no question that the liquidation is complete. However, if the exigencies of a situation necessitate partial distributions, the steps must be watched with much greater care. No type of liquidation should be undertaken without consulting counsel. It should be borne in mind that if a distribution be made in partial liquidation in a case, other than one involving a legitimate plan of complete liquidation, the distribution will be recognized as payment in exchange for the stock and the gain or loss recognized on such an exchange will be taken into account in computing net income of the recipient.

Other governing factors:

There are other governing factors that determine whether property received by a corporation in complete liquidation of another involves no immediate gain or loss to the recipient. The corporation receiving the property must have 80% voting control and 80% in number of all shares having voting rights of the liquidating corporation at the time the plan of liquidation is adopted and must continue to have at least that per cent. of control until the liquidation is completed. It may increase its holding but may not decrease it. No distribution pursuant to the plan of liquidation shall have been made prior to December 31, 1935 (or, in the case of a fiscal year, before the first day of its first taxable year starting after that date). Even though the liquidation be completed within one taxable year, there must be a plan of liquidation at least in the form of a directors' resolution authorizing the complete distribution of the assets of the corporation in complete cancellation of its stock. The three-year formal plan has been mentioned previously. If the transfer be not completed within that time or if the taxpayer fail to qualify at any time during the period of liquidation as to the percentage of ownership, no distribution under the plan shall be considered a distribution in complete liquidation.

The concluding single sentence of this section of the act, which comprises one hundred and sixty-three words exclusive of figures, parentheses and punctuation is a masterpiece of double negatives and repetition. It says in part:

"A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made";

In other words: state law concerning the liquidation of corporations has no bearing upon the provisions of the federal law governing taxable gain on liquidations as defined in the revenue act of 1936. It is worthy of repetition that the liquidation of subsidiaries should be approached with caution and under competent legal guidance.

Distribution in liquidation, as dividend-paid credit:

When distributions in liquidation constitute payment in exchange for stock and thereby involve taxable gain or loss to the recipient, the corporation making the distribution is entitled to a dividend-paid credit (relative to the corporate surtax) to the extent that such distribution is properly chargeable against earnings by the liquidating corporation, even though the method of taxing the distribution in the hands of the recipient be that relating to gain or loss on an exchange rather than that applied to a taxable dividend. On the other hand, in tax-free liquidations, the accumulated earnings of the liquidating company for purposes of the act are looked upon as intact transfers to the corporation receiving the property, in whose hands such earnings, being available for distribution to its stockholders, have essentially the same status for purposes of the act as earnings derived from its own operations. The regulations provide that no dividend-paid credit is allowable to the distributing corporation relative to such transactions. However, one may infer from the language of the regulations that the treasury department may hold that to the extent such transferred earnings represent current earnings of the subsidiary within the taxable year they must be included by the parent in determining its undistributed income, just as if the parent had been operating the subsidiary as a department instead of as a separate legal entity; and to the extent that such transferred earnings represent accumulations by the subsidiary at the beginning of the taxable year, so, too, the parent must consider them in all calculations which involve its own surplus at the beginning of the taxable year.

Taxes on Improper Accumulation of Surplus

In addition to the taxes previously discussed, the 1936 act continues to impose a tax on corporations improperly accumulating surplus, which applies to every corporation other than personal holding companies. This tax is levied for each taxable year upon the net income of corporations, however created or organized, if such a corporation be formed or utilized for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, by permitting earnings or profits to accumulate instead of to be distributed.

Prima-facie evidence:

The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, is prima-facie evidence of a purpose to avoid surtax upon shareholders.

Tax rates:

In the case of banks, trust companies and insurance companies, not subject to the surtax on undistributed profits, the surtax rate is 25% of the amount of the retained net income which is not in excess of $100,000 and 35% of the amount of the retained net income which is in excess of $100,000. In the case of corporations subject to the surtax on undistributed profits the surtax rates are 10% lower.

Definition:

Personal holding companies are subject to a surtax upon the undistributed adjusted net income at graduated rates ranging from 8% to 48%.

The term "personal holding company" means any corporation (other than a corporation exempt from taxation, and other than a bank or trust company, or a life-insurance company or surety company) if, (a) at least 80% of the gross income for the taxable year be derived from royalties, dividends, interest, annuities and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities and, (b) at any time during the last half of the taxable year more than 50% in value of its outstanding stock be owned, directly or indirectly, by or for not exceeding five individual shareholders. In computing the number of persons who hold the majority of the outstanding stock, all members of a family in the direct line as well as the spouse and brothers and sisters are counted as one.

Reasonable needs of business:

It should be observed that neither the surtax on improper accumulation nor the surtax on personal holding companies is imposed on prior surplus but is imposed on current year's earnings retained in order to prevent the imposition of surtax upon shareholders. In the case of personal holding companies there is a definite formula for determining the income subject to the surtax. In the case of corporations other than personal holding companies there is no prescribed formula for determining when earnings are retained beyond the reasonable needs of the business and therefore subject to surtax on improper accumulations. What constitutes the "reasonable needs of a business" is a question which may be answered only by considering all the facts of a particular case. No hard and fast rules can be laid down, but the following questions are pertinent:

1. How much surplus existed at the beginning and the end of the year and how was such surplus reflected in assets and liabilities?
2. What portion of net income has been distributed in the form of dividends?
3. What are the working capital requirements of the corporation at the peak of its business?
4. What obligations has the corporation maturing in the future?
5. What are the facts concerning the ownership of the corporation's stock?

When an analysis of these factors indicates the probable, or possible, application of this section of the law by the treasury department, it is advisable to take remedial action. The capitalization of earnings by the declaration of stock dividends has sometimes been considered a useful device for avoiding the imposition of this surtax, but it must be strongly emphasized that this is completely futile. The distribution of a taxable dividend is the only safe means of avoiding the imposition of the tax when the circumstances of the case indicate a precarious position.

On the basis of the adjudicated cases involving the surtax on improper accumulations, a business corporation which makes reasonable distributions of its current earnings probably need not fear the application of this section of the law merely because a prudent management may consider it necessary to retain a portion of the earnings either for expansion or as a safeguard against future emergencies.

Partial retention of surplus permitted:

In the section of the law relating to surtax on personal holding companies provision is made for the withholding by a corporation each year of (a) 20% of the excess of its adjusted net income over the amount of dividends received from other personal holding companies and (b) amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts be reasonable with reference to the size and terms of the indebtedness.

Importance of these provisions:

It is not generally understood that there may be large corporations which come within the definition of a personal holding company. Such corporations can not avoid the surtax by making "reasonable distributions" but must distribute 80% of their adjusted net income in order to escape the surtax (provided they are not using or setting aside sums to take care of the indebtedness incurred prior to January 1, 1934).

The surtaxes on personal holding companies and on corporations improperly accumulating surplus are not new, but commonly their importance is overlooked until they are invoked against a taxpayer. As a precaution, the provisions of the law should be considered carefully by every corporation to be sure that the taxpayer may not be subject to them.

Aliens and Foreign Corporations

Non-resident aliens:

Section 211 provides that in lieu of the normal and surtaxes payable by a citizen or resident alien, every non-resident alien person not engaged in trade or business within the United States and not having an office or place of business therein is taxable at the rate of 10% upon his gross income from sources within the United States consisting of interest, dividends, rent, salaries, wages, premiums, annuities, compensation or other fixed or determinable annual or periodical gains, profits and income, including royalties, except that the rate of 10% shall be reduced in the case of a resident of Canada or Mexico, to such rate (not less than 5%), as may be provided by treaty with those countries. As yet the United States has not entered into any such treaty. The items of income enumerated and any other fixed or determinable annual or periodical income are the only items of income from sources within the United States upon which such a non-resident alien is liable to tax. His taxable income does not include profits derived from transactions in the United States in stocks, securities or commodities through a resident broker, commission agent or custodian or profits derived from the sale within the United States of other property, whether real or personal. No deductions or credits are allowed. The tax is imposed upon the amount of gross income received. A non-resident alien engaged in trade or business in the United States or having an office or place of business therein is taxable upon his net income from sources within the United States at the regular normal and surtax rates.

Foreign corporations:

Section 231 divides foreign corporations into two classes:

(1) Foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, and

(2) Foreign corporations engaged in trade or business within the United States or having an office or place of business therein.

Foreign corporations coming within the first class are designated as non-resident corporations, while foreign corporations coming within the second class are designated as resident corporations.

A foreign corporation, whether non-resident or resident, is not subject to the surtax imposed by section 14 on undistributed profits.

Every non-resident foreign corporation is taxable at the rate of 15% upon its gross income from sources within the United States consisting of interest, rents, salaries, wages, premiums, annuities and other fixed or determinable annual or periodical income, including royalties, but not including dividends. Dividends which are treated as income from sources within the United States are taxed at the rate of 10%, except that in the case of non-resident foreign corporations organized under the laws of Canada or Mexico, such rate of 10% with respect to dividends may be reduced to such rate (not less than 5%) as may be provided by treaty with those countries. As yet, the United States has not entered into any such treaty.

The taxable income of a non-resident foreign corporation does not include any profit derived from effecting transactions in the United States in stocks, securities or commodities through a resident broker, commission agent or custodian, or the profits derived from the sale within the United States of other property, either real or personal. A non-resident foreign corporation is not allowed any deductions. The tax is imposed upon the amount of gross income received.

A resident foreign corporation is not taxable at the rate of 15% or 10% upon the items of income enumerated above; but its net income from sources within the United States (gross income from sources within the United States less statutory deductions) less the credits against net income allowable to corporations, is subject to the normal tax of 22%.

A foreign corporation which effects transactions in the United States in stocks, securities or commodities through a resident broker, commission agent or custodian is not merely by reason of such transactions considered as being engaged in trade or business within the United States which would cause it to be classed as a resident foreign corporation.

Withholding in case of non-resident aliens:

Withholding in the case of non-resident aliens is at the rate of 10%, except in case of a resident of Canada or Mexico, when the rate may be reduced by treaty, but not to less than 5%.

Resident or domestic fiduciaries are required to deduct the income tax at the source from all fixed or determinable annual or periodical gains, profits and income paid to non-resident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Income paid to a non-resident fiduciary which is otherwise subject to the withholding provisions of the act is not exempt from withholding by reason of the fact that the beneficiaries of the income are citizens or residents of the United States.

Withholding in the case of non-resident foreign corporations:

A tax of 15% is required to be withheld in the case of fixed or determinable annual or periodical income paid to a non-resident foreign corporation except, (1) income from sources without the United States, (2) interest on bonds or other obligations of a corporation containing a tax-free covenant and issued before January 1, 1934, where the liability assumed by the obligor exceeds 2% of the interest and (3) dividends.

A tax of 10% is required to be withheld from income from sources within the United States paid to a non-resident foreign corporation which consists of dividends, except that such rate of 10% shall be reduced, in the case of Canadian and Mexican corporations to such rate (not less than 5%) as may be provided by treaty with Canada and Mexico.

Withholding of a tax at the rate of 2% is required in the case of interest payments made to a non-resident alien or foreign corporation, representing income from sources within the United States, paid upon corporate bonds or other obligations containing a tax-free covenant, issued before January 1, 1934, where the liability assumed by the obligor exceeds 2% of the interest.

Important change in basis of taxing foreign corporations:

Under prior revenue acts, foreign corporations, whether resident or non-resident, were taxed at the same rates as domestic corporations, but only on net income from sources within the United States, including gains from transactions effected in the United States in stocks, securities, commodities, etc. In determining the net income subject to tax, deductions were allowed for expenses applicable to income arising within the United States and for a ratable portion of expenses which could not be allocated to any item or class of income. Foreign corporations were also allowed the credits against net income allowed to domestic corporations, but the allowance of deductions and credits was dependent upon the filing of a return.

These provisions remain applicable to resident foreign corporations under the new law, but, as indicated above, non-resident foreign corporations are now taxed at special rates, upon gross income from sources within the United States, excluding gains from transactions in securities, etc. without any deductions or credits.

Miscellaneous Provisions

Capital gains on distributions in complete liquidation subject to recognition percentages to individual taxpayers:

Under the 1934 act, all gains to persons from liquidation distributions (which included redemption of preferred stock) were recognized, while similar losses were subject to the recognition percentages. The new act provides that the percentages apply to gains from distributions in complete liquidation, which is defined to include any one of a series of distributions in complete cancellation of all of a corporation's stock within the time specified by the liquidation plan, which must not exceed two years from the close of the taxable year in which the first of the distributions under the plan is made. Gains from partial liquidations or liquidations which do not conform to the above definition of a complete liquidation are still recognized. Thus, if a corporation retires preferred stock at a profit to the shareholder, and the corporation does not liquidate in the manner discussed above, the entire gain on redemption will be recognized. If a loss were to result on retirement of such stock, such loss would, as formerly, be subject to the recognition percentages. In cases where there is only a partial liquidation or partial retirement of stock, the shareholder, if he expects to realize a gain on retirement, should sell the share before the retirement date in order that the profit might be subject to the recognition percentages.

Common trust funds:

Section 169 creates what is known as a common trust fund. This is defined as a fund maintained by a bank exclusively for collective investment and reinvestment of money contributed thereto in its capacity as a fiduciary in conformity with the rules and regulations of the board of governors of the federal reserve system, appertaining to the collective investment of trust funds by a national bank.

The purpose of this section is to avoid the possibility that such funds might be taxed as associations.

Returns must be filed by every bank maintaining a common trust fund. The return must show income, deductions and the proportionate share of each participant, in much the same manner as a partnership.

Mutual investment companies:

The act recognizes a new type of business company for income-tax purposes known as a "mutual investment company." A mutual investment company is especially defined in the act and if a corporation comes within such definition it may deduct its dividends paid as a credit against net income for the purpose of the normal tax. However, it does not get the benefit of the two-year dividend carry-over nor the benefit of the 85% credit for dividends received which is allowed other corporations for normal tax purposes.

Capital stock and excess-profits tax:

The revenue act of 1936 does not impose any capital-stock tax itself, but merely amends section 105 of the 1935 act to reduce the rate from $1.40 to $1.00 per $1,000 of declared value and to make references, where required, to the income-tax provisions of the 1936 act. As the 1935 act capital-stock tax provisions were first applicable for the year ended June 30, 1936, they were never effective prior to amendment by the 1936 act. Accordingly, no tax has been or will be payable at the rate of $1.40 per $1,000 of declared value.

Similarly, the excess-profits tax now in force is the one imposed by the 1935 act, as amended by the 1936 act. The only amendments made by the latter act are (1) to remove the allowance of federal income tax as a deduction in computing net income subject to excess-profits tax, (2) to allow the deduction of the "dividends received" credit of 85% and (3) to state that the excess-profits tax itself is not to be deducted in computing income subject to excess-profits tax. These amendments are applicable only to taxable years commencing after December 31, 1935. Accordingly, corporations with taxable years ending after June 30, 1936, but before December 31, 1936, will be permitted to deduct the income tax payable for such year in computing their excess-profits tax net income. Amendments (2) and (3) were necessary because the 1936 act changed the computation of net income by making 85% of domestic dividends received a credit against net income instead of a deduction in the computation thereof and by allowing the excess-profits tax as a deduction in computing net income. The rates of excess-profits tax prescribed by the 1935 act, applicable to all taxable years ending after June 30, 1936, are as follows:

6% of that portion of the excess-profits tax net income which is in excess of 10% but not in excess of 15% of the declared value of the capital stock.

12% of that portion of the excess-profits tax net income which is in excess of 15% of the declared value of the capital stock.

Conclusion

Revision of law:

It has been predicted that the tax on undistributed earnings will be repealed before returns for 1936 become due, and that other drastic revisions of the law will be undertaken. Much of this rumor is based probably on campaign promises and on hopes rather than probabilities. Time will be too short to draft and enact a satisfactory substitute before March 15, 1937. What may happen in the following year depends upon the new administration's need or desire for revenue.

Fixed principles needed:

The year-to-year revision of tax laws is an abomination bred of political expediency. We need fixed principles of taxation which will enable the taxpayer to face the future with greater confidence based on known factors, instead of being asked to sit in a poker game without knowing the stakes (particularly when the house takes a heavy toll on every pot).

It should not be assumed that the old system of taxing income was perfect. Questions of capital gains, consolidated returns, a broadened incidence of the individual normal tax and other principles require thoughtful attention. Perhaps some form of tax on undistributed income is desirable in the form of the "draw-back" previously discussed.

Permanent principles should be established soundly by the appointment of a non-partisan commission of experts (to be discharged when the job is done), to conduct an extended research, and to produce a system of federal income taxation, fixed in principles, but flexible in rates to meet the requirements of budget balancing.

Business can adjust itself to changing rates of taxation, but common sense deplores a continuous shifting of basis, form and incidence of taxation, which must be construed anew from year to year.