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THE PROBLEM OF  
ACCUMULATION OF SURPLUS BY  
CORPORATIONS

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ACCUMULATION OF SURPLUS BY  
CORPORATIONS

by

Lloyd A. Tatum

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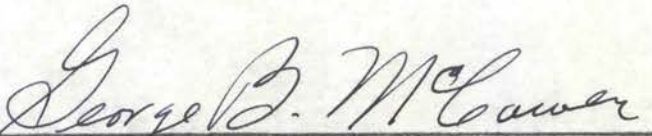
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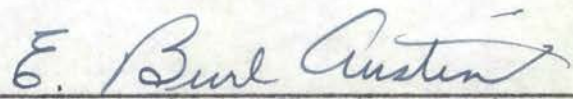
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APPROVED BY:

  
Chairman, Thesis Committee

  
Member of the Thesis Committee

  
Head of the Department

  
Dean of the Graduate School

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## PREFACE

This study deals with the problem of accumulation of surplus. Several writers have discussed the problem in some of its various parts. A summarizing of the problem and a survey of the effects of the tax laws regulating the accumulation of surplus seems desirable. This thesis is an attempt to satisfy the need of such a study. The study is limited to corporations incorporated in the United States of America. Special study is given to those types of corporations most likely to accumulate more surplus than necessary for business purposes and thus most in need of correction through the taxing power of the Federal Government. Such companies are the personal holding companies. They are subjected to special treatment by the Revenue Law, and will be given special emphasis in this study.

There are two questions involved in this problem, namely: the economic and the income tax aspects. Both sides of the problem are studied in this paper. The taxation of surplus accumulation started in this country in 1917 when Congress enacted a Revenue Law one section of which was entitled, "Improper Accumulation of Surplus". Amendments in 1924, 1928, 1934, 1938, 1940 and 1942, made this section more comprehensive. This special tax was assessed on the theory that stockholders were escaping high taxes because corporation rates were lower than individual income tax rates (especially high-bracket personal rates), and also because if dividends were declared

they would be taxed again as income of the stockholders. These provisions applied to most of the corporations subjected to the corporative income tax. In 1938, Congress removed personal holding companies from the sections pertaining to the improper accumulation of surplus and placed them in separate sections. A personal holding company was recognized as a special class over which the government needed more rigid controls. Personal holding company tax rates upon retained earnings are more than twice as high as on other corporations.

The undistributed profits tax, enacted in 1936, was an attempt by Congress to correct the loss of taxes and also the economic evils created by the accumulation of surplus by corporations. In 1938, Congress repealed the undistributed profits tax as undesirable and unworkable. Congress, having been unable to tax every corporation's surplus, has had to use only the milder form of taxation, namely, the unwarranted accumulation of surplus tax. It seems certain that more attempts will be made to regulate the accumulation of surplus in the future, both for economic reasons and to bolster our federal income. The undistributed profits tax is not in effect today, but it will be studied because it is the type of tax desired by those who believe that surplus should not be accumulated by corporations.

The problem of accumulation of surplus is defined and explained in Chapter One. It also presents the objectives and needs for the regulation of the accumulation of surplus, from both the economic viewpoint and the income tax viewpoint. The

second chapter presents the Internal Revenue Laws and Regulations, and also the decisions of the Courts concerning the accumulation of surplus by corporations. Major emphasis is placed upon laws that are in force in 1948. The third chapter presents the effects of regulating the unwarranted accumulation of surplus, and points out probable future developments. Possible methods of attacking the surplus accumulation are contained in the final chapter.

## CHAPTER I

### THE PROBLEM OF ACCUMULATION OF SURPLUS

The phrase "The problem of accumulation of surplus" is used to mean the problems created by corporations not paying their profits out as dividends. There are two sides of the problem, namely: economic and income tax. Various economic arguments exist against the accumulation of surplus by corporations. They will be studied in some detail. From a tax viewpoint, the problem is largely one of equality in taxation and plugging the places where taxes are escaped. This is the chief theme of the study. Congress has been able to tax corporations which retain unwarranted amounts of surplus. Unwarranted accumulation of surplus means an accumulation of profits in excess of actual business needs.

But before going on with the study some terms used in this discussion need to be explained and defined. Among these terms are: surplus, profits, and dividends.

Accountants have disagreed on the definition of surplus. Every accountant will admit that surplus, as he uses it, represents an excess of net worth over some other quantity, but the difficulty is in determining with what other quantity the comparison is made. The main diversion of opinion is whether the excess is the amount above the stated capital or the excess over the amount originally contributed by the stockholders.<sup>1</sup> A more

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<sup>1</sup> Henry Rand Hatfield, *Surplus and Dividends* (Harvard: Harvard University Press, 1943), 119 p.



limited definition is made by those who say that surplus, when used without modifying adjective, should be limited to that portion of total proprietorship which is a result of the major business activities.<sup>2</sup> As used in this study surplus is the accumulated profits from whatever source.

Also there is considerable lack of agreement as to the meaning of the word profits. The word "profit" is variously used and misused, being applied to such an interim figure as the difference between the net sales and cost of sales, or to the figure representing net results from operation only.<sup>3</sup> The American Institute's committee on the definition of earned surplus defined net profit substantially as follows: Net profits, net income, and gains include profits from the disposition of any corporate asset (other than the corporation's own capital stock,) and that which arises from transactions resulting in the acquisition of cash or of property which at the time of its receipt may ordinarily be classified as, or converted into, a current asset; or from transactions in which the considerations received includes the complete or partial discharge of a liability.<sup>4</sup>

Dividend is defined as any payment to the stockholders. There are several kinds of dividends such as: cash dividend, stock dividend, and liquidating dividend. Cash dividend is used

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<sup>2</sup> C. R. Rorem, Accounting Method (Chicago: University of Chicago Press, 1928), 382 p.

<sup>3</sup> Stephen Gilman, Accounting Concepts of Profits, (New York: The Ronald Press Company, 1939), 605 p.

<sup>4</sup> Accounting Terminology, (New York: American Institute Publishing Company, Inc., 1931), 119 p.

mean cash paid to shareholders arising from operations over and above operating costs. Stock dividend is a dividend paid in stock, which is largely just a bookkeeping entry transferring earned surplus to the capital stock account. A liquidating dividend is a payment to shareholders of part or all of their equity not arising from business operations. These meanings will be used in this study.

Also, as an introduction to the study the different types of income taxes upon corporations from 1936 to 1948 need to be explained. The general corporate income tax is based upon profits made by the business. This tax is paid by every corporation with net profits for the year, with the tax rate graduated according to the amount of net profits earned. The amount of the retained earnings have no bearing upon the corporations income tax as far as this tax is concerned. When earnings are distributed, the ones receiving cash or equivalent as a dividend will be subjected to the payment of personal income tax. Another form of income tax imposed upon corporations was the undistributed profits tax. Under this tax, the amount of tax levied against the corporation depended upon the amount of earnings distributed in the form of dividend. The more income distributed, the less would be the undistributed profits tax of the corporation. A corporation distributing all of its net earnings would be free from the undistributed profits tax. Any corporation which retained part or all of its earnings would be subject to tax on that part of the earnings retained. The tax was graduated in its rates according to the amount of net earnings retained by the business. Another form of income tax, which came later, is a tax imposed

upon the improper accumulation of surplus, sometimes known as the tax upon the unwarranted accumulation of surplus. This tax took the form of a penalty. It is levied about two years after the filing of the income tax return, upon corporations which accumulated surplus unwarrantedly. The word unwarrantedly means the accumulation of surplus beyond the amount necessary for ordinary business needs. When levying this tax the Treasury has the advantage of hindsight of some three years. The tax rates for this purpose are graduated according to the amount of earnings retained by the corporation that cannot be justified for business purposes. Unincorporated businesses are not subjected to income tax upon their earnings. The owners pay income tax on their share as it is earned, whether distributed or not. A corporate surplus tax should put the owners of both types of business enterprises on a similar tax basis.

The general problem of surplus accumulation has received much attention in recent years. Prior to recent years, in the eighteenth and the first half of the nineteenth century, free competition prevailed, keeping business surpluses small. But the growth of large-scale production and technological improvements of the last part of the nineteenth and 20th centuries has provided opportunities for great production and large surpluses. In the United States, corporations are used primarily for the concentration of economic activity, that is, for large scale production. Some reasons for their formation are outlined below. Corporation stockholders enjoyed limited liability which made it much easier to raise needed capital. The larger the business the greater seemed to be their chances of survival. Sole

proprietorships or partnerships could not grow in strength nearly as fast as corporations. They were in many cases forced to join some corporation or form new ones. According to Professor Tugwell, as stated in his book, The Battle for Democracy, corporations could build up large surpluses and ride through depressions. With large surpluses, corporations were partially able to shift the burden of the depression on small companies and sole proprietorships. With the burden of depression mostly upon small business, many were eliminated. The problem of the concentration of wealth and corporative surplus is becoming very apparent.

There are two sides of the surplus accumulation problem, namely: the economic aspect, and the income tax angle. The main argument against the regulation of surplus accumulation is that the regulation will interfere with management policies and prerogatives, and in general, limit free enterprise. Business management has claimed they have been deprived of the power to declare dividends as they please. But any revenue act tends to deprive someone of some of their economic power. Regulation of accumulation of surplus can be justified under the constitutional taxing power of the federal government.

The income tax angle will be presented first. It will be discussed under three headings. 1. That there is enough variation between taxes paid by corporations and owners and taxes paid by owners of partnerships and individuals to justify taxing the surplus accumulated by corporations. 2. That a surplus tax removes these inequities somewhat. 3. That a surplus tax will

prevent the avoidance of double taxation and especially the sur-tax on income through the accumulation of income by corporations.

Under the Revenue Laws of 1935, there was need for taxation on surplus retained by corporations. Shareholders in corporations had a distinct advantage over the owners of sole proprietorships or partnerships. The following examples will show how this was true.

Suppose that in the fiscal year of 1935 Jim Brigham's corporation made a net operating income of \$100,000. And that in the fiscal year 1936 it had a net operating loss of \$100,000. Jim Brigham's Corporation's income tax would have been computed as follows:<sup>5</sup>

In 1935.

Corporation's net income	\$100,000
Rate of the tax	14%
Tax for 1935	<u>14,000</u>

In 1936 the corporation wouldn't pay any income tax.

Net income 1935	100,000
Income tax 1935	<u>14,000</u>
Retained earnings	86,000
Net loss 1936	<u>100,000</u>
Net loss for 1935-1936	<u>14,000</u>

Suppose that in the Fiscal year of 1935, Jim Brigham, a sole proprietor, made a net operating income of \$100,000. And suppose

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<sup>5</sup> Rates and method of computation are from the United States Statutes at Large, 74th Congress, 1935-6, Volume 49, part 1.

that in the fiscal year of 1936, Brigham had a net operating loss of \$100,000. His income tax would have been computed as follows.<sup>6</sup>

In 1935.

Net income subject to surtax	\$100,000
Exemption for taxpayer	<u>1,000</u>
Surtax net income	99,000
Surtax	<u>29,450</u>
Net income subject to normal tax	100,000
Exemption for taxpayer	<u>1,000</u>
	99,000
Normal tax 4%	<u>3,960</u>
Total tax liability	<u>33,410</u>

There is no tax liability for the 1936 net operating loss.

Net income 1935	100,000
Income tax 1935	<u>33,410</u>
Amount retained in 1935	66,570
Net loss 1936	<u>100,000</u>
Total loss 1935-1936	<u>33,410</u>

The Brigham corporation with the same income and loss for 1935-1936 had to pay \$19,410 less than would Brigham as a sole proprietorship.

Under the Revenue Laws of 1948, assuming no tax upon the accumulation of surplus, there was still need for a tax upon the accumulation of surplus, there was still need for a tax on surplus retained by the corporations. A Corporation, in several cases, has a distinct advantage over a sole proprietorship or partnership, unless there is a tax upon corporation retained surplus. The following example will show how this is true. In the

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<sup>6</sup> Ibid., Volume 49, part 1.

fiscal year of 1947, The Dan McCroskey Corporation made a net operating income of \$100,000, and in the fiscal year 1948 had net operating loss of \$100,000. The net operating figure in the example is the same as the normal tax net income. The exemptions, used in the example, are typical for the types of business being analyzed. The corporation would be entitled to credit for net operating loss carry back. This would reduce the corporation income tax. The Dan McCroskey Corporation income tax would be computed as follows:<sup>7</sup>

In 1947

Normal tax net income	\$100,000
Normal tax rate of 24%	24,000
Surtax net income is 14% of 100,000	14,000
Total tax for 1947	<u>\$ 38,000</u>

In 1948, the corporation would not pay any income tax.

Net income 1947	\$100,000
Income tax 1947	38,000
Amount left as surplus in 1947	<u>\$ 62,000</u>
Net loss in 1948	<u>100,000</u>
Total loss 1947--1948	<u>\$ 38,000</u>

In the fiscal year of 1947, Dan McCroskey, a sole proprietor, made net operating income of \$100,000. In the fiscal year of 1948, McCroskey had net operating loss of \$100,000. Dan McCroskey income tax would be computed as follows:<sup>8</sup>

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<sup>7</sup> Rates and method of computation are from the United States Statutes at Large, 80th Congress, 1947

<sup>8</sup> Ibid.

1947

Net income subject to tax	\$100,000
Less: exemption for taxpayer	500
Surtax net income	\$ 99,500
Less Optional standard deduction	500
Surtax net income	\$ 99,000
Tentative surtax	\$ 63,800
Less 5% reduction (5% of 63,800)	3,194.50
Surtax	\$ 60,605.50
Net income	\$100,000
Less: exemption for taxpayer	500
Adjusted net income	\$ 99,500
Less Optional standard deduction	500
Amount subject to normal tax	\$ 99,000
Tentative normal tax is 3% of 99,000	2,985
Less: 5% reduction (5% of 2,985)	149.25
Normal tax	\$ 2,835.75
Total tax liability	\$ 63,441.25

In 1948, there is no tax on his net operating loss.

Net income 1947	\$100,000
Income tax 1947	63,441.25
Amount retained in 1947	\$ 36,558.75
Net loss 1948	\$100,000
Total loss for 1947 and 1948	\$ 63,441.25

The McCroskey Corporation, which had the same income and loss, had to pay \$25,441.25 less than McCroskey as a sole proprietor or partnership. The larger the amount of income that a sole proprietor makes the more income tax, in proportion, he will have to pay than a corporation with the same income, assuming no other tax. The reason for the difference in taxes in the above example is as follows: the corporation normal tax is 24 per cent for all over \$50,000 and surtax is 14 per cent for all over \$50,000, while the personal income tax is graduated until all over \$200,000 is taxed at the rate of 88 per cent. Injustice is worked on the sole proprietorship and partnership, in comparison with a corporation, whether the surplus accumulated is unwarranted or not.



surplus were paid to shareholders, the shareholders would pay income tax on the dividends received. This tax would equalize somewhat the different types of taxpayers.

Guy Helvering, United States Commissioner of Internal Revenue in 1936, made the point that a surplus accumulation tax would place all business on an equality so far as taxation was concerned. Discrimination in favor of incorporated as contrasted with unincorporated business in the prior laws is to be found in the fact that an individual who reinvests in his business the large profits of one year, and subsequently experiences losses, is nevertheless subject in full to the income tax on the profits of the good year, whereas the stockholders of a corporation would not be subjected to the income tax. The way a corporation escapes income tax when profits are plowed back into the business is that the stockholder pays income tax only when income is paid out in the form of dividends. The object of the regulation of the accumulation of surplus is not to tell corporate management what proportion of earnings they shall distribute and what proportion they shall retain. The object is to see that the Federal Government shall not be unreasonable and inequitable deprived of necessary revenues. Likewise, it is not the policy of the Administration to dictate whether business shall be carried on as individual enterprises or partnerships on the one hand, or as corporation on the other hand.<sup>9</sup>

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<sup>9</sup> Guy T. Helvering, "Should the Administration New Tax Proposal Be Adopted," Congressional Digest, (U.S. Government Publication) 15:146, 1936.

Some say that a tax upon the accumulation of surplus will permit a nearer approach to establishing taxation on the basis of ability to pay, and that if the Federal Government needs more revenue, surplus of the corporation would be a good source of tax revenue. Mr. Robert Doughton, Chairman, House Ways and Means Committee, testified before Congress that a surplus tax would be in accordance with the ability to pay principle rests with the individual, and not with the corporation. When we tax the corporation itself we are really taxing an artificial entity representing an aggregate of individuals in almost every degree of economic condition and owning all the way from a few shares of stock to blocks representing hundreds of thousand of shares. Obviously, then, no tax (with the exception, perhaps, of a withholding tax which would be administratively very difficult) could be devised which, when collected from the corporation, would equalize the tax burden with the ability of the individual shareholder to pay. This being true, we can never have equitable taxation of business income so long as we ignore the real ownership of the corporate income and continue to tax the corporation as an entity very much as if it were an individual. Ability to pay rests with the individual and the individual should be the bases, so far as possible, on which income taxation is applied.<sup>10</sup>

A tax on the accumulation of surplus will prevent the avoidance of double taxation, and this is especially true of the surtax on income through the accumulation of surplus by corporations.

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<sup>10</sup> Ibid, p. 150

If the stockholders are subjected to taxation of corporate earnings only if they are distributed. If corporations profits are not distributed the treasury will not receive revenue from the real owners of the business in proportion with ability to pay. If the corporation earnings are retained by the corporation, the stockholders would have to pay tax only on the net profit over the life of the business. A sole proprietor would have to pay income tax on his net profits each year. He cannot put long time losses against the gains as can the corporation in the long run. In President Roosevelt's message to Congress on January 3, 1936, he explained the evasion of income created by the accumulation of surplus by corporations. The President stated:

This method of evading existing surtaxes constitutes a problem as old as the income tax law itself. Repeated attempts by Congress to prevent this form of evasion has not met with any degree of success. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the Federal revenue. Thus the Treasury estimates that, during the calendar year, 1936, over \$4,500,000,000 of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of the stockholders and taxed as other personal income. As the matter now stands, it will be withheld from stockholders by those in control of these corporations. In one year alone, the Government will be deprived of revenue amounting to over \$1,300,000,000.<sup>11</sup>

The other side of the surplus accumulation problem is the economic aspect. The economic aspect of the problem can best be understood by tracing its causes and to show why some or most of

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<sup>11</sup> F. D. Roosevelt, "President Roosevelt Presents His New Tax Proposal to Congress," Congressional Digest, 15:14, May, 1936.

the accumulated surplus should be eliminated. Large-scale production has caused partial monopoly to replace competition. Under partial monopoly, there is a strong tendency for large business to charge the public what the traffic will bear. This practice has provided big businesses with large accumulative surpluses. Big businesses, if and when depression comes, will be able to curtail production and withstand the depression, and perhaps be even make a substantial profit. Small scale competitive enterprises, especially in agriculture, are unable to overcome the tendency of individuals to maintain production, with the result that the prices for competitively-produced products decline. The result, then, is dis-equilibrium between the flexible and inflexible industries. Flexible industries are those whose production changes with the change in price of the product. As the depression is prolonged, the more the flexible industries will suffer. What is really needed, then, is to make inflexible prices more flexible to business fluctuation. By eliminating the enormous surpluses accumulated by inflexible industries, they could not curtail production without going bankrupt. Since these inflexible industries cannot withstand depression without large surpluses, they are forced to expand production at the same time flexible industries are expanding. Equilibrium is then restored to the economy.<sup>12</sup>

The economic aspect of the accumulation of surplus will be further discussed under three headings. 1. That a surplus tax

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<sup>12</sup> Allen G. Gruch, Modern Economic Thought (New York: Prentice Hall, Inc., 1947), Chapter 7.

is needed to restrict saving so as to stabilize spending.

2. That a surplus tax prevents somewhat the concentration of wealth. 3. That a surplus tax is a check against over-saving and helps to eliminate wide fluctuation in the business cycle.

A surplus tax is needed to restrict saving so as to stabilize spending. Professor John Maurice Clark believes that there is some support for the argument that the growth of profits during prosperity, and its retention by corporations, indicates an absorption of purchasing power of which more than the general average might be saved or invested instead of being spent for goods. It may be argued that income disbursements should be stabilized in order to stabilize spending. The actual behavior of interest payments and dividends represents such a stabilization. Professor Clark further comments that stabilization benefits the upper-income classes primarily, who least need this stabilization, it also increases the instability of investment expenditures. The management of financial reserves thus aggravates, rather than mitigates, some phases of industrial disorder. The problem of controlling business cycles by modifying the distribution of spending power is complex and difficult. Professor Clark thus concludes his discussion by stating:

One may conclude that while changes in distribution and corresponding changes in the proportion of income actually play an important part in business cycles, attempts to control the cycles through altering the distribution of spending power are not easy or simple and may have effects tending to defeat the end in view. Tax based upon retained earnings will help to control the business cycle, but more is needed.<sup>13</sup>

A surplus tax prevents somewhat the concentration of wealth. This is one justification of a tax upon the accumulation of surplus by corporations. By plowing their profits back in the business in large amounts wealth is concentrated in the large corporations. A good example of business plowing profits back into the business is the Henry Ford Company. It started with very little capital. By plowing the profits back into the business, the company has increased its size enormously. This tends toward a more concentrated economy and away from free competitive economy. By taxing the accumulation of surplus, competition is fostered. The main reason for this is, the tax would cause more dividends to be paid and the ones receiving the dividends, having a varied interest, would spend the money for various types of goods. He would purchase many consumer goods as well as producers goods, thereby, lessening the concentration of wealth in our economy.

A surplus tax is a check on over-saving and eliminates wide fluctuation in the business cycle. The Editors of the New Republic have expressed the belief that the main purpose of the surplus tax was to eliminate wide fluctuation in the business cycle. The

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<sup>13</sup> J. M. Clark, Economics of Planning Public Works (Washington: United States National Planning Board, 1935), 234 pp.

opponents have argued that because the plan deprives corporations of the reserves that enable them to ride through depression, the plan will do much injustice and will curtail business. What does a corporation with a big surplus do when depression comes? It knows it can pay interest and perhaps dividends for some time to come, even if it operates at a loss or shuts down. It therefore sits back comfortably to ride out the depression. It lays off men, ceases ordering materials, but does not reduce prices. It thus spreads the depression, makes it more intense, and lays its burden on the unemployed and the weaker producers of materials, such as farmers, while it continues to sustain those who live on interest and dividends. In the end this makes the depression worse for everyone. What does a corporation without a big surplus do when depression comes? It reduces its prices, tries its best to improve and sell its products. If it cannot earn income, it is forced to deflate its capital structure by the process of reorganization or bankruptcy. The effect of its behavior is to sustain production, moderate the effects of the depression and bring a more prompt readjustment. If capitalism is to continue, a tax that discourages large corporate surpluses might add immensely to a needed flexibility of the system. The effect of a surplus tax would be to decrease the spread and downward swing of business fluctuation. One possible reason why the depression of the 1930's was so much more severe than earlier ones is that immense powers of resistance to deflation were developed by the great aggregations of capital.<sup>14</sup>

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<sup>14</sup> Bruce Bliven, "Taxing Corporation Surplus," The New Republic, 86:154, March, 1936.

Professor Tugwell seems to be of the opinion that something must be done to prevent too much corporation accumulation of surpluses. He explains:

The corporation's saving of profits for a rainy day defeats the very purpose which it is intended to meet. For when everyone saves, no one buys enough to keep things going. When every corporation turns its earnings into surpluses, a good deal of the purchasing power of the community is made sterile. If, instead of using its earnings to enlarge its surplus, the corporation used them to increase its payroll or to reduce its prices to consumers, it would be enlarging the demand for its own products along with those of others. This would be better insurance, really, against an anticipated rainy day than following any of the courses open to it in the management of surplus. Even if it paid these funds out in dividends the effect would be better than that of saving, for at least part of them would be spent for consumer goods instead of being added to an already overdeveloped equipment. It is as a result of following the course of saving, that industries find themselves periodically with a failing market. When too much is saved and finds its way into factories, our productive equipment tends to outgrow any demand there may be for the product. One of the favorite devices resorted to in this situation is an enlargement of high-pressure salesmanship and advertising in an attempt to create markets forcibly. But if physical purchasing power is actually deficient, the only result this can have is to take business away from someone else.<sup>15</sup>

Several methods have been suggested to be used in taking accumulated surpluses from big business. Gardiner C. Means, an economist, has suggested eliminating excess accumulation of surpluses by controlling prices of inflexible price industries. He would set inflexible prices at enough to cover cost of production and yield only a sufficient profit to induce investors to invest in the industry. Flexible price industries would be free from control. Under his plan, some governmental body would

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<sup>15</sup> Rexford G. Tugwell, The Battle For Democracy, (New York: Columbia University Press, 1935), 188-9 pp.



administrative prices in relation to the prevailing conditions.<sup>16</sup> Rexford G. Tugwell, an economist, has suggested that we can eliminate excess big business surplus with a tax based on a graduated basis of profits withheld by the corporation.<sup>17</sup>

Professor Tugwell's method seems to be much easier to accomplish than that of Professor Means proposal. There will be no radical change in our economy if Tugwell's suggestion were adopted completely. Franklin D. Roosevelt was in favor of the tax suggested by Professor Tugwell, but was partially against using the funds secured from such tax for the stabilization of economic conditions.

Corporate surpluses, Professor Tugwell maintains, have been employed for the diversion of capital from its proper uses. To attack the problem of the unwise investment of capital, corporate surpluses, which, he believes, are the chief source of maladjustments, should be forced into the open investment markets out of the hands of the boards of directors. If these corporate profits were distributed in dividends, under government pressure, they would seek re-investment through the regulated investment markets. There should also be federal control of new issues of stock by corporations. The revenues that were obtained from the undistributed profits tax could, according to Professor Tugwell, be utilized to support government expenditures which were directed toward the stabilization of economic conditions. The

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<sup>16</sup> Gardiner C. Means, "Notes on Inflexible Prices," The American Economic Review, 26:23, March, 1936.

<sup>17</sup> Rexford G. Tugwell, The Battle For Democracy (New York: Columbia Press, 1935), 188 pp.

government would thus enjoy twofold benefits from the undistributed profits tax, for the tax would serve as an agency of reform in attaining control over the uses of capital in industry, and it would also provide revenues for desirable government expenditures.<sup>18</sup>

In an attempt to meet the surplus accumulation problem, Congress passed an undistributed profits tax in 1936, but repealed or changed it in 1938. Tax evasion and protest of vested interest were strong enough to defeat the undistributed profits tax. Thus Congress was unable to tax all surplus accumulation of every corporation, but they have been able to tax the surplus accumulated unwarrantedly by corporations. The unwarranted accumulations of surplus tax sections place high surtax upon corporation who cannot justify that their accumulation is necessary for ordinary business operations. Congress in 1938, placed personal holding companies in separate sections of the Revenue Law and levied rates twice as much as rates levied against other forms of corporations that cannot justify the retention of their surpluses. The main reason for such action is that personal holding companies cannot justify retention of profits for expansion nearly as well as can ordinary corporations.

The main section of the Revenue law regulating unwarranted accumulation of surplus by domestic corporation is section 102. The provisions of Section 102 were partly enacted in 1917 and has been amended in 1928, 1932, 1934, 1938 and 1942. According

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<sup>18</sup> Tugwell, Loc. Cit., 192 p.

to tax experts, Section 102 of the 1934 Act, which covers this subject, varies only slightly from Section 104 in the 1928 and 1932 Acts, or from similar provisions in each preceding law back to the first one in 1917. Revenue Amendments of 1938 and 1942, raised the rates and made the provisions more comprehensive. Since 1919, internal revenue collectors have looked suspiciously upon comfortable surpluses as possible harbors of incomes that would fall into the lucrative surtax brackets if passed on to individual shareholders. Up to 1934, only inconsequential collections had been made through compromise settlements involving tax dodging by means of dummy corporations. Significant changes in the new Act, as far as they apply to operating companies, were limited to reduction in the penalty and including a sliding scale that levied a tax of 25% on improper surpluses up to \$100,000 and 35% on those above that figure. Since 1934, amendments have given the Treasury much more leeway to tax surpluses. The treasury has assessed and collected considerable amount of money from corporations under this law.

In 1938, Congress enacted a new section of the Internal Revenue Law. This section applied to personal holding corporations. Previously, these provisions were partly contained in sections relating to general corporations, but were in very mild form. In 1938, Congress removed them from the improper accumulation of surplus section and placed the personal holding company surtax provisions in a separate section. In 1942, these sections were permanently placed in sections 500, 501, and 504 of the Internal Revenue Law. The main changes in these provisions were to make them more comprehensive and increase the tax rate. Personal

holding companies have thus been singled out and subjected to harsh provisions for the accumulation of surplus. The main reason for such action is that personal holding companies are used primarily for financial advantages. They cannot justify retention of profits for expansion nearly as well as can operating corporations.

The unwarranted accumulation of surplus law, as applicable to operating concerns, depends for its teeth upon the interpretation of "reasonableness" of the purpose for which surpluses are built up. Within the limits of that word, it is felt that operating companies have ample leeway to justify any dividend policy that directorates choose. Holding companies, which have less tangible reasons for not passing along dividends received from subsidiaries, have found the tax applicable to them, and it was expected that private investment companies would provide less evasion than has previously been the case.<sup>19</sup> After the Revenue Act of 1938, Section 102 was more rigidly enforced. However, during the Second World War this section was not rigidly enforced.

In summary, the problem of accumulation of surplus means the problems created by corporations not paying their profits out in dividends. There are two sides of the problem, namely: economic and income tax. The main argument against the regulation of surplus accumulation is that the regulation interferes with management policies and rights.

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<sup>19</sup> Ralph B. Smith, "Safe Surpluses," Business Week, p. 19, December 22, 1934.

A surplus tax is legal under the taxation powers of the federal government, and such a tax can be justified four ways from the income tax viewpoint. First, that there is enough variation in taxes of shareholders of corporations and owners of proprietorships as to justify taxing the surplus accumulation of corporations. Second, that a surplus tax would remove inequities and serious inequalities between corporate, partnership, and individual enterprise. Third, the surplus tax will permit a nearer approach to establishing taxation on the basis of ability to pay. Fourth, a surplus tax will prevent the avoidance of double taxation and especially the avoidance of the surtax on income.

The surplus tax can be justified three ways from the economic aspect of the tax. First, Surplus tax is needed to restrict saving so that spending will be stabilized. Second, a surplus tax will prevent, somewhat, the concentration of wealth. Third, a surplus tax is a check on over-saving and thus helps to eliminate wide fluctuation in the business cycle.

## CHAPTER II

LAW, REGULATIONS, COURT CASES CONCERNING THE  
ACCUMULATION OF SURPLUS

Ever since 1936 the United States Government has recognized the need for regulating the accumulation of surplus by corporations. In that year Congress passed an undistributed profits tax; but under pressure from various sources, this Tax was repealed in 1938.

Being unable to tax the accumulated surplus of every corporation, Congress passed legislation taxing the accumulated surplus of corporations that could not justify their retained surpluses as being necessary for normal business needs. There are three classes of taxes, which regulate the accumulation of surplus by corporations that are in force at the time of this writing.

They are: Improper Accumulated Surplus tax, Personal Holding Company tax, and the Personal Service Company tax. The tax requires personal service companies stockholders to pay income tax upon their share of profits as they are earned, whether distributed or not. There is also a tax on personal holding companies which separates personal holding companies from other corporations and taxes them as a special class. Each above provisions of the Revenue Law relating to the surplus accumulation problem are studied below. Special emphasis will be placed upon them.

Before taking up laws still in force, some attention will be given to the 1936 law taxing all undistributed profits. This tax was based upon undistributed part of corporate income. The rates

were graduated according to the amount of profits withheld from the stockholders. If the corporation distributed its entire profits of the taxable period to the stockholders, it was not subjected to the Undistributed profits tax. If the corporation retained part of its profits of the taxable period, it was subjected to the undistributed profits tax. This tax was a tax upon corporations in addition to the regular corporation income tax. The regular corporation income tax was allowed as a credit in arriving at the undistributed taxable income. The tax applied to corporations regardless of their size and regardless of their need for retaining their profits. Labor, agricultural organizations, banks, and nonprofits organizations were expressly exempt from the undistributed profits tax. The Commissioner of Internal Revenue, in the process of collecting the tax, met much resistance to the payment. Consequently there was considerable tax evasion. The regulations were difficult to enforce and developed ill-will with many taxpayers. The significance of the undistributed profits tax was that it represented a Congressional attempt to force corporations to declare all profits as dividends or, failing in that, to secure a tax return equal approximately to that which would be secured if all profits were declared a dividends.

The method of computating undistributed profits tax can best be explained by applying the regulations to a specific case. The figuring of undistributed profits tax, for a company with a \$100,000 income is:

Step 1. Income is \$100,000; the normal tax would be \$13,840, obtained as follows: 8% of first \$2,000; 10% on next \$13,000; 13% on next \$25,000; 15% on all over \$40,000.

Step 2. Assume dividend paid is \$10,000, then undistributed earnings tax would be \$14,962, as follows:

A. Subtract normal tax of \$13,840 and dividend of \$10,000 from \$100,000 net income. That leaves \$76,150 subject to retained earnings tax.

B. Net income equals \$86,160, on 10% of that (\$8,616) apply 7% tax-- \$603.

C. On next 10%, apply 12%--\$1,034.

D. On next 20% (\$17,232), apply 17% tax--\$2,929.

E. On next 20% apply 22% tax--\$3,791.

F. On balance of net income (\$24,464), apply 27% tax--\$6,605.

G. Add B, C, D, E, F, which gives retained earnings levy of \$14,962.<sup>1</sup>

The method is adaptable to all corporations--with this exception: companies have the election of applying the 7% tax rate to the first \$5,000 of net income retained or to the first 10% of the retained income whichever is higher. For the small corporations, with net income under \$50,000 this choice is helpful.

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<sup>1</sup> Methods and Rates are from the United States Statutes at Large (Washington: United States Printing Office, 1936, 50: 1655-7.



The undistributed profits tax was repealed by Congress in 1938. During the time the undistributed profits tax was in force, the Courts uniformly held the Law to be constitutional.<sup>2</sup>

Turning now to the laws still in force at the time of this writing, we will study Section 102 of the Revenue Law taxing corporations that have accumulated surplus unwarrantly. In 1924, 1928, and 1934, Congress passed regulations relating to the accumulation of unwarranted amount of surplus by corporations. In 1938, 1942, this provision was amended and made more comprehensive. The intent of Congress was to lessen the chances of corporations withholding profits from their shareholders in excess of normal business need. Especially when this was done so that the shareholders would escape personal income tax on most of the corporation's profits which they would have received had all profits been declared as dividends. The main section of this regulation is Section 102 of the Revenue Law. Section 102 of Revenue Law in force at the time of this writing, is as follows:

Section 102 (a) Imposition of tax--There shall be levied, collected, and paid for each taxable year upon the net income of every corporation (other than a personal holding company as defined in section 504) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed.

(1) Corporations subject to this tax a surtax equal to the sum of following will be levied and paid.

25 per centum of the amount of the retained net income not in excess of \$100,000, plus;

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<sup>2</sup> Crane Johnson v. C.I.R., 1938, 105 2d. Federal Reports, 740.

35 per centum of the amount of the retained net income in excess of \$100,000.

(b) **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, shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(d) definitions. As used in this chapter--

(1) Section 102 net income. The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry\* over provided in section 117(E) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction in section 23(S) minus the sums of:

(A) Taxes: Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income tax law.

(B) Disallowed charitable, contributions. Contributions or gifts, payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23(O), for the purposes therein specified.

(C) Disallowed losses. Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(D) Income subject to excess-profits tax. The credits for income subject to the tax imposed by Subchapter E. of Chapter 2 provided in Section 26(E).<sup>3</sup>

Section 102 of the Revenue Law faces the accumulation of surplus problem more squarely than any section of the Revenue Law that is in force today. It partly solves the income tax problem of surplus accumulation, but fails to have much effect on the economic problem of surplus accumulation. Section 102 imposes high taxes upon surplus accumulation that the business retains which they cannot justify as needed for ordinary business

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<sup>3</sup> United States Statutes At Large (Washington: United States Printing Office 1942), 55:234.

purposes. If the corporation retains too much in the opinion of the tax commissioners, it is the duty of the commission to assess additional tax upon the corporation. Section 102 provides for a penalty tax on "improper" accumulation of surplus, and the Bureau is made the judge of the impropriety. If accumulations exceed what the Treasury holds to be reasonable, the presumption is that reserves are piling up to avoid taxes, and to escape the penalty, corporations must prove the Treasury is wrong.<sup>4</sup>

The constitutionality of Section 102 of the Internal Revenue Code has been tested in several cases. The Courts have generally held this section to be constitutional. Corporations have used at least five reasons why this section should be held void as applied to a legitimate business corporation. None of these have been held to be sound. They are as follows:

1. It has been said that the statute violates the Tenth Amendment because it interferes with the power to declare or to withhold dividends--a power which the State conferred upon the corporations. The courts have answered that the statute in no way limits the powers of the corporation. The statute has merely laid a tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. Congress, in raising revenue, has incidental power to defeat obstructions to that incidence of taxes which it choose to impose.<sup>5</sup>

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<sup>4</sup> David Lawrence, "Tax Power Over Reserved Profits," United States News, 20:22, May 24, 1946.

<sup>5</sup> United Business Corporation v. Commissioner of Internal Revenue, 1933, 62 2d. Federal Reports, 754,756.

2. It has been said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by an individual all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. The sole owner of the business, could not by conduction as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits. If it preferred, Congress could lay the tax upon the corporation, as was done by section 102. The penal nature of the imposition does not prevent its being valid, as the tax was otherwise permissible under the constitution.<sup>6</sup>

3. It has been said that Section 104 of the 1934 Act, now Section 102, is unconstitutional because the liability is laid upon the mere purpose to prevent imposition of the surtaxes, not upon the accomplishment of that purpose; and that thus, it is a direct tax on the state of mind. The courts would not follow this line of reasoning. The United States Supreme Court states in substance that the arguments by the corporation were good logic, but this was not so in practice. The tax is laid "upon the net income of such corporation." The existence of the defined purpose is a condition precedent to the imposition of the

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<sup>6</sup> Helvering v. National Grocery Company, 1938, 304 United States Supreme Court 289.

tax liability, but this does not prevent it from being a true income tax within the meaning of the Sixteenth Amendment. The instances are many in which purpose or state of mind determines the incidence of an income tax.<sup>7</sup>

4. It is said that Section 102 applied, deprives the corporation of its property without due process of law; that it is unreasonable, arbitrary and capricious in that no standard or formula is specified to guide the Commissioner in assessing, or the corporate directors in avoiding, the additional tax; that it is assessed retroactively; and that it is unfair to non-assenting minority stockholders. The prescribed standard is not too vague according to the ruling laid down by the United States Supreme Court. Judge Hand said in the *United Business Corporation v. Commissioner of Internal Revenue* case, applying to the above argument, as follows:

Standards of conduct, fixed no more definitely, are common in the law; the whole law of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all. The vice of fixing maximum prices in that it requires recourse to standards beyond ascertainment by sellers, by which therefore they cannot in practice regulate their dealings. That is not true of the reasonable needs of a business, which is immediately within the ken of the managers, the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor.<sup>8</sup>

5. It has been said that Section 102 is void because it delegated to the commissioner legislative power. The statute

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<sup>7</sup> Ibid, p. 290.

<sup>8</sup> *United Business Corporation v. C.I.R.*, 1933, 62 2d Federal Reports 754, 756.

provides that if the corporation is availed of for the forbidden purpose, the tax "shall be levied collected and made prima facie evidence of the existence of this purpose." No power is delegated to the Commissioner save that of finding facts upon evidence. The legislature has given to the Commissioner of Internal Revenue only power to carry out what it has commanded. Any legislative body can delegate to some other body only administrative work, any delegation of legislative is strictly unconstitutional. The United States Supreme Court has held the delegated power to the Commissioner of Internal Revenue to be constitutional.<sup>9</sup>

The Courts have generally held sub-section b of Section 102 to be constitutional. In the case of Semagraph Company v. C.I.R., the United States Supreme Court clearly held this sub-section to be valid, the courts have sighted this case as authority and ruling case. The Semagraph Company petitioned for a review of a decision of the Tax Court which approved the determination of income tax deficiencies against the corporation for the taxable year ended March 31, 1939, and March 31, 1940. The question to be decided is whether the taxpayer was availed of in each of these years in order to prevent the imposition of the surtax upon earnings and profits to accumulate instead of being distributed. Considerable progress was made in the field of experimentation and in the development of the new machine, before the incorporation of the Semagraph Company took place. The purpose of that company was conceded to be for the development of the

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<sup>9</sup> Helvering v. National Grocery Company, 1938, 304 United States Supreme Court, 290.

invention and to reduce the idea to practical form, and not for the purpose of avoiding the imposition of surtaxes upon Johnson. All of the activities consumed considerable time as well as money and it was not until after the tax years in question had passed that the machine was finally determined to be a practical success. But by far the greater part of the assets of the taxpayer corporation was invested in securities and was not used in the development of the machine. It would seem that these funds were held by the taxpayer corporation primarily for the convenience of Johnson individually and not for the development of the invention. The U. S. Supreme Court, thus affirmed the decision of the lower court.<sup>10</sup>

In the case of Universal Steel Company v. C.I.R., the evidence was not sufficient to violate Section 102 b. The company had paid its general manager a large salary, and the Collector of Revenue claimed it was not deductible and was subject to taxation under Section 102. The Court's records show the general manager was largely responsible for the petitioner's successful operation since its formation. He carried it through periods of financial stress with a voluntary reduction of salary and with the fact understanding that, when the company should become financially able to do so, appropriate adjustment of his compensation would be made. The court held, the company was not an "incorporated pocketbook" of a single individual or a group of wealthy stockholders who could use it for holding or investment

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<sup>10</sup> Semagraph Company v. C.I.R., 1945, 153 2d Federal Reports 62.

purposes. The complete absence in its balance sheet of any loans to officers or stockholders and of investment of securities unrelated to its business tends to confirm its lack of either an intent to circumvent the law or of action imputing a purpose of preventing imposition of the surtax upon its shareholders. Its accumulations in 1941 were impelled by sound and cogent business reasons and were not beyond the reasonable needs of its business.<sup>11</sup>

In the case of *Hemphill Schools v. C.I.R.*, the United States Circuit Court, faced the problem of what constitutes unreasonable accumulation. The issue was whether the Hemphill Schools gains and profits were permitted to accumulate beyond the reasonable needs of its business. The Court affirmed the ruling of the lower court stating that the immediate cash on hand and very near future have no bearing on the reasonableness of accumulation of earnings.<sup>12</sup> The case of *Chicago Stock Yards v. C.I.R.*, is another case facing the problem of what constitutes unreasonable accumulation of surplus. The issue of the case was to determine whether there was deficiencies in income tax of the Chicago Stock Yards Company. The lower court held that the company had accumulated surplus beyond its reasonable needs, and, therefore, was subjected to the tax under Section 102 of the Revenue Law. The Supreme Court said the lower court's very

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<sup>11</sup> *Universal Steel Company v. C.I.R.*, 1945, 5 Tax Court 627.

<sup>12</sup> *Hemphill Schools v. C.I.R.*, 1943, 137 2d Federal Reports 963-4.



narrow view of petitioner's needs as taken by the Board proceeded from a failure to recognize petitioner's as that of the stockyards enterprises as a whole. Accumulation "for the reasonable needs of the business" is not limited to making provision for the bare legal obligations of the corporation but may include accumulation in furtherance of a reasonable business program for protection and enhancement of the corporation's pecuniary interests.<sup>13</sup>

An editorial in the United States News, published in August 8, 1947, issue, gives a very excellent summary of the rulings on the Section 102 of the Revenue Law. The tax court rulings have been liberal in recent rulings. It said, in part, that several principles have been recognized. The right to grow has been recognized. A company may hold back money for new buildings or new equipment. It is not to be forced to deplete its capital through dividends so that it has to borrow money for expansion. Tax avoidance must be the purpose of withholding earnings from stockholders if penalties are to be assessed, and that the particular problems of a corporation are controlling. In one case, a company delayed dividends until the following calendar year to await the auditor's report, and this was upheld by the Court. In another case, a company paid out no dividends at all, and the Court found no objection. Unknown risks can be the ground for accumulating earnings. The Court upheld one company that withheld its earnings for whatever unnamed difficulties it might encounter in the future. Wide latitude is to be allowed businessmen in deciding how much to pay out to stockholders. The Treasury cannot count on the Tax Court's backing in

any strict enforcement of the 70 per cent rule. The 70 per cent rule is that corporations must pay out in dividends 70 per cent of their profit for each year and if not the accumulation must be explained in the tax report and is subject to investigation.<sup>14</sup>

An important section supplementing Section 102 is Section 115 of the Revenue Law, which defines a dividend and states the tax rule for stock dividends. The importance of this section, in relation to the surplus accumulation problem, is that some dividends are deductible when computing the surplus accumulation tax. The main provisions of Section 115 of the Revenue Law concerning the surplus problem are:

a. Definition of dividend. The term "dividend" when used in this chapter means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913, or out of the earnings or profits of the taxable year, without regard to the amount the earnings and profits at the time the distribution was made. Such term also means any distribution to its shareholders, whether in money or in other property.

f. Stock dividends--1 General rule. 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. 2 Election of shareholders as to medium of payment. Whenever a distribution by a corporation is, at the election of any of the shareholders, payable either in its stock, of a class which it distributed without election would be exempt from tax, or in money or any other property, the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.<sup>15</sup>

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<sup>14</sup> David Lawrence, "Ruling on Reserve of Corporation," United States News, 23:48-9, August 8, 1947.

<sup>15</sup> "U.S.C.A., 26," Internal Revenue Code, (Washington: United States Printing Office, 1945, p. 324.

The interpretation of whether a dividend is a stock or cash dividend is set forth in the case of Henry Vogt Company and has been sighted in later cases as authority. This case involves the question of whether a certain dividend declared by the plaintiff was a stock or cash dividend. The court held that the evidence presented shows the increase of capital stock arising from the dividend. In order to be a deductible dividend the net resources of the corporation must be reduced by the amount of the dividend, or it will be considered to be a stock dividend and not deductible by the corporation.<sup>16</sup>

Another section which supplements Section 102 is Section 148 of the Revenue Law, which requires every corporation to make information returns, stating the amount of income retained and address of its shareholders. The main reason for this is that the Commissioner of Internal Revenue can analyze these returns and see if the companies are violating the unwarranted accumulation section of the Revenue Law. Every corporation is required under oath to file a correct return of its payments or dividends, stating the name and address of each shareholder, the number of shares owned by him, and the amount of dividends paid to him. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

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<sup>16</sup> Henry Vogt Machine Co. v. United States, 1932, 39 2d Federal Reports 987-90.

Whenever a company fails to make adequate information return as requested they are subject to a penalty.<sup>17</sup> In the case of National Contracting Company v. C.I.R., a penalty was imposed for the failure of the Company to make an adequate information return, and the Federal Court upheld the action of the Commissioner of Internal Revenue.<sup>18</sup> In subsequent case, this case has been sighted as authority on the subject.

Another tax relating to the surplus problem is the tax upon personal service companies. In October 1940, Congress enacted a tax on the shareholders of personal service corporations. The tax was amended in 1942, but the main provisions remained unchanged. These sections of the Revenue Code are 392, 393 and 394.<sup>19</sup> Stockholders are required to include their share of profits, made by the corporation in their gross income, on their return regardless of whether distribution is made. The essential motive of the law was that the personal service corporation has all the capital required to run their business, and profit accumulation is unreasonable. Corporation income is taxable income to the shareholders of such corporation in nearly the same way as sole proprietorship or partnership incomes are. This type of the tax might be applied to every corporation in the United States and would help solve the surplus accumulation problem.

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<sup>17</sup> "U.S.C.A. 26," Internal Revenue Code, (Washington: United States Printing Office, 1945, p. 435.

<sup>18</sup> National Contracting Co v. C.I.R., 1938, 105 Federal Reports 488.

<sup>19</sup> United States Statutes At Large (Washington: United States Printing Office, 1940), 54:1005.

When one is being taxed upon something he does not have, he will exercise every means available to obtain the income being taxed. When he does that, the surplus accumulation problem probably will be eliminated.

Another tax relating to the surplus problem is the tax upon personal holding companies. In 1938, Congress passed regulations governing retained earnings by personal holding companies. Personal holding companies were formed largely to evade personal income tax. Congress, made these regulations especially harsh, so as to discourage continuation or organizing of personal holding companies. The United States Court commenting on the law, stated that if Congress so desired, they could prohibit personal holding companies entirely. Commissioners have found personal holding company to be a good source of revenue, and have not taxed them to prohibit their existence. The main provisions of the Revenue Law are contained in section 500, 501, 504. Section 501 defines a personal holding company. A personal holding is any corporation if at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.<sup>20</sup> Section 504 defines undistributed personal holding company income. Its undistributed income means the net taxable income minus--

- a. The amount of the dividends paid credit.
- b. Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to

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<sup>20</sup> United States Statutes at Large (Washington: United States Printing Office, 1942), 55:326.

January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

c. Dividends paid after the close of the taxable year and before the 15th day of the third month following the close of the taxable year providing it shall not exceed either.

d. Amount distributed before January 1, 1944, in redemption of preferred stock outstanding before January 1, 1934.<sup>21</sup>

Section 500 places a surtax on personal holding companies.

This section reads as follows:

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed net income of every personal holding company, a surtax equal to the sum of the following:

1. 65 per centum of the amount thereof not in excess of 2,000; plus
2. 75 per centum of the amount thereof in excess of 2,000.<sup>22</sup>

Personal holding company tax sections have been held to be valid. The principles of constitutionality were sustained in early cases and these decisions have been sighted as authority in later cases. In the case of *Foley Securities Corporation v. C.I.R.*, the constitutionality of the tax was tested. The taxpayer contended that if the law is interpreted strictly and as the Commissioner and the Board have interpreted it, it becomes unconstitutional because the law ceases to provide for income tax and provides for a capital levy; and violates the Fifth Amendment because it takes the taxpayer's property without due process of law by establishing a purely arbitrary basis for the taxation of the personal holding company having an impaired

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<sup>21</sup> Ibid, p. 330.

<sup>22</sup> United States Statutes At Large (Washington: United States Printing Office, 1942), 55:325.

capital. The court held this tax does not violate the Sixteenth Amendment. The surtax is based upon income. The court held this tax does not violate the due process of law clause contained in the Fifth Amendment. Except in rare and special instances the due process of Law clause contained in the Fifth Amendment is not a limitation upon the taxing power conferred upon Congress by the Constitution. However, a tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth amendment. Since the power of Congress to tax is not limited normally by the Fifth Amendment and since that Amendment contains no equal protection clause, and even though it be confiscating, the tax is held constitutional.<sup>23</sup>

In summary, Congress has recognized the need for regulation of the accumulation of surplus by corporations. They have passed the undistributed profits tax, section 102, 115, 148, 393-4-5, and 500-1-4, of the Revenue Law, except the undistributed profits tax are enforced at the time of this writing. Congress was unable to regulate the surplus of every corporation, and had to substitute taxation on surplus accumulated unwarrantably.

The main section dealing with unwarranted accumulation of surplus is section 102 of the Revenue Law. Under section 102, corporations are taxed on surpluses retained in which they can not defend as necessary for business growth, or new equipment, or for unknown risk. Section 115 supplements section 102, it

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<sup>23</sup> Foley Securities Co. v. C.I.R., 1939, 106 2d. Federal Report 731.

defines dividends and gives rules for taxing different kinds of dividends. Generally, stock dividends are deductible if the stockholders are subject to tax on them. Section 148 requires every corporation to make information returns, so the Tax Commissioner can determine if corporations are violating section 102 of the Revenue Law.

Stockholders of personal service companies are required to include their share of profits, made by the corporation in their gross income, in their return regardless of whether distribution is made. Such procedure, if applied to every corporation might help solve the surplus accumulation problem.

Surplus accumulation tax on personal holding company, separates personal holding companies from other corporations, and taxes them as a special class. A personal holding company cannot justify retaining earnings as easy as can operating or manufacturing corporations. Personal holding companies are subject to tax rates more than twice as high as other corporations. Every provision regulating surplus accumulation has been held to be constitutional. The courts have enforced regulations relating to the surplus taxes more rigidly upon personal holding companies than any other kind of corporation.



## CHAPTER III

THE EFFECTS OF THE UNWARRANTED ACCUMULATION OF SURPLUS TAX  
AND PROBABLE FUTURE DEVELOPMENT

The effects of the taxation of surplus accumulation by corporations discussed below are two-fold. For one thing, corporations have attempted tax avoidance--both of the general income tax and the surplus accumulation tax. They have overstated their depreciation expenses, and they have spent more freely for such things as advertising expenses to build goodwill and secure probable future benefits. The latter is a legitimate business expense, but nevertheless it reduces current profits and thus temporarily, at least, reduces surplus. Also, the effect of the tax upon different types of business seems to operate to the detriment of the small growing business. Changes in the tax regulation have been proposed so as to aid small growing business, but such changes have not as yet been enacted.

The enforcement of the surplus accumulation tax was relaxed during the Second World War. The question of whether there is now a need for strict enforcement of Section 102 of the Revenue Law will be presented in the latter part of this chapter, as one of the probable future developments. The arguments for strict enforcement are: large amount of liquid assets are held by corporations which should be paid to their stockholders,

retained profits are too large, and therefore the concentration of economic power is becoming great. The arguments against strict enforcement will also be presented in that part of the chapter.

The high surtax under Section 102 of the Revenue Law have forced corporations to find methods of building up cash reserves without paying the high taxes. These methods operate so as to reduce corporations general corporate income tax and the surtax upon surplus accumulations unwarrantably. They are deductible for income tax purposes in arriving at net taxable income, as ordinary business costs. By paying less corporate income tax, corporations are able to conserve cash. The corporations have tried various ways of understating their asset values mainly:

1. Depreciation. By establishing high depreciation reserves, cash has been conserved; but the government has rigid rates of depreciation and obsolescence, so that dangers of a belated assessment lurk in this procedure.

2. Advertising. This is considered a legitimate business expense. Companies may decide on large expenditures, either to expand new business or for the development of institutional good will. The effect would be to build up a substantial "good will" as a future surplus item without being taxed.

3. Paying dividends and taking them back. This can be done by declaring a cash payment to stockholders and asking stockholders to subscribe to stock in the corporation to the amount of the disbursement. The income tax is not escaped by

this method, but the unwarranted surplus accumulation tax is, of course, avoided.

4. Insurance. The Internal Revenue Bureau regards insurance premiums paid as an ordinary expense in the conduct of business. Thus a corporation which forms its own insurance companies can charge the premiums to operating costs. In that way the normal income tax plus the retained earnings tax on the amount of the expenditure is avoided. The practice of placing insurance with casualty and indemnity companies is prevalent, but some large corporations have their own insurance funds, making appropriations out of earnings each year to guard against loss. These appropriations are allocated to an insurance reserve.<sup>1</sup>

It is to be expected that business will continue taking advantage of all means possible to escape the rigors of the surtaxes--particularly if and when the small companies obtain concessions and when certain companies are specifically exempt. A law which everyone violates is very hard to enforce.<sup>2</sup>

The general effect of the tax upon the accumulation of an unwarranted amount of surplus has been increased spending by corporations. The more a corporation spends money (or pays dividends) the smaller will be its tax bill under Section 102 of the Revenue Law. Thus, if a company reduces its net income

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<sup>1</sup> Ralph E. Smith, "New Taxes Mean Higher Prices," Business Week, June 27, 1936, p. 12.

<sup>2</sup> Ibid, P. 13.

(by advertising, say), Uncle Sam will become an automatic contributor to the business. In certain cases, \$100,000 worth of advertising would cost a company only 68% of the dollar. The government, by not collecting taxes on that sum, would pay the rest. Table number 1<sup>3</sup> is a sample of what would happen when a corporation increases its expenditures \$100,000 to cut its tax bill. Note how the law of diminishing returns is at work.

Table No. 1  
Spending--A Way Out of Taxes

Dividends %	\$1,000,000 Retained Earnings tax	Net Income Total tax	After Spending \$100,000 Retained Earnings tax	Total tax	Saving in Taxes
None	\$174,487	323,327	157,062	290,902	32,425
10	151,506	300,346	136,376	270,216	30,130
20	128,525	277,365	115,690	249,530	27,835
30	105,543	254,383	95,003	228,843	25,540
40	82,562	231,402	74,317	208,157	23,245
50	63,837	212,677	57,462	191,302	21,375
60	45,111	193,951	40,606	174,446	19,505
70	30,642	179,482	27,582	161,422	18,060
80	16,172	165,012	14,557	148,397	16,615
90	5,958	154,798	5,363	139,203	15,595
100	none	148,840	none	133,840	15,000

Includes 148,840 normal income tax in each instance.

Includes 133,840 normal income tax in each instance.

Also, the effect of the surplus accumulation tax seems to operate to the detriment of the small growing business. This

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<sup>3</sup> Ralph B. Smith, "Advertising Can Soften Tax," Business Week, p. 20, June 27, 1936.

can best be shown by explaining the stages of business growth. The corporations of the country are of all sizes, from those with very trivial capital and business to enormous concerns which are almost monopolies in their lines. It is commonly understood that the law of corporation growth is divided into three stages. Most corporations begin in a rather small way and struggle along for a number of years establishing themselves as sound economic units. Then they begin a period of growth and expansion during which time they are increasing their markets both in respect to territory covered and variety of product; they are developing their organization and their business to the limits of their economic possibilities. The third and final stage represents the complete development or, in other words, the maturity of the corporation. During the second stage, while the corporation is building, the corporation usually plows back all or nearly all of its earnings into its capital structure. By the time the final stage is reached, the corporation has all the capital that is required for business purposes and, therefore, devotes itself chiefly to holding the business it has secured, and is then able to distribute practically all of its earnings as required by law. The smaller corporations of the country in the second stage of development are heavily taxed when they should be plowing most all their earnings into their surplus account for the purpose of developing their business and competing with companies which are in third stage of development.

This effect has defeated one of the very purposes that the legislature had in mind when they enacted a tax upon retained earnings of the corporation.<sup>4</sup>

One of the objectives of the sponsors of the tax was the retarding of the growth of large corporations and the preservation of small enterprises. Large corporations have not been retarded, and the small, growing corporations have felt its harsh effects. Most economists believe that competition is vital; that keeping small business enterprises alive preserves competition. Section 102 tax dries up small enterprises and keeps them from growing. It penalizes them in their efforts to raise capital. It makes of them empty shells by emptying their reserves into dividends. Nobody wants to loan to an empty corporation.<sup>5</sup> In 1947, a proposal to aid small corporate businesses was introduced in Congress by Mr. Stam, a tax expert. He proposed to exempt retained earnings of small business from being taxed by Section 102 of the Revenue Law. The proposal was found by the Treasury to be a possible way of helping small firms raise outside capital. But it was argued that such an exemption would discriminate in favor of one kind of saving and against other kinds. Also, it was contended that the system might lead to widespread tax avoidance. The proposal has its good points as well as its

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<sup>4</sup> David Lawrence, "Tax Aid for Small Business," United States News, 23:42, November 7, 1947.

<sup>5</sup> John Nuhl, "Letter from John Nuhl Relative to the Proposed Tax on Surpluses of Corporations," Congressional Record, 38-4076, March 20, 1936.

bad points. The passage of the proposal, at the time of this writing, seems to be doubtful.<sup>6</sup>

Turning to the problem of possible future developments, it has been noted that the enforcement of the unwarranted surplus accumulation tax was relaxed during the Second World War. It may be enforced more strictly in the future. Revived interest in the Section 102 weapon is a warning to corporations that tax officials are ready to press for a sharp change in the dividend policies that were pursued during war years. As previously explained in the opening paragraphs of this chapter, the question of whether there is a need for a more strict enforcement of Section 102 of the Revenue Law may be found by seeking answers to three questions, namely: First, are there enough liquid assets to justify the strict enforcement of the tax? Second, are profits retained large enough as to justify rigid enforcement of Section 102? Third, does the tax need to be enforced rigidly so as to stop the concentration of economic power in large corporations and thus usable by the majority of stockholders.

The study of the question of whether there are enough liquid assets held by corporations so as to justify the strict enforcement of the tax will be presented first. The amount of liquid assets held by corporations, in 1939, was \$6,660,000,000, and has increased to \$25,000,000,000, in 1946. The amount of

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<sup>6</sup> David Lawrence, "Tax Aid for Small Business," United States News, 23:42, November 7, 1947.

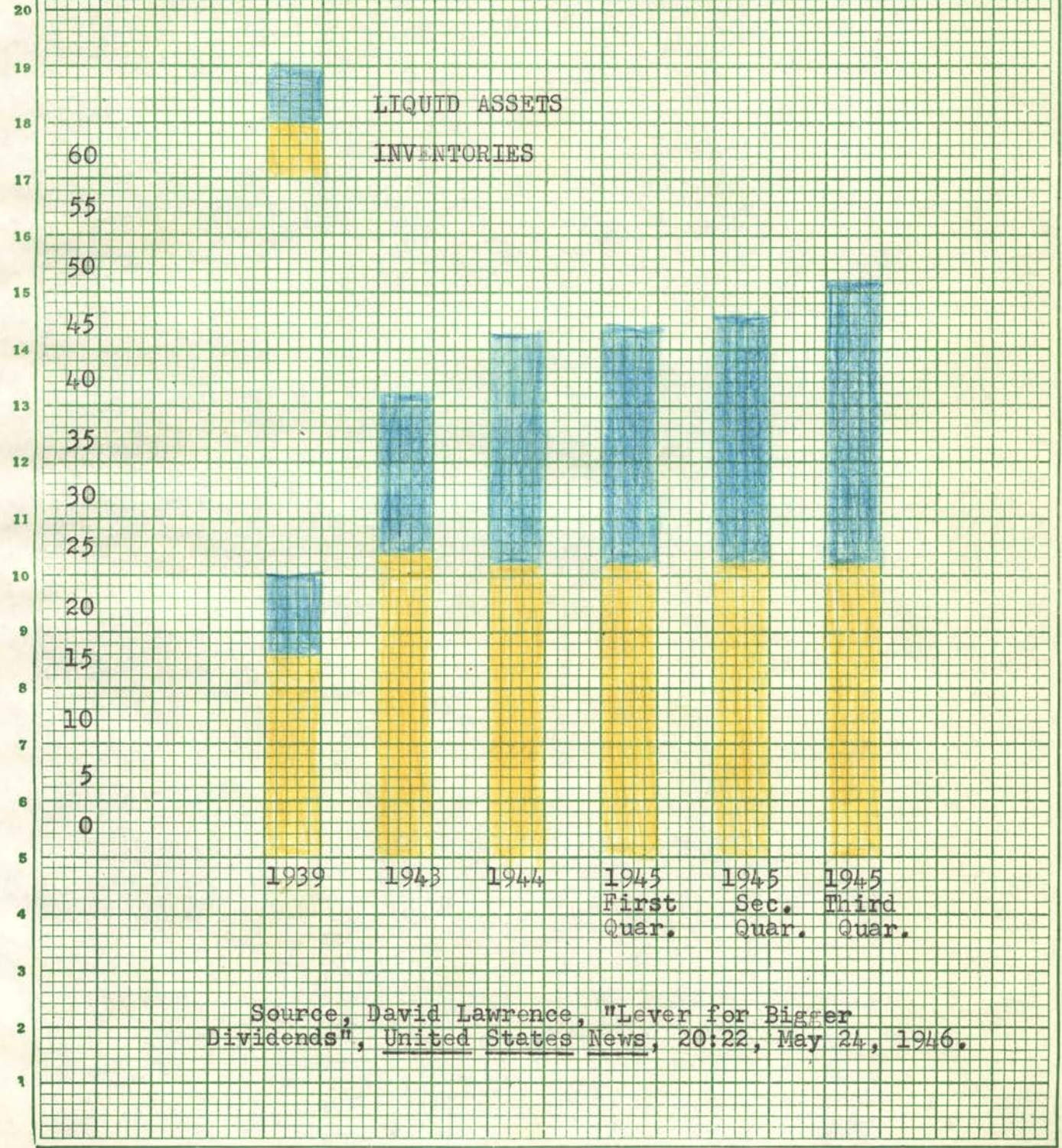
inventories held by corporations, in 1939, was 18,000,000,000, and has increased to 26,000,000,000, in 1946. Liquid assets have increased 385 percent from 1939 to 1946. The amount of corporation inventories increased nearly 150 percent for the same period. These statistics are the latest available data at the time of this writing. Sufficient data is already in the Treasury files to throw some light on this question. This reveals that United States corporations have more cash on hand, in the aggregate, than ever before in their history. The Treasury, thus, is likely to conclude that further cash accumulations are unwarranted, that earnings should go to stockholders in large volume and come within the grasp of the tax collector in that manner or be taxed under section 108.<sup>7</sup> Liquid assets of United States corporations was \$6,600,000,000 in 1939, the last peace-time year, which amount was sufficient to satisfy normal business needs. By the end of 1945, as shown in the Chart, liquid assets had jumped to \$25,000,000,000, almost four times the prewar amount. These assets consists chiefly of cash and Government bonds. Such holdings suggest to the Treasury that corporations probably have all the ready cash they need and that there is little reason for corporations to continue building reserves at such a pace. The Chart shows that in 1939 inventories were eighteen billion and liquid assets were about seven billion. At the end of 1945 inventories were twenty-six

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<sup>7</sup> David Lawrence, "Lever for Bigger Dividend: Tax Power over Reserve Profits," United States News, 20:22, May 24, 1946.



CHART NO. 1  
 THE INCREASE IN WORKING CAPITAL OF CORPORATIONS  
 (IN BILLIONS OF DOLLARS)



Source, David Lawrence, "Lever for Bigger Dividends", United States News, 20:22, May 24, 1946.

billion and liquid assets were twenty-five billion. The enormous increase in liquid assets in comparison with inventories demonstrate that corporations are now accumulating surplus beyond reasonable business needs. This condition seems to indicate that strict enforcement of Section 102 of the Revenue Law is desirable. However, many people contend that the economic conditions in our country warrant large amounts of liquid assets for business purposes. Expenses, and taxes require much cash to be retained. However, much of the liquid assets consist of Government securities that cannot be justified as necessary for ordinary business operations. This condition seems to indicate that strict enforcement of Section 102 is desirable. However, corporations would have to sell their Government securities, increasing spending and inflation. (Inflation probably should not be increased.) The unwarranted surplus accumulation tax, however, should be increased so as to do away with liquid assets that normally should be paid to shareholders in the form of dividends.

The study of the question of whether there are enough profits earned and retained by corporations so as to justify the rigid enforcement of Section 102 of the Revenue Law will be studied next. In Nineteen hundred and thirty nine, corporations earnings for the year were \$5,005,000,000, of which \$3,796,000,000 was distributed leaving \$1,209,000,000 as retained earnings. In nineteen hundred and forty six, corporations earnings were \$12,539,000,000, of which \$5,614,000,000 was distributed leaving \$6,925,000,000 as retained earnings.

Twenty five percent of all corporations profits were retained in 1939, as compared with fifty five percent in 1946. Many corporations today are retaining larger percentages of their earnings than during any previous periods.<sup>9</sup>

Many people hold contrary ideas about taxing corporate profits. An example of this view is that of Mr. Robert Driver, who wrote an article in the Saturday Evening Post, titled, "How Rich Are Our Corporations." He seems to be of the opinion that corporations are being taxed too heavily. He explains it is unfortunate that so many of us assume that a corporation has all the capital it needs and can pay higher wages, pay more in dividends or reduce prices because it has a lot of cash or a large surplus. He states that only in rare instances are those assumptions correct. Many corporations have been liquidated as bankrupts while they had more cash on the date of liquidation than they had during their successful years. Corporations need a vast amount of equity capital, but they will find it difficult to get as long as this type of capital is discriminated against. Income on equity capital is taxed sometimes three times by the Federal Government alone. Several States have income tax laws which levy a tax on dividends received by stockholders. If a corporation distributes its income, both the corporation and the stockholders are taxed. If the corporation is subjected to Section 102 of the Revenue Law, it would have to pay a larger percent of the income to the tax authorities

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<sup>9</sup> "Liquid Assets Estimate 1933-1946," Survey of Current Business, p. 20, July 1947.

Corporations are faced with the necessity of producing far more goods with less capital, and at this time it takes more capital than ever to operate a business. The success of corporations is only an indication of how well we are maintaining our standard of living and moving ahead to improve it. We depend upon corporations and modern industrial plants to maintain our high standard of living and prepare an adequate defense against possible enemies in the future. We cannot go on milking corporations if we refuse to feed them.<sup>10</sup>

Inflationary prices and wages have led to inflationary profits. But the decline in the purchasing power of profits has been lost sight of in the general discussion. A dollar does not have any more purchasing power for a company than it does for an individual. Reese Taylor, who was the author of the famous "controlled material plan" for the War Production Board has presented, in recent writings, some significant aspects of this problem. Mr. Taylor explains that the casual reader of the business pages of the newspaper cannot help but be impressed by the apparently high profits being reported today by a majority of the nation's leading corporations. In most instances the companies reporting these increased profits are retaining in the business a higher percentage of the profit figure than had been the custom in the past. This situation has led many individuals

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<sup>10</sup> Robert L. Driver, "How Rich Are Our Corporations?," The Saturday Evening Post, 220:76, December 27, 1947.

and groups to express concern over the possible effects such profits and such a dividend policy might have on the general economy. The main difficulty is that the figure marked "profits" does not represent money that management can distribute to the shareholders, since a portion of that amount must be retained in the company to continue its operations. A glance at any of the Department of Labor's commodity indices will suffice to prove that for the consumer the dollar today will not purchase as much as it did five, ten or twenty years ago. Wage and salary increases during the same period have more than equalled the rise in commodity prices. As a unit of exchange the dollar will purchase no more for a corporation than it will for an individual. The buyer of a new house or automobile realizes that today he must pay a greater number of dollars for his purchase than he did previously. Therefore the industry will have to pay more for its automobiles, buildings, machinery and so on as they become obsolete and worn out. These increased costs are amply documented by work now being done by the oil industry. Refinery equipment, which before the Second World War could be built at a cost of \$400 per barrel of capacity, now costs more than \$1,000 per barrel. Formerly a mile of pipeline could be laid for \$12,000; it now takes \$30,000 to do the same job. Replacing a barrel of oil lifted from the ground has reached the point where it requires almost three times as much money as it did only a few years ago. Because of these inflationary conditions current provisions for depletion and depreciation do not provide sums sufficient to meet this cost of doing

business. It is evident that a percentage of the profit dollar will have to be retained to furnish these replacements to the extent that the amounts representing recaptured depreciation costs are unable to do so. Business' bookkeeping procedures and the ruling of the Bureau of Internal Revenue do not take cognizance of the effect of today's inflationary condition on such reported profits. It may be that some companies reporting profits actually are liquidating their assets.<sup>11</sup>

However, many people hold that profits made by corporations as a whole are large enough to justify tax on the unwarranted accumulation of surplus. To combat such dangerous thoughts, the financial press is plugging the theme that current profits are largely illusory. Two factors are usually given for the support of the illusory current profits idea. First, altogether inadequate provisions are being made for the cost of replacement of fixed assets. Secondly, higher unit prices, which boost the value of year-end inventories, temporarily inflate profits. Discussing the first of these factors, the writers usually cite a case similar to the following. A manufacturer with plant and equipment costing \$10,000,000 before the last war cannot now replace it for less than twice that sum. He must, therefore, find \$10,000,000 over and above his depreciation reserves. In practice, many corporations--United States

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<sup>11</sup> Reese Taylor, "Profits, Too, Are Losing Purchasing Power," The United States News, 23:32-3, October 10, 1947.

Steel, du Pont, and General Motors are examples--are reporting profits after making provision for extra depreciation, not for tax purposes but to impress on stockholders the need for withholding dividends. But much of the plant and equipment now being installed takes the place of facilities purchased in the twenties when prices were much higher than in 1939 and in some cases nearly as high as today. And new machinery purchased today is not usually identical with that which is being discarded; much of it, presumably, is a great deal more efficient and more profitable to operate, even allowing for greater first costs. The suggestion that rising inventory valuations create an illusion of profits also bears further study. Actually, many corporations have largely eliminated inventory profits and losses by adopting the "Lifo" (last in first out) system of costing. Others, notable the big retailers, have set aside, before striking profits, large reserves against possible inventory losses. Corporations which have not taken such precautions may be hit by sharp price declines. However, most corporations now protesting have provided adequate reserves against losses by sharp price decline.<sup>12</sup>

Most corporations have generally made large enough profits as to be financially able to withstand the loss of assets by rigid enforcement of the surplus accumulation tax. Many corporations have reported large profits after provisions for unusual expenses and income tax. Idle profits are some times used for

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<sup>12</sup> Keith Hutchison, "Up, and Up, and Up!," The Nation, 165:532, November 15, 1947.

investment or expansion of business that are not necessary. The surplus accumulation tax, if increased, would tax idle profits and thus prevent, so to speak, profits from being wasted by overinvestment in plant. By transferring such profits to the government, the public would benefit, probably, more than it would if profits were retained by the corporations.

The question of using the surplus accumulation tax to stop the concentration of economic power is, at least, an interesting thought. Some writers contend that consolidations should be fostered. Concentration, to them, seems to be a good thing, but they would regulate such concentration so as to operate in the interest of the public. Mass production methods can be best employed when industries are more concentrated. Under concentrated conditions, therefore, more goods could be produced for the benefit of the public.

If competition is to be promoted, concentration of economic power will have to decrease. There is a worldwide movement toward consolidation in every industry. Some statistics will well illustrate this contention. These statistics are based upon the year 1932; abnormal times of later years would somewhat complicate the picture, but fundamentally the relationships are largely the same. In the manufacture of automobiles two companies, out of a total of nearly 200 engaged, account for 61 per cent of the total output. In the meat-packing industry, in which over 1,200 corporations were engaged, the two largest do 60 per cent of the total business. In the production and refining of petroleum, one of American's largest industries, 87 per cent of



the business is controlled by four companies. Out of 486 steel companies, five account for 75 per cent of the combined investment. In the manufacture of soap and soap products, three companies, out of a total of over 250, do 92 per cent of the business. In the refining of sugar, 8 per cent of the refineries do 89 per cent of the business. There are 60,000 telephone systems reported by the United States Census, yet 89 per cent of this country's telephone business is handled by the 23 associated companies of the Bell System. The trend of concentration of capital in the major industrial fields is increasing with time.<sup>13</sup> During World War II, the concentration of economic power in America was stepped up another notch. Perhaps it would have stepped up still more were it not for the constant resistance of liberal forces, chiefly the Small Business Committee. The Small War Plant Corporation reported to the Senate Small Business Committee that before the war, 250 corporations controlled two thirds of our total production and almost without exception what the big companies hold is the newest plant. Since 1943 there has been a new wave of mergers in many industries that previously had been more or less free. On the other side of the picture, the total number of independent business (other than farm and professions) fell to 2.8 millions in 1943, and by April, 1946, had recovered to 3.3 millions. By the end of 1946, the figure was reported as over 3.6 millions, the

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<sup>13</sup> William Hodges, "Defense of the Holding Company," Annals Of American Academy Of Pol. And Soc. Science, 159:7:14, Jan., 1932.

largest number of independent establishment in our history, being mostly one-man businesses.<sup>14</sup> This increase in small businesses took place while the surplus tax was not being strictly enforced. These statistics demonstrate that the concentration of economic power has been increasing. Many corporations have used their idle surplus to buy controlling interest in other companies, thereby increasing concentration of economic power. Another way of increasing concentration of economic power is for business to use idle surplus to expand their economic activity. By taxing surplus away from corporation, it seems logical that rate of concentration of economic power will decline. However, this method alone will not stop or decrease the rate of concentration of economic power. We feel, that in our economy that there are forces that tend to promote concentration of economic power. The rigid enforcement of the unwarranted accumulation of surplus tax would probably lessen the rate of concentration of economic power in our economy.

In summary, corporations have tried to increase spending that would be deductible on the income tax return and yet be of considerable value to the business in future years. Most notable example being increased advertising. The effect of the tax upon surplus accumulation upon different types of business seems to operate to the detriment of the small growing business. Tax relief seems to be desirable for growing business.

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<sup>14</sup> David Coyle, "The Big Cannot Be Free," Atlantic Monthly, 179:78, June, 1947.

Section 102 of the Revenue Law should be enforced more rigidly for three reasons. First, corporations have too much liquid assets. The unwarranted surplus accumulation tax should be increased only to do away with liquid assets that normally should be paid to shareholders in the form of dividends. Second, profits are large enough so as to justify more rigid enforcement of Section 102. Business have argued that profits are large, but that they aren't too large, because purchasing power has declined. This argument can be met by explaining that new equipment costs are high, but the company isn't replacing the same productive unit. The unit generally is much more productive and efficient than the replaced unit. After considering all factors, unit cost per produced unit is lowered with the use of new equipment. Third, the tax should be enforced more rigidly to stop concentration of economic power. The rigid enforcement of the unwarranted accumulation of surplus tax would probably lessen the rate of concentration of economic power in our economy.

## CHAPTER IV

POSSIBLE METHODS OF ATTACKING THE SURPLUS ACCUMULATION  
PROBLEM

In chapter one, it was shown that there are certain economic arguments against the accumulation of surplus by corporations. It was also shown that this is one of the ways that certain wealthy individuals can and do escape paying some income taxes. The laws taxing unwarranted surplus accumulation and other laws previously discussed were passed for economic as well as for tax purposes. At least those who supported such laws used the economic arguments as partial support for the tax. Perhaps the chief reason for the laws was simply to get the tax revenue.

The problem still exists. Present laws have not solved the problem with complete satisfaction to all concerned. And, if wealth and the control over business becomes more concentrated in the hands of a few, the problem will become more intensified. It seems possible that the above concentration may continue if dividend policies are unregulated.

How, then, shall the problem be attacked? Three lines of procedure appear to be possible: first, discontinue all such form of regulation as are now in effect and let normal business and economic forces operate; a second possibility is that of increasing the provisions of Sections 102, 500, 501, and 504

of the present Revenue Law; a third line of attack is to try some new form of regulation.

The first method--that of letting normal forces of a free economy operate is the simplest to do, but probably would not remedy the situation. Such procedure would appeal to the disciples of Adam Smith. In the United States, we feel that under free competitive conditions the economic forces work for the maximum benefit of all. Adam Smith was of the opinion that in a free competitive economic system there is a guiding hand at work causing goods to be produced in such way as to give the maximum benefit to society. He felt that under free competitive conditions, economic forces tend to allocate commodities equitable among those who may rightfully claim to goods produced. But we have not found this to be entirely true. Instead it appears that, under free economy, there is a tendency toward the development of monopolies. Under monopolistic conditions, economic forces are controlled by some segments in the economy which cause wealth to be allocated inequitably. These segments acquire control of the economic forces so that they obtain goods that do not rightfully belong to them, and by so doing they take goods away from those who are entitled to have them. Sometimes management, at other times labor, may acquire control of such economic forces and may be able to obtain profits which are not rightfully theirs. Because of the forces that check the incorrect allocation of profits, controlled by monopolistic forces, the problem of surplus remains. The accumulation of surplus is the effect of the

ill-working economic forces in our modern economy. By correcting the ill-working economic forces, the economic problem of surplus accumulation will disappear. Most economic systems of the World, before our Civil War period, were free competitive systems in their entirety. After the Civil War, many nations steadily drew away from the nearly free competitive systems to a more controlled economy. Concentrated economies have developed into partial monopolistic systems until today many of the major nations of the World have partially monopolistic economies. Since our economy is partial monopolistic, a solution which allows the free play of economic forces does not seem to be feasible. It would not solve the economic problem involved in surplus accumulation. Neither would it solve the tax problem. Corporations would be free to retain profits in order to save stockholders taxes without fear of government interferences. Shareholders self interest would dictate the policy, to the Board of Directors, of managing earnings so as to cause the least amount of taxes to be paid by the stockholder.

Another possible method of trying to solve the problem is to increase regulations used in Section 102, 500, 501, and 504 of the Revenue Law. If the profits which had accumulated were transferred to the government for the benefit of the general public, most ill-effects of the accumulation problem would be lessened. No doubt these sections have reduced the unfavorable economic effect of surplus accumulation and the loss of revenue by causing more dividends to be paid; or if not paid the tax is collected. One thing that must be remembered is that

the surtax levied by Section 102 does not require immediate payment of a corporate taxpayer, but may be assessed by the Bureau of Internal Revenue some two or three years after the taxable year when the income return is audited. Thus the Bureau has the advantage of several years' hindsight. Although there have been a number of court decisions covering this section of the law over a period of years, there have been comparatively few rulings since the end of the second World War. Nevertheless, we have enough information in the way of Bureau pronouncements and cases to attempt the evaluation of the effect of Section 102. The effect has been that management has undoubtedly declared more dividends than they would have declared, had there been no law governing the unwarranted accumulation of surplus. The Treasury Department has the power to require every corporation to file an information return, to explain each item and to indicate why their earnings were retained. If the Treasury Department does not feel that the explanation is reasonable, the corporation is liable to assessment by the Treasury Department. One of the unusual features of Section 102 is the way in which the responsibility of tax payments is placed entirely upon the shoulders of the taxpayer. The Statute states:

The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholder unless the corporation by clear preponderance of the evidence shall prove to the contrary.

The Treasury Department will give close attention to determine whether or not Code Section 102 is applicable to the following:

1. Corporations not having distributed at least 70% of their earnings as taxable dividend.
2. Corporations having sums advanced to officers or shareholders in forms of loans from the undistributed profits or surplus of which taxable dividends might have been declared.
3. Corporations having invested earnings in securities or other properties unrelated to their normal business activities.
4. Corporations--a majority of whose stock is held by a family group or other small groups of individuals, or by a trust or trusts for the benefit of such groups.
5. Corporations, the distributions of which, while exceeding 70% of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

The Treasury Department has been very liberal in the enforcement of the tax payment. One reason for such liberality may be because of the resistance put forth by wealthy interest. The Collectors of Internal Revenue have enjoyed more success in administering the tax upon personal holding companies. These sections have enjoyed considerable success and should be enforced more rigidly. The income tax angle of the surplus accumulation problem has been partially solved by these sections of the Revenue Law. But the economic angle of the problem remains entirely unsolved. What is needed to solve the economic angle of surplus problem is legislation taxing every



corporation's surplus. Therefore, other provisions should be enacted supplementing these provisions if the surplus accumulation problem is to be solved.

The third method of attacking the surplus accumulation problem is to try some new form of regulation. Since neither of the above described methods completely solve the problem, other methods seem desirable. Instead of being one thing this is broken down into three plans for the purpose of our discussion, which are: the British plan, the partnership plan, and the tax on undistributed profits.

The British have developed a plan for avoiding double taxation of corporate earnings which will avoid the problem of accumulation of surplus. In recent years, under the British plan, the corporations pay an income tax at the "standard rate" of 50% of net income. Personal income is also taxed at 50% of their taxable income. Dividends received by the shareholders are not subjected to the income tax. This plan has the advantage of taxing income from all sources at the same rate, whether it be income from corporations or from other sources. The exemption for the taxpayer will normally be large in order to counteract the violation of the principle of taxing according to the taxpayer's ability to pay. A plan similar to the British system has been proposed in the United States of America but never has been adopted. It is known as the "withholding approach". Under this proposal, the corporate tax would be regarded as a withholding tax paid by the corporation on behalf of the shareholders in the ratio in which the

dividends paid are to the net earnings of the corporations. Under this plan, corporations could not withhold profits for the purpose of saving shareholders taxes. Corporation retained earnings would be taxed at the same rate as personal income, therefore, there are no chances of saving taxes by retaining earnings. The arguments against both plans are approximately similar. The main argument against such tax is that taxpayers are taxed at the same rate regardless of their ability to pay. A personal income of \$100,000 will be taxed at the same rate as an income of \$2,000, after exemption for the taxpayer. The people in the lower income group will suffer much more than the higher income groups. The exemption for the taxpayers will normally be large for each dependent in order to counteract the violation of the principle of taxing according to the taxpayer's ability to pay. The British have had considerable success with their plan, but it probably will not be adopted in this country. This plan faces the problem of surplus accumulation, but it violates the principle of taxing according to the ability to pay, which is serious enough to defeat such a tax plan.

Another plan which has received considerable attention is referred to as the "partnership method". Under this plan, all corporate income, whether distributed or not, would be taxed through the shareholders just as though they were partners. If the corporation is nothing more than a legal fiction, this is the ideal plan. Each person would be taxed on all of his earned income whether distributed to him or not. Under this plan, no tax would be imposed on the corporation, but stockholders would

be required to include in their incomes the undistributed, as well as the distributed earnings of the corporation. The only profits with the respect in which no tax is paid, would be those which are paid or allocable to exempt individuals or exempt institutional recipients. The partnership approach accomplish the complete integration of corporation and individual income taxes by eliminating the corporation tax. The problem of the evasion of taxes by the retention of earnings would then be eliminated.<sup>1</sup> Many stockholders will not have enough cash for the payment of the tax upon their share of corporate earnings not distributed by the corporation. When one has to pay tax upon income he does not receive, he will exercise every possible means of obtaining the income in the form of dividends. There are, however, two major difficulties with this approach. First, there is the matter of treating a small stockholder of General Motors or of American Telephone and Telegraph stock as though he were a partner (which he clearly is not). Can or should such a stockholder be taxed on income which he has not received, and which cannot be forced from the corporation, and which may not even be reflected in the price of his stock? Furthermore, will it be possible to administer a law which requires the Bureau of Internal Revenue to follow each dollar of corporate profits through to the individual

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<sup>1</sup> Gordon E. Keith, "The Corporation in the Tax System," The Commercial and Financial Chronicle, 163:3233, June 13, 1946.

stockholder in order to make sure that it was correctly reported on his tax return? Until satisfactory answers can be found to these questions, the partnership plan cannot be regarded as a practical or general approach to the corporation tax problem.

Some propose that in order to correct the problem, corporations should be granted a deduction from taxable income for dividends paid. The corporation would be taxed only upon earnings retained as surplus by the corporation. The general corporate income tax would be discontinued. Shareholders would be taxed upon dividends when received. The main differences in this plan from the undistributed profits tax is that general corporate income tax is eliminated. During the years 1936 and 1938, we had an undistributed profits tax. This tax was repealed by Congress as unworkable and undesirable. The undistributed profits tax meets the problem squarely and is simple and effective. However, there is some criticism to the plan. It would affect managements business decisions. Retention of earnings is penalized by the tax, and the rate of such tax normally will be high to prevent tax avoidance by such a retention. The tax becomes a penalty on business development and expansion, and is especially harsh on small and growing corporations with small capital resources, and upon those which must retain a substantial share of earnings for legitimate growing purpose. New tax based upon retained earnings will be criticised for the above reasons. However, this plan will remedy the surplus accumulation problem if enacted.

In summary, we have studied three possible methods of attacking the surplus accumulation problem. First, is discontinuing the regulation and let normal forces operate. Our economy is partial monopolistic, and therefore this method will probably not work. Second, is to increase the provisions of Sections 102, 500, 501, 504, of the Revenue Law. Other provisions should be enacted to supplement these provisions, if the surplus accumulation problem is to be solved. Third, is trying some new form of regulation of the accumulation of surplus. Example of the new forms of regulations are: the British plan, the partnership plan and the tax on undistributed profits. New forms of regulations are desirable and worthy of consideration.

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Typist:

Elizabeth J. Kerby