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REVENUE ACT, 1936

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

SEVENTY-FOURTH CONGRESS

SECOND SESSION

ON

H. R. 12395

AN ACT TO PROVIDE REVENUE, EQUALIZE TAXATION
AND FOR OTHER PURPOSES

PART 1

APRIL 23, 24, and 25, 1936

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REVENUE ACT, 1936

THURSDAY, APRIL 23, 1936

UNITED STATES SENATE,
Committee on Finance,
Washington, D. C.

The committee met in executive session pursuant to call, at 10 a. m., in Senate Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, George, Walsh, Barkley, Connally, Bailey, Byrd, Lonergan, Black, Gerry, Couzens, Keyes, La Follette, and Capper.

Also present: Hon. Henry Morgenthau, Secretary of the Treasury; Herman Oliphant, General Counsel for the Treasury Department; Guy T. Helvering, Commissioner of Internal Revenue; Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue; George C. Haas, Director of Research and Statistics, Treasury Department; A. S. McLeod, Statistician, Treasury Department; C. E. Turney, Assistant General Counsel for the Treasury Department; L. H. Parker, Chief of Staff, Joint Committee on Internal Revenue Taxation and members of his staff; Middleton Beaman, Legislative Counsel, House of Representatives.

The CHAIRMAN. The committee will come to order.

Mr. Helvering, will you take the stand? Just proceed with an explanation of the provisions that were put in the bill by the House.

Mr. HELVERING. You have copies of the bill there, I understand?

The CHAIRMAN. Gentlemen of the committee, it has been called to my attention that there are two prints of the bill before us, and it is suggested by the clerk of the committee that the one called the revenue bill of 1936, the comparative print, showing the changes in the law, is probably the best for us to follow in this discussion.

Senator COUZENS. Is that your opinion, Mr. Helvering?

Mr. HELVERING. That is a comparative print of the bill.

Senator COUZENS. Do you think that is the best one for us to follow?

Mr. HELVERING. I think it will show, Senator—

Senator COUZENS (interposing). The changes?

Mr. HELVERING (continuing). The changes more definitely, than the straight roman type, which is the print as introduced in the House.

Senator COUZENS. I assume you are only going to discuss the changes now, and not the old law; is that right?

Mr. HELVERING. That is all, yes.

Now, Mr. Chairman and gentlemen of the committee, there are three specific major problems presented here.

The greater of these three in importance of course is the change in the corporate earning tax.

On page 14 it carries out the provisions of this new arrangement on the type of corporate income. And you will notice commencing at the top of page 14 we provide in this bill for the cancelation of the present taxes on a corporate income.

Senator COUZENS. You mean the repeal of the existing law on the taxes?

Mr. HELVERING. How is that?

Senator COUZENS. You mean the repeal of the existing law on the taxes?

Mr. HELVERING. Yes.

Senator BARKLEY. As I understand it, the language in this comparative print through which a line is stricken is the old law?

Mr. HELVERING. Yes.

Senator BARKLEY. And the italics are the new law?

Mr. HELVERING. Yes.

Senator WALSH. The law of last year, is it not?

Mr. HELVERING. Of course, that is stricken out. It will only have reference to the years after this becomes effective. That will remain in effect for the years before.

Senator COUZENS. Yes.

Mr. HELVERING. Now, I am not advised, Mr. Chairman, just whether you want to ask questions about this bill or what you want to do.

The CHAIRMAN. You go ahead and explain it. Explain just what the changes are.

Mr. HELVERING. In the first instance, the changes are based on the distribution of corporations, using the distributions as a yardstick, or as a retention as a yardstick, to measure the tax.

In order to adjust this tax bill so it would affect small corporations and large corporations equitably we have designed two tables of corporate tax.

First, in those corporations with incomes of \$10,000 or less.

The CHAIRMAN. That is on profit?

Mr. HELVERING. Yes.

The CHAIRMAN. Net profit?

Mr. HELVERING. Yes; adjusted net income.

The CHAIRMAN. Yes.

Mr. HELVERING. And in another table are those where we have adjusted net incomes in excess of \$10,000.

Then, so as not to have a big jump from the \$10,000 to those above \$10,000 we have adjusted that by a table that will smooth off and work a harmonious incline on the tax applied for these corporations.

In other words, I might say a corporation having \$10,000 might be adjusted under table 1. Then if it had \$10,500, it would jump into a higher tax rate, so we have made a table on what we call the straight-line method. An income of \$11,000 is computed on the two tables, therefore it would give a man with \$11,000 as compared with \$10,000, a comparative tax on the \$11,000.

The CHAIRMAN. That table is found on page 16, is it not?

Mr. HELVERING. Yes.

Senator KING. You have, as I understand it, a schedule I-A, adjusted net income of \$10,000 or less?

Mr. HELVERING. Yes.

Senator KING. Then if the adjusted income was \$10,001 or \$10,002, and \$10,500, then you would jump into the other table?

Mr. HELVERING. Yes; but we give them the privilege of computing on the basis of both tables, so as not to make a man coming along at \$10,000 jump up to \$11,000 and put him into the higher brackets.

Now, Table 1, on page 16, has to do with those who compute their income on retention; that is, if a corporation can say, "We are going to retain 20 percent", this table applies to those. They can look at this table and immediately know what the tax is going to be.

Senator COUZENS. In other words, they compute their own tax?

Mr. HELVERING. Yes.

Senator COUZENS. And that is the danger to your income.

Mr. HELVERING. For instance, on that table you see 10-percent retention, and the tax would be 1 percent on the small corporations.

The CHAIRMAN. I do not understand that. I would like you to explain that. I did not understand those tables. On page 16 you have got columns 1, 2, and so forth, three different columns. Explain what all that means.

Mr. HELVERING. For instance, a corporation has an adjusted net income of \$10,000. They say "We are going to retain in our reserves 10 percent, or \$1,000.

Senator KING. And distribute the \$9,000 as dividends?

Mr. HELVERING. Yes.

Senator KING. Yes.

Mr. HELVERING. Then the rate of tax on that would be 1 per cent on the total adjusted net income; in other words, \$100.

Senator COUZENS. May I suggest the experts back there did not seem to agree with your answer to Senator King? Have you understood his question? This is frequently going to be referred to, and I think you might be sure you gave the correct answer there.

What was the question Senator King asked?

Senator KING. The question was this: Supposing that a corporation had a net income of \$10,000, and the officials determined to distribute \$9,000 of it as dividends, and reserved \$1,000 for reserves. Then the tax would be on the \$1,000 rather than on the \$9,000 which had been distributed?

Mr. HELVERING. Now, if you want to refer to table no. 2, that would be a 90-percent distribution. The ratio is 0.9091.

The CHAIRMAN. Is that on page 18?

Mr. HELVERING. Yes.

Senator BARKLEY. Let us get clear up to table 1 before we get to table 2.

For instance, if a corporation decided to retain in its treasury a surplus—we will jump down from the top of column 1—10 percent of its net earnings, or adjusted net earnings, then the tax on that 10 percent would be 1 percent in column 2, would it not?

Mr. HELVERING. The tax on what?

Senator BARKLEY. On the 10 percent it keeps in the treasury and does not distribute. I am taking the 10 in column 1 as an example instead of the one at the top. You go on down to 70?

Mr. HELVERING. Yes.

Senator BARKLEY. In your table here; but let us take 10 there in column 1 to the left. If the corporation decides to retain as undistributed earnings 10 percent of its adjusted income, then the tax on that 10 percent retained, would the figure that is set out opposite to that in column 2, being 1 percent, is that correct?

Mr. HELVERING. One percent on the adjusted income?

Senator BARKLEY. One percent on the 10 percent they keep.

Mr. PARKER. No; 1 percent of the whole net income.

Senator BARKLEY. That is confusing. That is not what it says in the language. It says:

If the undistributed net income equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Mr. PARKER. The percentage of the adjusted net income, not the percentage of the undistributed net income.

Senator COUZENS. No; that is where your difference is, Senator.

Mr. PARKER. The rates shown in the table apply to adjusted net income, which is practically the net income. Adjusted net income is simply net income less Liberty bond interest.

Senator BARKLEY. That is on the theory that the corporation pays the whole of the tax. And as to the shareholder who gets the income, how does your bill operate on the distributed income? Do you levy tax on total net income, or is the distribution subtracted from the net income in order to get this adjusted net income referred to?

Mr. PARKER. No, Senator. The adjusted net income is computed practically the same as it is now.

Senator BARKLEY. Yes.

Mr. PARKER. Except we take off Liberty bond interest. The word "adjusted" mean that Liberty bond interest has been subtracted from net income.

Senator BARKLEY. I understand. So that the shareholder who gets a distribution pays an income tax on that income under this bill and the corporation also pays a tax on it?

Mr. PARKER. It pays no tax if it distributes all of the income. It pays tax at the rate of zero percent.

Senator BARKLEY. If it only distributes part of it you tax all of it?

Senator KING. Is that true?

Mr. PARKER. When this bill and these rates were first discussed, we had a schedule of rates that applied to just the part of the income that was not distributed, but those rates of course were higher. And the Ways and Means Committee decided to accomplish practically the same result by stating the rates in terms of the net income. So that with these rates to get the tax you apply them to the adjusted net income. If you wanted to adopt the other method and just apply your rates to the undistributed income you could accomplish practically the same result, but you would have to have much higher rates.

Senator BARKLEY. I understand; but I am trying to get this table in my mind where under this bill then after you have made deductions for Government bonds, obligations and things, you arrive at your net adjusted income and if all of it is distributed the corpora-

tion pays no tax on that at all, but it is paid by the individual shareholder. If only half of it is distributed then you charge these rates on the whole adjusted income of the corporation, and then the shareholder when he gets his part pays his tax on that too.

Mr. PARKER. That is right; but the rate the corporations pay will depend on the amount distributed.

Senator BARKLEY. Yes.

Mr. PARKER. Or on the amount retained, either way you want to put it.

In your example you assumed a \$10,000 net income and the corporation puts \$1,000 to surplus. You look in your table and you find a rate of 1 percent.

Senator KING. On what?

Mr. PARKER. One percent of \$10,000.

Senator KING. Yes.

Mr. PARKER. One percent of \$10,000 is \$100.

Therefore, you have \$1,000 in surplus, you have \$100 tax, and the other \$8,900 is to be distributed in dividends.

Senator BARKLEY. In other words, if the net income is \$10,000 and all of it is distributed the Government collects tax on that \$10,000 from somebody. And if they distributed only \$1,000 and kept \$9,000 in the treasury the Government collects tax on \$19,000?

Mr. PARKER. No, Senator; not exactly that.

Senator BARKLEY. No; I mean on \$11,000.

Mr. PARKER. Yes; \$11,000.

Senator BARKLEY. The Government collects on the whole \$10,000 plus \$1,000 that is distributed?

Mr. PARKER. That is right. And the rate will be high in such a case, because we get very little tax out of the stockholder on account of so much being retained.

Senator BARKLEY. What I am trying to get clear in my mind—

Senator KING. Pardon me, Senator. This is probably a duplication of what you have in mind. Assume a corporation has a net income of \$100,000 and it determined to set aside \$50,000 for reserves, and to distribute \$50,000 in dividends to its stockholders—

Mr. PARKER (interposing). Right there, excuse me, Senator, you are making an impossible case. It is impossible to retain \$50,000 and declare \$50,000 out in dividends, because you have got the tax to consider.

It is just like this: The adjusted net income will always equal the dividends, plus the tax, plus the undistributed net income. Those three elements have got to equal your income.

Senator COUZENS. While you are giving that illustration, just tell us how that would work out on a hundred-thousand-dollar income.

Mr. PARKER. A hundred-thousand-dollar income?

Senator COUZENS. Yes.

Mr. PARKER. And the Senator said he wanted to retain \$50,000 surplus?

Senator COUZENS. Yes.

Mr. PARKER. That takes you into schedule II, because that is a high amount.

Senator COUZENS. That is on page 18?

Mr. PARKER. No; that is schedule I-A. You want schedule II-A. **Senator COUZENS.** On page 21; yes.

Mr. PARKER. Now, the corporation had \$100,000 net income and retained \$50,000. Look down column 1 and find 50 percent, and opposite in column 2 you will find 35 percent, and that is the rate of the tax. That 35 percent applies on the whole \$100,000, so the tax is \$35,000. And you have got the \$50,000 surplus, and \$35,000 tax, and therefore \$15,000 must be paid in dividends.

Senator COUZENS. That is clear.

Senator BYRD. Suppose, **Mr. Parker**, he paid that tax out of an old surplus, an existing surplus? Could he not do that and still declare it a dividend?

Mr. PARKER. Under existing law, dividends are presumed to be paid out of the most recently accumulated earnings. The amount of the corporate tax will be computed from the table in schedule II-A automatically and mathematically; under this bill the undistributed net income will have to be a certain amount, depending on that amount of dividend distribution.

Senator KING. The tax would be as heavy on the capitalization of \$10,000,000 in good faith, bona-fide capitalization of \$10,000,000 as upon \$1,000,000, providing the net income of \$10,000,000 was no greater than the net income of the \$1,000,000.

Mr. PARKER. That is right.

Senator KING. It makes no difference.

Mr. PARKER. The capitalization question has nothing to do with the amount of tax under this bill.

Senator KING. You are penalizing the big corporations where there is a large capitalization bona fide, where it has large assets, large capitalization, and has no greater income than the small corporation, and you are going to tax it just the same?

Mr. PARKER. Yes; tax it just the same.

I do not think it penalizes the big corporation. It does not penalize them when they only make a small amount.

Senator KING. You are penalizing, however, the stockholders, because they have invested say \$10,000,000 in a corporation, and they get less, very much less than the stockholders of a \$1,000,000 corporation.

Mr. PARKER. That is true. But of course the stockholders cannot very well get more than the corporation makes. And if a \$10,000,000 corporation only makes \$10,000 they will get the advantage of this low-rate schedule I instead of the high-rate schedule II.

Senator BARKLEY. Let us take the \$100,000 adjusted net income of **Senator King's** illustration. On page 18 the second column 1 where it says 50 percent that means if there be a 50-percent distribution then the tax on the whole hundred thousand would be 11.98 percent?

Mr. PARKER. Yes, sir. The question can be approached from two angles. First you said you wanted to put \$50,000 in surplus. Now, as I understand it you want to figure on what the tax would be if you wanted to distribute \$50,000 in dividends.

Senator BARKLEY. That is what I understand, that the corporation makes \$100,000, distributes \$50,000 in dividends, and retains \$50,000 in surplus.

Mr. PARKER. His example was a retention of \$10,000 in surplus.

Mr. BEAMAN. Senator, may I interject right there? Under this bill, you cannot pay \$50,000 in dividends and retain \$50,000 in surplus, as the tax has to come out of that \$100,000.

Senator BARKLEY. That is true.

Mr. BEAMAN. And that is a substantial amount of tax.

Senator BARKLEY. You are being technical.

Mr. BEAMAN. You cannot compute the tax without being technical.

Senator BARKLEY. We want to find out what these tables mean. Of course, you cannot do that.

In order to find out what this table means, if they distribute \$50,000 out of the \$100,000 that is 50 percent distribution under column 1.

Mr. BEAMAN. On what page, Senator?

Senator BARKLEY. Page 18.

Mr. PARKER. Page 18; yes.

Mr. BEAMAN. That is schedule I. It does not apply to incomes of \$100,000. That would be true if you have a net income of \$100,000.

Senator BLACK. What does this column on page 18 refer to, what income?

Mr. BEAMAN. Which income, Senator?

Senator BLACK. All of them on page 18.

Mr. BEAMAN. That is schedule I-A relating to adjusted net incomes of \$10,000 net incomes or less.

Gentlemen, you will get the picture if you will just let me read it. It is about as simple as it can be. What I am now about to read is just about as simple a thing as was ever put in a tax bill.

Senator BARKLEY. Let me ask you this question: Get over on page 22. Where there is a 50 percent distribution then the tax on the whole income would be 15 percent, is not that right?

Mr. BEAMAN. That is right. And you have left the difference to pass to surplus of \$17,500.

Senator BARKLEY. Of course, you have to take the tax out.

Mr. BEAMAN. You have got to pay some to the Government.

The CHAIRMAN. All right, Mr. Beaman, tell us what these tables mean.

Mr. BEAMAN. I say if you will just let me read on page 15 then it is perfectly clear, and when you do read it I think you can understand it. On page 15, line 2, it reads:

There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

Senator GERRY. What do you mean by "adjusted." What does that show?

Mr. BEAMAN. That is with the ordinary Liberty bonds interest taken out.

Senator BYRD. At that point, do you allow depreciation off?

Senator GERRY. Does that allow depreciation off?

Mr. BEAMAN. The net income is the same as under the present law. You see the important change made in this bill is the change in the method of taxing the corporation and taking away from the individual his credit, for the purpose of normal taxes, of dividends received, and taking away from corporations who receive dividends the deduc-

tions now given them in computing their income. In other words, all dividends are taxable, and that is one of the significant changes in this bill.

Now, it reads:

There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

(1) **ADJUSTED NET INCOME \$10,000 OR LESS.**—If the adjusted said income is not more than \$10,000 the tax shall be computed on schedule I or, at the option of the corporation, under schedule I-A (the tax being the same under both schedules).

It seems to me nothing could be simpler than that.

When you get over to schedule I and I-A you may have some trouble.

(2) **ADJUSTED NET INCOME MORE THAN \$10,000.**—If the adjusted net income is more than \$10,000 the tax shall be computed under schedule II or, at the option of the corporation, under schedule II-A (the tax being the same under both schedules;) except that if the adjusted net income is less than \$40,000 and if the tax would be less if computed under schedule III, then the tax shall be computed under schedule III.

I do not think any words could be plainer than that. That tells you what to do. You turn to those schedules and then you have the troubles you have adverted to.

Senator GERRY. What does this first column refer to—2,000 or 3,000, on page 16?

Mr. BEAMAN. Senator, there again you cannot understand the table without reading what comes in front of it at the bottom of page 15:

If the undistributed net income—

which is a defined term defined on page 14—

equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

There does not seem to be any ambiguity in that.

Senator COUZENS. That is quite clear, but I am still confused about the issue which was raised by Senator King. I think it is an important issue.

If a corporation has \$10,000,000 invested and makes \$100,000 it pays the same tax as a corporation with \$100,000 capital which makes \$100,000.

Mr. BEAMAN. That is true.

Senator COUZENS. You take away from the \$10,000,000 corporation on the \$100,000 income the same percentage as you would from the \$100,000 corporation showing a \$100,000 profit, is that correct?

Mr. BEAMAN. That is correct. In that respect it is just like the present law that taxes a corporation from 12½ percent to 15 percent, 15 percent on the amount over \$40,000, whether that be \$41,000, or \$41,000,000.

The CHAIRMAN. In other words, now they pay on the net income, and they would pay here on the net income.

Mr. BEAMAN. Regardless; that is right.

But the important thing I wanted to emphasize, Senator Barkley, is that you cannot use schedule I or schedule II and assume that you can take your net income and, say, 30 percent to surplus and 70 percent to dividends, or 20 percent to surplus and 80 percent to

dividends, and you just cannot do it because you have got to take the tax out.

Senator BLACK. Where do you find I-A and II-A?

Mr. BEAMAN. Immediately following the statement of law I read on page 15 there follows schedule I, and that is followed by schedule I-A.

Senator BARKLEY. On page 17?

Mr. BEAMAN. Page 17. And then following it schedule II. And on page 19 following it schedule II-A.

Senator GERRY. Why should not they be labeled under the different schedules? It would be a lot easier to refer to.

Mr. BEAMAN. They are labeled. Page 15, line 10, says:

Adjusted net income of \$10,000 or less based on undistributed net income.

Page 17, line 17, says:

Adjusted net income of \$10,000 or less based on dividend credit—

And so on. Each one is labeled.

Senator GERRY. I see.

The CHAIRMAN. Suppose you give us an illustration on each one of these schedules now, Mr. Commissioner.

Mr. HELVERING. I did not understand you.

The CHAIRMAN. Under each one of these schedules nos. I and I-A, II and II-A, give us an illustration.

Senator COUZENS. Have you any worked out mathematically?

Mr. HELVERING. No; I have not.

Mr. PARKER. There are some examples in the House report.

The CHAIRMAN. Do we have the House report?

Senator COUZENS. Yes; we have. On what page, Mr. Parker, are those examples?

Mr. PARKER. Beginning on page 5 it says, "First method", and there are three examples on page 6, examples (1), (2), and (3). And there is another example on page 7 down at the middle of the page.

Senator COUZENS. I do not think there is much use of going all over that if it is in the report.

Senator GERRY. I do not understand the report.

Senator COUZENS. If you do not understand the report you won't understand the statements of the experts.

Mr. PARKER. We can figure it out as an example on the blackboard if you think it will be more understandable.

The CHAIRMAN. Proceed, Mr. Helvering.

Mr. HELVERING. Taking the adjusted net income, it is computed exactly as it is under the present law. We take that after all the deductions for depletion and obsolescence just the same as we do now, which is quite an item, of course.

Then, applying these schedules the distribution is simply the yardstick which measures the tax. And those are provided in these schedules. The men who prepared these schedules can explain them a great deal better than I can.

We take it from both ends. Many corporations may say they do not want to go into a certain computation and we will distribute a sum that will amount to 5.7-percent distribution. So we fall back on the other tables so if they wanted to say, "We want to declare a

10-percent dividend, or a 5-percent dividend" they can compute that and see what that rate is under the second table by taking into consideration these various classes. I might say that there are really three ways of computing this.

First, for the \$10,000 and under. For those just above the \$10,000 it would be unjust to compute a tax under the higher table. Now, the income that may be computed on both tables run from \$10,000 to \$40,000, and there would be a gradual step up in the tax when computing under both tables, and measured either by the distribution method or by the retention.

Senator BARKLEY. In other words, the amount of tax that a corporation will pay on its total adjusted net income will be determined by the amount of that income it distributes.

Mr. HELVERING. Absolutely.

Senator BARKLEY. One more question. Now, of course they would have to determine how much they are going to distribute before they know what their tax is, and after they have determined that the practical effect is the tax they pay is taken out of what might be regarded as surplus they desire to keep, provided that is enough to pay the tax, and otherwise they have got to deduct it from the whole income before the distribution.

Mr. HELVERING. There never would be a place where the retention, the tax, and the dividends could equal more than 100 percent, of course.

Senator BARKLEY. No; I understand.

Senator COUZENS. May I ask you this, Mr. Commissioner: Is it not true any competent executive can take these tables and through the analysis of his monthly income fix substantially his own tax?

Mr. HELVERING. Yes, indeed.

Senator COUZENS. So that in this case you are leaving it wholly to the debtor to determine how much he will pay the creditor, which is the Government?

Mr. HELVERING. The Government levies the tax which is paid by the corporation.

Senator COUZENS. Yes. And say the Government in this case is the creditor and the corporation is the debtor, and the debtor takes his pencil and paper and figures how much he is going to pay the creditor.

Mr. HELVERING. That is substantially the result.

Senator COUZENS. Yes.

Senator BARKLEY. He determines how much also he is going to distribute to the stockholders?

Senator COUZENS. In that way he regulates his earnings, Senator.

Senator CONNALLY. What Senator Couzens says is he can figure out a level which will be most productive to the corporation by the method most favorable to the corporation.

Senator COUZENS. Yes; he can do that. And he can almost figure out the exact amount of business for the year. If I was an executive running my business and had my statements during the 12 months I could manipulate those figures by lowering wages, figuring my commodities up and down, or increasing wages so at the end of 12 months I could figure exactly how much tax we were going to pay.

Mr. PARKER. You can do that now.

Senator COUZENS Yes; but not when there is a flat tax like we have now.

Senator CONNALLY. The theory is you are going to distribute all this income, and in the same ratio the ultimate taxpayers will pay the tax, and if it is not distributed the corporation pays the tax.

Mr. HELVERING. Yes.

Senator CONNALLY. How can you do that when one taxpayer pays one rate and another another? A large taxpayer pays surtaxes and things of that kind, and a little taxpayer might not pay anything for that matter and might have an exemption.

Mr. HELVERING. Of course, there will be some of this income going to the small taxpayer.

Senator CONNALLY. And he won't pay anything.

Mr. HELVERING. No. But the average, as the statisticians tell me, will be an average that will produce a relatively comparative proposition.

Senator CONNALLY. Yes; but what comes of your theory, though, that you are going to tax them with the rate they would have paid had they received the income? In other words, while the average is all right, some of them are penalized and some of them are given a premium. Is not that the true actual result?

Mr. HELVERING. Getting down to a stockholder in a small corporation, today, of course, he pays on his net income just as he will under this. The whole theory of this proposition is to get all the money that is made in income to pass through the tax mill once.

Senator BARKLEY. It is all an approximation. You cannot be exact about it. It is impossible to be exact.

Mr. HELVERING. We cannot on the various individuals; no.

Senator KING. Would not this bill tend to a greater diffusion, if I may use that expression, or division of capital stock owned by individuals, who under the present tax system would be compelled to pay rather large surtaxes because of the dividends which they would receive, large dividends because of large holdings, may they not by diffusing, dividing, or distributing to their relatives or friends, or otherwise, in good faith or bad faith, capital stock defeat very largely the anticipated dividends, the taxes, which you have estimated would flow into the Treasury, because you have predicated your views upon the theory that the capital stock will remain in status quo?

Mr. HELVERING. I do not see, Senator, why there would be any more incentive to do that perhaps than there is under the present law. Whatever they receive now the same rates under this law apply to the individual.

Senator CONNALLY. Suppose I receive, as an illustration, \$50,000 dividends from a corporation now, and you pass this law; would I not escape the surtaxes which I would be compelled to pay now with \$50,000 dividend, if I divided that among A, B, and C, my stock, so that I would be relieved perhaps from the payment of any surtax, and the distributees, my son, my daughter, and my wife, and my relatives would likewise be relieved from any surtax, so that the Government would lose a large amount which it now receives in taxes from large dividends.

Mr. HELVERING. I think that is possible if they wanted the control—

The CHAIRMAN (interposing). Would not they have to pay a gift tax if they gave it away?

Mr. HELVERING. Yes.

The CHAIRMAN. And if the other fellow sold it he would have to pay a profit on what he made?

Mr. HELVERING. Yes.

Senator CONNALLY. There might not be a profit.

The CHAIRMAN. If some man had \$100,000 of stock and wanted to divide it up by giving it away he would have to pay a gift tax; and the fellow he gave it to sold the stock or property, he would have to pay a tax.

Mr. HELVERING. That is true.

The CHAIRMAN. What I am interested in, Mr. Helvering, is in what Senator Couzens said about the matter of leaving it to the debtor to decide what tax the Government can get, and he can go ahead and fix it to suit himself. And I assume this follows: If they can do it in this instance, escape it by a system of bookkeeping and by increasing wages, and this and that, why could not they do it today in the matter of the corporation profit tax?

Senator COUZENS. May I amplify on that? That is, under the present tax law being static, substantially so, the incentive is not so great, is it?

Mr. HELVERING. I would not think so.

Senator COUZENS. The higher the rate the greater the incentive, and that is the point I left out of my previous question.

Senator BARKLEY. Of course, it would be hitting the stockholders if by manipulating the pay roll there was a reduction of the net income; it would be hitting the stockholders in the face, because you have got to compute that income before you distribute it to be subject to the tax.

Senator CONNALLY. Is it not really then the variable factor concerning distribution, and that control being there it can be lower or higher as the case may be? That is what you may have in mind, Senator Couzens?

Senator COUZENS. Yes. Of course, assume a corporation is paying regularly a dividend along at 6 percent, and they set aside their regular 6 percent; and suppose they earn 12 percent. The other 6 percent which under the present law they may keep in their treasury would be dissipated perhaps for advertising or expanding of the business or increasing their wages, or becoming a greater business. And the Government would not get it.

I am only speaking of it from the point of view of the revenue to the Government, and not from the point of view of the taxpayer. I do not understand how they compute any specific amount of revenue, or even an estimated amount of revenue.

Mr. HELVERING. Of course, these amounts are computed, the statisticians of the Treasury Department, whom I am depending on, say we will get these amounts of revenue from this bill.

The CHAIRMAN. And you figured to get about \$620,000,000 more by this change in the corporation tax?

Mr. HELVERING. Yes. And the whole thing is based on the equity of all the money either being paid on a rate comparable to the rates

paid by the taxpayers, going through the tax mill, either by the corporation or the shareholder, and that is where the equity of the bill comes through. In other words, Uncle Sam on all the income collects a relatively equal income from all earnings made in the United States. That is what the main purpose of the bill is.

The CHAIRMAN. Mr. Commissioner, may I ask you this: You fixed a cushion which they have over in the House. There was some controversy about this cushioning business. You have heard much about that?

Mr. HELVERING. Yes.

The CHAIRMAN. How much is this cushion, about what percent, where the percent of the corporation tax would be about the same, where they could hold back in the surplus and not distribute?

Mr. HELVERING. That cushion has reference to the debt-ridden corporation.

If I may use a colloquial phrase, if we were all starting from "taw" I think this would be an ideal situation. But we are confronting a condition that has been in existence ever since the income-tax laws have been on the books. So we find certain corporations upon which this perhaps works a hardship after they have proceeded all these years under one established practice. So for those who have bonded indebtedness they have certain requirements in the bonded indebtedness that they must meet, a contractual obligation; we treat those in one way by allowing them to go in on a flat rate which we think is comparable with the average increase we have asked in the taxes to be collected.

In other words, I might say that the present rate is an average of about 15 percent. We are asking to raise about 50 percent over what we are collecting now on this class of income, and we have changed the 15 to 22.

Senator CORZENS. And so that increases the incentive that I was previously talking about, does it not?

Mr. HELVERING. You mean, Senator, that the corporation, if their buildings were run down, there would be more incentive for them to build those up, and perhaps increase labor charges and things of that kind?

Senator COUZENS. Yes.

Mr. HELVERING. Oh; I think that could be done.

Senator COUZENS. And, obviously, a good industrialist, or a good merchant would undertake to improve his plant and to better satisfy his employees and lower his prices as long as he can take it out of the Government.

Mr. HELVERING. Of course, as long as that is confined to repairs and not permanent equipment or permanent buildings.

Senator BARKLEY. After all, if he undertook to absorb all of it in expenses he would be worse off.

Senator COUZENS. That was not the experience we had when we analyzed the excess-profits tax. We spent many months in analyzing that. That was in force during the war and after the war for some time. And we found in a very close analysis, and I think Mr. Parker will verify it, because he was with us at the time, that the industries made much more improvement in respect to the upkeep of their plants, repairs, equipment, and wages and so on within their plant

than they did when they had no excess-profits tax. In other words, the obvious desire of the taxpayer is to spend his own money rather than to turn it over to Uncle Sam and let him spend it. There is no use trying to get away from that. That is a fact. And as long as that is a fact the smart and intelligent executive will do that very thing, and to the extent that he does it the Government's revenue will be decreased. That is true.

Mr. HELVERING. I think there is no doubt but what the man who is right into his business, taking care of it by making repairs on his plant, and adjusting his wage scale so as to charge in the expense of doing business.

Senator COUZENS. And that comes out of the Government and goes into his own expense.

Senator GERRY. For instance, during the war they increased newspaper advertising tremendously.

Senator BARKLEY. The only way to remedy that would be to have Uncle Sam have an agent there and watch each one, and, of course, that would not be practicable.

The CHAIRMAN. The more they increase wages the more they add to purchasing power.

Mr. HELVERING. Oh, yes.

The CHAIRMAN. And the more advertising they do, the more money made by people who do advertising.

Mr. HELVERING. Yes.

The CHAIRMAN. And the more money they make the more they pay to the Treasury in the profits they make.

Mr. HELVERING. It amounts to practically a distribution of dividends to the various shareholders, some of which pay a small income tax, that is true.

Senator CONNALLY. You say in the case of these debt-ridden corporations you figure about 22½ percent. Will they pay less under that than they would under the provisions of the bill?

Mr. HELVERING. They are confronted with contracts of such a nature—

Senator CONNALLY (interposing). I know what they are confronted with, but what about it, do they get off with a lower rate than other corporations?

Mr. HELVERING. Yes.

Senator CONNALLY. Why should they?

Mr. HELVERING. They pay the increased rate that is comparable with the increased total tax here.

Senator CONNALLY. Why not apply that to everybody if it is good for them? I do not see why a concern should pay any less because it is in debt. That is its own business. It means that they have got less money invested in the business pro rata than some other concern. I do not see why a corporation in debt should be let off with any less tax than any other concern.

Senator COUZENS. You cannot take in money from a man who owes debts, and has not got it.

Senator CONNALLY. I owe debts frequently and they do not exempt me from any tax.

Mr. HELVERING. We do not exempt those.

Senator CONNALLY. No; you do not exempt them but you adopt a different method of taxing which is a less rate. Why not use

that for all corporations? I do not see why it is not good for all corporations.

Senator BARKLEY. Do you allow them a different rate or allow them some advantage in deduction?

Mr. HELVERING. No; we give them a flat rate in this bill, but the general increase of a flat rate simply extenuates the inequities in the present law.

Senator COUZENS. Extends the inequities?

Mr. HELVERING. Yes.

Senator BYRD. How do you define a debt-ridden corporation?

Senator CONNALLY. Before you get to that, Senator, permit me to ask this question: Here is one corporation who has got \$5,000,000 and owes \$2,000,000, it is only worth three. Here is another one that has \$3,000,000 and does not owe any debts. What is the difference between the two so far as paying the Government the tax?

Mr. HELVERING. We do not give these debt-ridden corporations a chance to reduce it down. They have to pay a flat rate.

Senator CONNALLY. I know; but, why should they not pay just like the other corporations?

Mr. HELVERING. Because we give the other corporation either a chance to distribute, where we will collect a greater amount from the stockholders and perhaps a less amount from them.

The CHAIRMAN. Take one that is not a debt-ridden corporation, the \$3,000,000 corporation you are talking about that owes nothing.

Mr. HELVERING. Yes; they come under this.

The CHAIRMAN. And it wants to go into an enlargement of its plant; we will say it feels like it wants to build up a certain surplus; what percent do you allow it to build up?

Mr. HELVERING. Under this bill a corporation with an income of \$100,000, computed under the second table, could set aside, I think, 32½ percent without any more taxes than they do now or, in other words, over a period of 3 years, with an average net income, they could set aside 100 percent practically of 1 year's total income as a reserve and not pay any more tax than they do at the present time.

Smaller corporations coming under table I could go as high as 40 percent in setting aside a reserve without paying any more tax than they do under the present law.

Now, when they try to set aside reserves in excess of that, then of course the rate commences to go up to 42½ percent.

The CHAIRMAN. That is to force the distribution of dividends?

Mr. HELVERING. Yes, sir.

Senator GERRY. You do that, do you not, or otherwise they could not borrow any money unless you allowed them that percentage? They would have difficulty in borrowing money otherwise? Is it for only debts that are now in existence?

Mr. HELVERING. It is for debts of various classes in existence at the time of the passing of this law.

Senator GERRY. It is not for any future indebtedness?

Mr. HELVERING. No; it is not for any future indebtedness.

Senator GERRY. They do not have any of this exemption, then, for any future indebtedness? Is that right?

Mr. PARKER. This only applies to debts created before March 3, 1936. It does not apply to future debts.

Senator BARKLEY. You recognize the status quo up to that time?

Mr. PARKER. We recognize the status quo up to that time.

Mr. HELVERING. Notice was served on the country about the proposal in the President's message on March 3, 1936, and the Ways and Means Committee of the House adopted that as the date after which they could not come in and create other indebtedness under this bill.

The CHAIRMAN. That confuses me. You just stated under column II, I think it was, a corporation would have 32½ percent on the same basis as the tax it was paying now.

Mr. HELVERING. Yes.

The CHAIRMAN. Does that pertain to the future, too?

Mr. HELVERING. Yes; that is all in the future.

The CHAIRMAN. I do not see the distinction you make about this past indebtedness.

Mr. PARKER. That is the general rule. That is the thing you were interested in as to a corporation reserving 30 percent for improvements without paying any more tax than it does now.

The CHAIRMAN. Yes.

Mr. PARKER. And the debt proposition is entirely separate.

And as to a corporation in debt there is a certain rule set out which practically allows them to amortize these debts over a period of not less than 5 years. In other words, after a corporation has determined its debts as of March 3, 1936, it can pay a flat rate of 22½ percent on such amounts of its adjusted net income as would be required to amortize such debt over a period of not less than 5 years. The other portion of their net income will be taxed under the general plan.

The CHAIRMAN. What is the reason, first, for fixing 22½ percent, and, secondly, why do you put them on this basis instead of the other?

Mr. PARKER. Here is a corporation which has bonds which must be retired. The corporation makes money and could retire these bonds in an orderly manner under a tax rate of 22½ percent. It could not do so under a tax rate of 42½ percent.

Senator KING. What if their net income, not including, of course, the interest and amortization requirements, is inadequate to meet the amortization and interest requirements?

Mr. PARKER. If it was inadequate, that would mean the whole of the income in that case would be taxed 22½ percent.

Senator KING. Take a corporation whose amortization requirements were \$10,000 and the net income was only \$19,000, then they would have to pay on the net income just the same?

Mr. PARKER. The corporation would pay 22½ percent on \$10,000 and be taxed under the new plan on \$9,000 less the 22½-percent tax.

The CHAIRMAN. Then they would only pay on \$9,000.

Mr. PARKER. The corporation would be taxed on its entire net income, but that net income would be divided into two parts and each part would be taxed differently. Moreover, the interest on debts is a deduction in arriving at net income.

The CHAIRMAN. He did not subtract the interest.

Mr. KING. In my illustration I did not.

The CHAIRMAN. But you do subtract the interest on this indebtedness?

Mr. PARKER. That comes off.

The CHAIRMAN. And you do not have to pay on that sort of a proposition?

Mr. PARKER. That comes off in computing net income.

Senator GERRY. Mr. Parker, how do you arrive at paying one-fifth in amortization in 5 years?

Mr. PARKER. That is an arbitrary rule.

Senator GERRY. I do not get that.

Mr. PARKER. And we set up that arbitrary rule because each company has a different situation and some will have long-time debts that they won't have to pay off in 40 years, and other companies will have debts which will have to be paid in the coming year. To protect the revenue, we didn't think we could allow them to amortize their whole debt in the first year. So we just compute the debt, as defined in the bill, as of March 3, 1936, and then allow the corporation to amortize that debt on any basis, except it cannot amortize it in less than 5 years, which means we do not allow it to take off more than 20 percent. But it can amortize the debt over 40 or 50 years if it wishes to.

Senator GERRY. In other words, they do not have to pay off this debt?

Mr. PARKER. It does not make any difference whether they pay it or not. We allow them an amortization of that debt, whether they pay it or not.

Senator GERRY. Is there a 3-year limit or what is it, that you have this amortization and you allow this percentage for how many years?

Mr. PARKER. It is up to the corporation to elect the rate of amortization. If they want to amortize it in 20 years, they can get this special treatment on one-twentieth of the debt in each year. That is one-twentieth will be taxed 22½ percent each year.

Senator GERRY. I understand that.

Mr. PARKER. Or they can take 10 years and they can take one-tenth. They make the election of the time over which they will amortize the debt, but they cannot take less than 5 years.

Senator GERRY. In other words, what you do is that you limit the number of years. They have got to take a certain number of years, but they can have more time if they want it?

Mr. PARKER. And we do not check them up to see whether they actually pay the debts or not.

Senator BLACK. What about an individual who owes debts?

Mr. PARKER. He does not get any relief.

Senator BLACK. In other words, it creates a new system for the benefit of a corporation, which is not applied to the individual?

Mr. PARKER. That is true, Senator, but we have got to remember that this is not a deduction like interest, that on this amount they set aside they pay 22½ percent, a rate 50 percent greater than under existing law.

Senator BLACK. Sure; but a great many individuals owe a lot of money. If it is fair to permit a corporation to take a part of its earnings out and put them aside to amortize their debt, why should not an individual have that right?

Mr. PARKER. Of course, a great deal can be said for that argument, but the corporation can be looked at, especially under this bill,

as a mere conduit through which profits go to the stockholders. A corporation makes money but it is the stockholders' money, and whatever the stockholder gets out of that corporation he is going to pay taxes on; therefore, it seems that the corporation's case may be distinguished from that of the individual.

Senator BLACK. It is an incentive to people who are engaged in business individually to organize corporations?

Mr. PARKER. This only applies to past indebtedness. It won't have any effect on future indebtedness.

Senator BYRD. You spoke of classes of indebtedness. What do you mean by that?

Mr. PARKER. On page 26 of the bill, section 16, there is a definition of debt. Permit me to read a portion of that:

As used in this section the term "debt" means an indebtedness of the corporation existing at the close of business on March 3, 1936, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on March 3, 1936, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date, to the following extent—

And here are three classes of debts that are allowed to come in. Anything that does not fall within those classes are not considered as a debt for the purposes of this provision.

(1) If having a maturity at the time of issue of 3 years or more, then to the full amount thereof.

That is, if your bond is for 3, 5, or 10 years, it would be counted, and if it was only for 2 years it would not be counted.

(2) If having a maturity at the time of issue of less than 3 years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to represent indebtedness incurred by the corporation prior to March 4, 1933.

March 4, 1933, is 3 years before March 3, 1936, the basic debt of determination.

Senator GERRY. There is no appeal from that no. 2?

Mr. PARKER. No; because we are afraid of a great deal of difficulty on this proposition. What that means is this. A corporation may have a 90-day note outstanding on March 3, 1936. If the Commissioner finds in tracing that note back that this note has been renewed and renewed, or a new note given for the old note so that the debt is really 3 years or more old, then such a debt will be taken into account for the purpose of this provision. This is especially important for the small corporations, since many of them will have short-term notes. They won't have bonds like the large corporation, and no such notes are brought in, providing you can trace them back.

Senator BAILEY. What do you mean by maturity?

Mr. PARKER. The date when the obligation is due to be paid.

Senator BAILEY. That is ordinarily so, but suppose I write my note on or before 60 days, what is the maturity date of that?

Mr. PARKER. Well, I think it would be 60 days.

Senator BAILEY. On or before?

Mr. PARKER. That is how we would count it.

Senator BAILEY. Then I could adjust myself to this very easily. I could make it on or before 4 years from date, and put it in?

Mr. PARKER. We are dealing with old debts existing as of March 3, 1936. Whatever you do on future debts will not permit you to get any advantage.

Senator BAILEY. I want to get it clear. I understand that I could operate both ways.

Mr. PARKER. Then there is a third clause:

If having a maturity at the time of issue of less than 3 years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to evidence indebtedness of the corporation incurred in the acquisition of capital assets—

I do not think I need to read further.

Senator BLACK. What is the protection, if any, there about various indebtednesses between corporations and their associates, which frequently will occur from time to time, in which they may pay excessive rates of interest, under the principle Senator Couzens announced a moment ago of being a great incentive. Is there any protection of having advantage taken of any such thing as that?

Mr. PARKER. No. We have not done anything about that.

Senator BLACK. There are many millions of dollars, which is known to all of us—

Mr. PARKER (interposing). As far as excessive interest is concerned, I do not think that is a factor, because a corporation receiving the interest will of course have to include it in income. It just reduces the net income of the subsidiary, but it increases the net income of the parent company.

Senator BLACK. Of course, that would be one way of dividing up the assets in such a way to see that none of the surplus is paid.

Mr. PARKER. Of course, we abolished consolidated returns and treat each corporation separately, and unless you return to that system it is going to be hard to do anything about this matter.

Senator COUZENS. You do not mean to suggest that you return to the consolidated return, do you?

Mr. PARKER. No, Senator. I simply say that it would be about the only kind of treatment by which, it seems to me, that you could exclude the indebtedness of a sub to a parent.

Senator BLACK. The whole theory that we are on now of this new tax would produce an incentive, would it not, to create multitudinous small affiliated corporations, or corporations of various types, where it is immaterial how much interest is paid, so far as the tax of the parent corporation is concerned. It would be an incentive to decrease profits in that way, would it not?

Senator COUZENS. They could not do that, if the debt had been incurred prior to this bill.

Senator BLACK. That is true on this question, but the incentive is to see that not too much profit is returned, to be kept as reserves on which dividends could be paid.

Mr. PARKER. There is theoretically some incentive under this bill to create additional corporations. For instance, a corporation which made \$100,000 a year, might split up into 10 corporations, making \$10,000 each, and secure the advantage of lower rates contained in schedule I.

Senator BLACK. It has been shown that that is used every day by practically every corporation in this country, and the banking in-

terests, if they happen to be tied up with them—what I want to know is, do you and the others think that there is an incentive, as Senator Couzens suggested, and it may be from raising wages or gift to small dividend holders which would be an advantage to the business, what protection is there from their dissipating profits, as they have done in various corporations through this ramification of various associates and affiliates, and service contracts and types of that kind?

Mr. PARKER. We have a provision in the bill that is directed at holding companies, to prevent not exactly the kind of thing you have described, but which does prevent the retaining by each corporation of a certain small amount and accumulating a large amount within the group by each one of the chain retaining 10 percent. We have a provision in the bill that reduces this dividend credit they are allowed where 80 percent of the corporation's net income is derived from dividends.

Senator BLACK. For instance, we had a certain investigation of shipping contracts which showed that in every one of the corporations the dividends were dissipated by the payment of service contracts and things of that type. I am admitting, and I am sure that Senator Couzens is right in saying, that this is an incentive.

Mr. PARKER. How about these service corporations, when they pick up this income? Your shipping companies probably dissipate these profits through giving favorable contracts to a lot of special corporations, probably owned by influential people—won't we catch those service corporations by our income tax?

Senator BLACK. That is what I want to know. If it is dissipated by smaller payments to all of them, instead of being used, as I understand it to be the purpose, to increase and accentuate the flow of commerce by agencies who turn it over in dividends, what protection are we going to have, or has any effort been made to see that that object is not prevented by spreading it out to various corporate manufacturers in a network? We had one corporation which had 93 associates and affiliates, all of which were connected in a way, and when you went into the operations of the separate corporations none of them made a profit.

Mr. PARKER. Are not a great number of those 93 corporations mere holding companies?

Senator BLACK. No; very few of them were holding corporations. One was engaged in one business and one in another. Some of them were loaning money at exorbitant rates to the company and some of the very parties who are trusted to direct it will have these debts, with exorbitant rates of interest.

Mr. PARKER. It seems to me that while there is more incentive, as Senator Couzens says, for a corporation to spend more money when the tax rates are high, that it will never pay to waste a dollar in order to save 42½ cents tax.

Senator BLACK. These are not wasted. They eventually trickle around in a small stream.

Mr. PARKER. You mean each one of them will get less than \$10,000 and get advantage of the lower rate?

Senator BLACK. They manage to see that it trickles around in such a way and is paid out in such a manner.

Mr. PARKER. We have a clause under existing law. It is not new. It is section 45, on page 58, which does permit the Commissioner under certain cases to allocate the income between business groups or between corporations:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or more clearly to reflect the income of any such organizations, trades, or businesses.

Senator BAILEY. Do you think you could levy a tax on me because I owe some money and levy tax on another man at another rate because he does not owe money?

Mr. PARKER. That comes down to a matter of reasonable classification.

Senator BAILEY. Is that a reasonable classification? You run a very grave risk. You may put out an unconstitutional act on taxation. Why is it you cannot do it with respect to individuals and you can do it with respect to corporations? I do not believe you can do it with respect to corporations. That is the way the question impresses me.

The CHAIRMAN. I will ask Mr. Oliphant to answer that.

Mr. OLIPHANT. I understand, without having time to reflect upon it, that the situation might be like this. The question is not whether you can take two individuals, Mr. Jones and Mr. Smith, and levy one type of tax on Mr. Jones and another on Mr. Smith.

Senator BAILEY. Would that be constitutional?

Mr. OLIPHANT. I do not like to decide offhand a question like this. This is a more limited thing, it seems to me. We are dealing here with classification between corporations and individuals are not involved at all, and I think we all recognize, don't we, from a reading of the Constitution cases, that greater liberty is allowed the legislative power in classifying corporations within the limits of due process than in the case of individuals, because of the special and artificial character of the corporations, because they are creations of the State and because they have certain special rights and privileges. So, limiting the question to the question of corporations, what you have in this proposal is that Congress has taken a look at this situation—I am not now expressing my personal opinion as to whether or not this exemption should be made—the Congress has taken a look at this corporate situation and has found that some corporations having surplus and profits are debt-ridden, and some corporations are in good shape. May we take that matter into consideration in taxing them and would the court say that action on the part of Congress is capricious, arbitrary, and unreasonable?

Senator BAILEY. You agree that you have no precedent for that situation in the opinions of the Supreme Court?

Mr. OLIPHANT. I agree that I have not them here. I have not had an opportunity to look that up.

Senator BAILEY. On the tax question, with respect to the differential between corporations in debt and corporations out of debt?

Mr. OLIPHANT. Yes, sir.

Senator BARKLEY. Even in incomes of individual taxpayers, we recognize that. If I have a net income of \$10,000 and I have no indebtedness and pay no interest to anybody and have had no debt which I have assigned, I have to pay the tax on the whole \$10,000. But if Harry Byrd has an income of \$10,000 and pays it out in interest or assigns a debt, to the extent of \$10,000, he gets the total exemption.

Senator BAILEY. There is no loss. That is entirely different from this. If you have these precedents I would be very glad to hear them.

Senator CONNALLY. You said something about corporations having special powers and privileges and that the law does not require that we treat them as we would an individual, but as between the corporations, is there any reason we should differentiate there?

Mr. OLIPHANT. I should think that the classification should have to be reasonable.

Senator CONNALLY. It would have to be reasonable in the sense that they were both treated on a parity rather than discriminated against.

Mr. PARKER. There is one more feature of this debt matter, which is on page 28 under the title "(b) Commutation of Tax." It is possible that by not mentioning this subsection before I have given an erroneous impression to the committee that all of the debt existing on March 3, 1936, was taken into account. The debt that is taken into account is only that debt which exceeds the earnings and profits. In other words, if a corporation has got a big surplus in excess of their debt, they do not get the debt relief.

Senator CONNALLY. Take railroad companies, are not nearly all of them bonded up to practically the value of their property?

Mr. PARKER. The bonded debt of railroads runs about 18 billion dollars.

Senator CONNALLY. That is more than they are worth. And isn't it true that all of these big corporations finance themselves in that way?

Mr. PARKER. That is true, but many corporations have a bonded indebtedness and they have an earned surplus, and if the debts of a corporation on March 3 were a million dollars and earnings and profits were two million, it would not get any relief. If its debts were two million and its surplus one million, then the amount of indebtedness is reduced a million dollars, and it is the million which they amortize, and not the whole amount of the debt—merely the amount of the debt in excess of the earnings and profits.

Senator CONNALLY. What would be the effect of this debt provision as between a big corporation and some little corporation which has got no debts, wouldn't it operate to discriminate in favor of the big corporation as against the little fellow?

Mr. PARKER. It is hard to tell. Here is a company with no debts. They do not have to pay any tax if they do not want to. So they are not very badly treated. Here is a corporation that is in debt. It may be that its obligations are such that it cannot declare out all of its earnings. It has practically got to pay the debt. It may not be a matter of choice, and it does seem hard in such a case for the corporation to pay a tax of 42½ percent. All we say is, "Well, you

pay 22½ percent on that amount to amortize this debt, not the full amount of the debt, but only the amount in excess of what you have already got accumulated by way of surplus." If we were exempting the debt that would be quite different.

Senator BYRD. Suppose a corporation had a hundred thousand dollars of debt and they were to issue stock and sell that stock to a small group of stockholders or the public and then declare all in dividends, couldn't they avoid any payment of taxes at all?

Mr. PARKER. Yes; the corporation can. It has been pointed out in arguing in favor of this plan that the corporations can declare everything out in dividends and issue, for instance, stock rights and get the money back again into the corporation if they need it.

Senator BYRD. They would not have to issue stock rights, for instance. They could offer the stock for sale on the market and pay their debts in an orderly way, so much a year, and then all the dividends would be cash, and thereby avoid the payment of any tax at all.

Mr. PARKER. That is right.

Senator BYRD. Is not that another loophole in the bill?

Mr. PARKER. No. Under all of these relief provisions, so-called, they all say that every taxpayer is entitled to the general plan if he does not want to come in under this 22½ percent. He does not have to. He only comes under that when it gives him less tax.

Senator BYRD. What I am calling attention to is that we are giving quite a number of options to the taxpayers to either pay taxes or not to pay taxes.

Mr. PARKER. The whole theory is that you are going to get it out of the individual stockholder.

Senator BARKLEY. If it is ever distributed in dividends, the individual pays his taxes.

Senator BYRD. But the individual does not pay 22½ percent until he gets into the higher brackets. If the corporation pays the tax it would pay more than that.

Mr. PARKER. That is right, and of course you have that proposition now in the case of a partnership. A partnership is not taxed, and if the members of the partnership do not have earnings of \$1,000, we get no tax.

Senator BARKLEY. Even in corporations which are not in debt, that same thing would apply. That is to say, it is all distributed. The whole thing of it is that the individual who received it would not pay as high a rate as a corporation might pay, but as I understand when these schedules were framed, they were framed on the theory that that would approximate the receipt of the same amount of income.

Senator BYRD. That is an estimation that, in my opinion, no human being can make. I do not think it can be arrived at at all, to transfer this to the corporation and saying that it would amount to so much, because there are so many options that the corporation can exercise which no one knows whether it will exercise or not. For instance, issuing stock to their debts—certainly, some companies are going to do that, certainly the small companies which can sell their stock to a limited number of people and then declare no dividends at all, and then the individual will have to go up to pretty high brackets before he pays 22½ percent.

Senator BLACK. Don't you believe that the tendency with reference to his provision with regard to debt would be to maintain a higher interest rate, and would it not also tend to maintain a debt structure, even though the debt structure is unsound economically?

Mr. HELVERING. That would be true, Senator, if that applied to anything you can do now, but we take these corporations as they appear at the first notice of this proposed legislation.

Senator BLACK. I understand, but some of them were indebted—for instance, we had just a short time ago a man who had been in the business of a power company for 30 years, who stated that the bonded indebtedness in his judgment was equal to the value of every power company in the country. What I am talking about is this: Here you give an incentive to people and to companies to continue to collect that same rate of interest, because they do have an advantage by owing debts, and an incentive to pay off the debts even though, under naturally sound economic principles, it ought to be liquidated for less than its value, which is true with reference to a great many of these old debts. Naturally, it is very generally recognized that the debt structure is too top-heavy to be borne as it is, and the interest rate is too high.

Mr. HELVERING. Of course, this 22½ percent only applies to that part used to amortize the debt.

Senator BLACK. But it would take a long time for a particular interest to amortize its debt, if it is true that the debt is equal to the whole value of everything it owns. We would change the law for practically 50 times before that anticipated event would ever occur.

Mr. HELVERING. I think it is conceivable for Congress to do that.

Senator BLACK. The thing I am talking about is the natural economic tendency. If there is an incentive to continue to pay an interest rate and to collect it and maintain an inordinate and unsound debt structure, I cannot see why this is a sound provision.

Mr. HELVERING. Of course, this is very greatly restricted as to what comes under this debt situation.

Senator COUZENS. But I think we ought to read the whole thing. There are exceptions that we ought to take into consideration before coming to any conclusion.

The CHAIRMAN. Let me make this observation. Mr. Parker and Mr. Beaman have got to leave to go to the House. They are taking up this bill over there. So you are at liberty to leave. And now, what is your pleasure? Do you want to sit this afternoon? I do not suppose Mr. Parker and Mr. Beaman will be here, but the Treasury experts can be here.

(Discussion off the record.)

The CHAIRMAN. Then suppose we meet in the morning at 10 o'clock, and proceed with this bill.

Senator CONNALLY. There were some questions I would like to ask Mr. Oliphant, but I can ask him tomorrow.

The CHAIRMAN. You may ask them now.

Senator CONNALLY. I was asking you a while ago, Mr. Oliphant, about the different rates of taxes as between corporations, in one case one owing a debt and in the other case not owing it. Suppose you had two corporations, and each one had a net income of \$100,000.

Have we got the power to tax one of these corporations at one rate and another at another, depending on whether one of them has debts or whether it has not?

Take my original case. Here is a five-million-dollar corporation which owes \$2,000,000 and is therefore a \$3,000,000 corporation, and another that owes nothing, with a capitalization of \$3,000,000. Each one makes \$100,000 net. Can we tax one at one rate and another at another?

Mr. OLIPHANT. As I say, we will never get two cases with just those facts present.

Senator CONNALLY. There might be a lot of other facts, but I am assuming that those facts are true.

Mr. OLIPHANT. It seems to me, without time to reflect, that the question we are talking about boils down to the reasonableness of this type of classification. Is there a difference in ability to pay?

Senator BAILEY. That is not the basis of the reasonableness. It is not ability to pay. Reasonableness is the ability to compete, as I understand it. The basis of all taxation is uniformity, and uniformity is based on equity and soundness. The Government can kill one corporation as against another, if that is not the basis.

Mr. OLIPHANT. That is certainly true, but the nearest analogy I can think of at the moment is the validity of a graduated tax, and I am not citing that as a precedent, but I am just suggesting it as analogous. As I understand this bill, assuming given debt situation with reference to a corporation, it will treat every corporation in the country in a similar situation in the same way.

Senator BAILEY. There is no uniformity there. But you are going to give me some authorities. As I said, my first impression is that you are probably laying the basis here for a construction of this legislation in the Supreme Court. We do not want to do that in a tax bill.

Mr. OLIPHANT. No indeed; unless the fact that I am pointing out, the difference in the facts I am pointing out, would constitute such a difference in law that the courts would say that the Congress was not acting unreasonably.

Senator BAILEY. We cannot predicate a great revenue act on a question of opinion. I have the greatest respect for yours, but we cannot do that.

Mr. OLIPHANT. Both of us at the moment can discuss it only in terms of our own experience with the cases.

Senator BAILEY. We must have some assurance that the bill will hold water in the Supreme Court.

Mr. OLIPHANT. To my preliminary statement on the matter I would like to have this statement made, that in the case you suppose there is an enormous difference in the credit rating of these two corporations.

Senator CONNALLY. We are not talking about credit. We are talking about income and taxes.

Mr. OLIPHANT. And their ability to pay.

Senator CONNALLY. They have both got a net investment of \$3,000,000 and they make \$100,000 apiece. How can you tax them differently? The object of this bill is to force the distribution of income, is it not?

Mr. OLIPHANT. I could not accept that as my statement of the thing.

Senator CONNALLY. I understand that the purpose is to make them distribute it or tax them as if they had distributed it. What about the Supreme Court decision in the A. A. A. case, in which they held that the Government had not the right to tax for the purpose of coercing or forcing somebody to do something which they otherwise would not do? These are mostly State corporations, and what right has the Federal Government to tax them for any purpose except to get revenue?

Mr. OLIPHANT. I have not stated that this bill is for the purpose of forcing a distribution of income.

The CHAIRMAN. This is a bill to raise revenue.

Mr. OLIPHANT. I have not stated the purpose of this legislation is to force the distribution of dividends. The purpose is to raise additional revenues, and in the process to seek to apply the same burden to business profits wherever derived and whenever received.

Senator BLACK. It is impossible to draw any tax bill that won't have some incidental effect, of course.

The CHAIRMAN. We will meet in the morning at 10 o'clock.

(Whereupon, at 11:55 a. m., the committee adjourned until the following day, Friday, Apr. 24, 1936, at 10 a. m.)

REVENUE ACT OF 1936

FRIDAY, APRIL 24, 1936

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met in executive session, pursuant to adjournment, at 10 a. m., Senate Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, George, Lonergan, Black, Gerry, Couzens, Keyes, La Follette, and Capper.

Also present, Herman Oliphant, General Counsel for the Treasury Department; Guy T. Helvering, Commissioner of Internal Revenue; Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue; George C. Haas, Director of Research and Statistics, Treasury Department; A. S. McLeod, statistician, Treasury Department; C. E. Turney, Assistant General Counsel for the Treasury Department; L. H. Parker, Chief of Staff, Joint Committee on Internal Revenue Taxation, and members of his staff; Middleton Beaman, Legislative Counsel, House of Representatives.

The CHAIRMAN. All right, Mr. Helvering; you may proceed from where we left off yesterday.

Mr. HELVERING. Mr. Chairman and gentlemen of the committee; I hope you will not consider me presumptuous in making the suggestion, but I would like you to hear from the drafting service and from Mr. Parker, to just scan through the changes made in this law, and then I would like to call on the statistician of the Treasury to explain the sources of this revenue, the people affected, and all that. We will have a chart here in a few minutes, and we would like, with your approval, to scan through the drafting of this bill and the changes made.

Senator KING. Changes over the existing law, you mean?

Mr. HELVERING. Yes. In the first 188 pages there are 6 changes, and some of them are not so very important.

The CHAIRMAN. I think that is a good idea.

Senator COUZENS. I do too, because this is a revenue bill, and I want to know something about the sources of the revenue before I go into the details of revamping the bill. What is the use of discussing the revenue unless we know where the revenue is coming from, or how?

The CHAIRMAN. Then you would suggest that Mr. Parker go through these changes that we have made, and then the statistician go through the question of revenue; is that the idea?

Mr. HELVERING. Yes; either Mr. Parker or Mr. Beaman.

Senator COUZENS. Whoever knows the most can make the clearest statement.

Mr. PARKER. We might as well start from the beginning, section 1, page 6, of the comparative print. The changes made there provide that the new plan shall be effective for taxable years beginning after December 31, 1935. That is important; that is, this bill is retroactive to January 1, 1936, this year.

Senator GERRY. Does that mean the fiscal year of the corporation?

Mr. PARKER. If the corporation is on a calendar-year basis it will come under the new plan for the year beginning January 1, 1936, and ending December 31, 1936. If it is on a fiscal year, beginning February 1, 1936, it will first come under the plan from February 1, 1936, to January 31, 1937.

Senator COUZENS. That applies to each month down the line?

Mr. PARKER. That is right.

Senator KING. Would not that result in those corporations having the 12 months paying a larger tax than those that fall in the other class?

Mr. PARKER. In respect to corporations coming under the plan, the calendar-year corporations, will come under the plan first. We had a considerable discussion about this provision, I think, in the 1934 act. Senator Couzens raised a number of objections to it, but I think in this case it is about the only thing we could do. We would have been in a hopeless situation here with this radical change in our system. If we tried to apply this system to a short year, it would be troublesome.

Senator COUZENS. This always applies.

Mr. PARKER. This always applies. If you change the plans in the future those fiscal-year corporations will have to stay under the old plan much longer. Then, I want to point out that this is not necessarily a penalty—to come under the new plan. A corporation may be able to pay no taxes at all under the new proposal. Some of these fiscal-year corporations perhaps would like to come under the plan from January 1.

Senator KING. Nevertheless, this bill is founded on the theory that it will raise more revenue than under the existing law?

Mr. PARKER. Yes, Senator.

Senator KING. Then the corporations will pay a larger tax than under the present law?

Mr. PARKER. Not necessarily; not the corporation. Maybe the stockholders.

Senator KING. The stockholders?

Mr. PARKER. Yes, sir.

The CHAIRMAN. Go ahead.

Mr. PARKER. Now, on page 14, there is a change. The language that was put in last year, in the 1935 act, has been omitted.

Senator COUZENS. Repealed?

Mr. PARKER. Made ineffective as to 1936 and future years. That means, of course, that the graduated corporation tax which we discussed here last August, and which was to take effect for taxable years beginning after December 31, 1935, will never apply in any case if this bill is enacted into law.

The CHAIRMAN. Because it has not applied up to date?

Mr. PARKER. You see, this was prospective legislation, and therefore it will never come into effect if this bill passes.

Senator KING. As I understand, your position is that the normal tax and surtax upon individuals, found on pages 8 to 14, are continued unchanged?

Mr. PARKER. Yes; they are continued unchanged.

The CHAIRMAN. We do not touch the income tax at all?

Mr. PARKER. Yes; we subject dividends to the normal rate of 4 percent.

The CHAIRMAN. That is later on?

Mr. PARKER. That is later on. I will show you how that is done.

Now, under "Definitions", the term "adjusted net income" is practically the same as "net income" under the existing law, except we take out this Liberty Bond interest. So we do not need to be confused about that.

Senator GERRY. May I ask you a question there? In your adjusted net income, does that apply to insurance companies and banks, or is there a separate provision with exemptions there?

Mr. PARKER. Insurance companies and banks are treated differently, they are stated practically the same as under the existing law, with the flat tax rate of 15 percent.

Senator GERRY. That comes somewhere else in the bill?

Mr. PARKER. That comes somewhere else in the bill.

Senator GERRY. All right.

Mr. PARKER. Now, under paragraph 2—

the term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27.

Senator COUZENS. Is that the holding company dividend?

Mr. PARKER. No; this is the ordinary corporate dividend, and for practical purposes you may consider that as dividends paid within a certain period. That is the dividends paid.

(B) The tax computed under subsection (b).

The CHAIRMAN. The dividends paid will be taken as credit?

Mr. PARKER. Ordinarily, yes.

The CHAIRMAN. I am talking about (2). "The term 'undistributed net income' means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27.

Now, that is a credit?

Mr. PARKER. That is right. When you are working from undistributed income it is used as a credit. When you work from the dividend end, that credit is really not subtracted, but that is unimportant.

Let me illustrate: If we had a circle here representing the adjusted net income, that circle is divided into three parts; one part is the tax, one part is the dividends paid, and one part is the undistributed net income. In other words, stated differently, the sum of the undistributed net income, and the dividends and the tax equals the adjusted net income.

There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

We found out yesterday that all these rates apply to the adjusted net income.

Senator GERRY. I would like to ask a question. Would you allow anything on debts? Does that come in there?

Mr. PARKER. What we allow on debts is a special treatment, and the portion of the net income that is used to amortize a debt takes a flat rate, and then the remaining portion, less the tax, is subject to the new plan, just as if it was the whole of the adjusted net income.

Senator GERRY. Suppose the corporation has to borrow for current expenses which it is able to pay back at the end of the year, would that come into this?

Mr. PARKER. Well, of course, current expenses are a deduction in arriving at net income.

Senator COUZENS. As I read this, I understand this debt must be a sort of a funded debt before you consider it, not a current debt.

Mr. PARKER. That is right.

Senator GERRY. What I had in mind, for example, you take the textile industry where they are buying a large amount of raw materials and then pay for them, and then manufacture the goods, does that come into this?

Mr. PARKER. No, sir. The committee did not think we ought to take into account current obligations where corporations merely borrow in anticipation of selling the goods.

Senator GERRY. Is not that relieved at all?

Mr. PARKER. No, sir. That was done purposely by the Ways and Means Committee.

Senator KING. Suppose you should borrow in 1 year to meet current expenses, and, to use the textile mills as an illustration, they purchase cotton and wool anticipating the market for the finished product, and suppose you start in the next year with a great loss. Is there provision made here under which credit may be had for that loss?

Mr. PARKER. This bill gives relief where a company has a deficit. At the end of the year if they have a deficit we give them a relief. The bill does not give a relief where they have a surplus, the theory being they may make up their losses out of surplus.

The CHAIRMAN. Let us get that clear now, Mr. Parker. Suppose there is a concern in Rhode Island that is in the textile industry, and it has a surplus on a million dollar capitalization of \$200,000 and it incurs a \$100,000 loss, say, this year, in the matter of purchasing cotton, or whatnot; now the next year to come, can you take that as a credit, that \$100,000 loss?

Mr. PARKER. No; there is no net loss carried over. Of course, in this first year, having had a loss, they will pay no income tax.

The CHAIRMAN. Let us take it the other way. Suppose the same corporation has no surplus but it incurs a \$100,000 loss and the next year it makes \$300,000, what would you do in that instance?

Mr. PARKER. As I understand your example, they have a deficit in the second year of \$100,000. Now, they made \$300,000. They do not have to distribute that \$100,000. They can take the \$100,000 necessary to retire the deficit and pay a tax of 22½ percent on that—then they can take the balance of the income, \$300,000, minus

\$100,000, minus the \$22,500, which amounts to \$177,500, and be taxed on that residue under the new plan. Now, if they declare that all out in dividends there is no tax on it. If they do not declare it all out in dividends then it comes under the new rates. The new proposal simply divides the net income up into two parts, one of which is taxed at a flat rate and the other under the new plan.

The CHAIRMAN. As I understand it, where they have a surplus it would not apply, and where there is no surplus it might apply in the carry-over from one year to the other?

Mr. PARKER. It amounts to a carry-over because that deficit is something that is built up from prior years. To that extent there is a carry-over. We will come to those provisions.

Senator GERRY. I am not clear on this. I am trying to get this straight. Does not that mean that you have to have a great deal more surplus to carry on your business? For example, if a corporation buys raw material which it is going to manufacture, and it manufactures that material and happens to sell before the end of the year and pays off that debt, of course, that would just wipe itself out, would it not?

Mr. PARKER. Yes; and that is the idea of it. For instance, you might be in a seasonal business and you might buy a lot of materials in the spring which would at that particular time raise your inventory, and you might have a lot of 90-day paper on which you borrowed money, and perhaps in 90 days you renew your note, or you dispose of the material at the end of the season, and you get that money all back, you pay off your note; there is no relief necessary there.

Senator GERRY. There is no relief necessary there, is there?

Mr. PARKER. No. Then the question arises: Why is the relief necessary if you build up your inventory in October and sell it in the spring when you are on the calendar-year basis? Then you have the high inventory in one year and the low inventory in the other. I think it will wash out.

Senator GERRY. Where there is no profit, where it is just a turn-over business, then, of course, there is no debt question that comes into it. Now, if you have one year where you have to buy a large amount of goods, say toward the end of the year when it is advantageous to buy, and then you sell the next year, does that complicate the situation?

Mr. PARKER. Yes; I think it does. There was nothing more fair in the law than the net loss carry-over. The only reason you cannot restore it is because it costs too much money. One year does not always fairly reflect income and a longer period is more preferable. England allows such losses to be carried forward 6 years. Certainly if a company loses money for 3 years and makes money the fourth year, the company has not really made any money until it makes up its losses. We did have that plan in mind, but we had to cut it out on account of the revenue.

Senator GERRY. Suppose you have a plant buying a large amount of cotton to manufacture into textiles and they feel if they buy toward the end of the year they will not be able to manufacture it in time enough to sell until the next year—is that not a possibility?

The result would be they would have to buy their cotton earlier in the year or not at all, would it not?

Mr. PARKER. That would not necessarily go into net income. What you would start off with in computing net income, of course, is your gross income; that is, your receipts. Now, they haven't sold this inventory. I do not think they are hurt.

Senator GERRY. They buy at the end of the year and then they manufacture and sell. Now, when we sell the goods they pay off what they had to borrow in order to buy the raw materials. Now, as long as the profit does not come into it there, there is no tax question involved, is there?

Mr. PARKER. I do not think so. I think they are off perfectly all right there.

Senator GERRY. That is what I was trying to get clear. Of course, if they make any profit, then it is a question of what goes into surplus, isn't it?

Mr. PARKER. Yes, sir. Of course, there are two methods of keeping the inventory, which makes some difference. Some companies have an inventory on cost and other companies have an inventory on cost or market, whichever is lower.

Senator KING. When you have a tax bill, or any legislation, your views are modified or influenced, in part, by your experience. Take a case like this—and it is an actual case: A mining company lost its ore bodies and it had to drive drifts, tunnels, and underground workings costing several hundred thousand dollars; several years elapsed and it was spending hundreds of thousands of dollars, borrowing, and finally, at the end of 2 or 3 years, it found an ore body from which it realized sufficient to meet the obligations which had been incurred in the prosecution of that work and a very small amount over. But in the meantime there had been no profits, and when they got that ore body there were slight profits, after deducting all those losses incurred in the prosecution of the work. Now, I inquire first, would they get credit for those losses before determining what the profits were for that year?

Mr. PARKER. Undoubtedly, in the case you cite, they would have debts.

Senator KING. What?

Mr. PARKER. They would have debts which have continued more than 3 years. In the second place, they are likely to have a deficit in addition, so at least they can keep the tax down to the 22½ percent.

Senator KING. But they would have to pay the tax on the small profit which they made that year, notwithstanding there had been no dividends or profits for 2 or 3 years?

Mr. PARKER. Yes; but they get a substantial allowance for depletion. A mining company would not be in such bad shape.

Senator KING. There would be no depletion.

Mr. PARKER. There must be depletion as soon as they begin taking out ore. Of course, there was no tax question involved when they were having a loss every year. Now, they have struck the ore and are making a profit; therefore, they get the depletion, which is a considerable help.

Senator GERRY. Let me ask you another thing, Mr. Parker. In the example that I gave you there, of where they are buying raw mate-

rials and borrowing money, the interest on that debt, do they deduct that?

Mr. PARKER. Yes; that is a deduction from net income in every case.

Senator GERRY. That is deducted?

Mr. PARKER. Yes. I think it is pretty well taken care of.

Now, we come to the tax computation. We went over that yesterday. Does the committee desire to go through that again on these schedules?

Senator GEORGE. Explain it, Mr. Parker. I would like to have you explain just one item, as an illustration.

Mr. PARKER. All right. On page 15, paragraph (b)—

There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

Note that the tax is upon the adjusted net income. It is not, as is ordinarily supposed, upon the undistributed net income. Some of these plans in the beginning contemplated applying the rate just to that portion of the net income that was not distributed, but all these rates apply to the entire adjusted net income.

The CHAIRMAN. What was the reason that prompted you to take the adjusted net income instead of just the net income?

Mr. PARKER. It is entirely a technical matter, and I could almost say "net income" and be near enough.

The present law requires the corporation to include in its net income the interest upon certain obligations of the United States which are free from normal tax but are subject to surtax. That goes into the income. Under the set-up of the present law they are allowed to credit the Liberty bond interest against net income.

Senator COUZENS. Would not that also include municipal and State bonds?

Mr. PARKER. They are out of gross income, they are not in the net income.

Senator COUZENS. They are not put in the gross income?

Mr. PARKER. We are barred from putting it in the gross income, but Congress could tax a corporation on Liberty bond interest. There is nothing to stop that, if you want to do it, except as a matter of policy. But under such a policy State securities would enjoy an advantage.

Senator KING. You could not make it retroactive as to Liberty bonds?

Mr. PARKER. I do not think we could make it retroactive as to Liberty bonds.

Senator KING. If the Government sold its bonds upon the understanding that they were not to be taxed under a law which did not permit that?

Mr. PARKER. That is exactly the point. We sold these bonds that we are talking about, not on the understanding that they would not be taxed, but that they would be free from normal tax, and would be subject only to graduated income taxes like the surtax.

Senator KING. Doubtless the Government had that authority.

The CHAIRMAN. The only difference is if you do that you just penalize the Federal bonds and give the State bonds and municipal bonds an advantage.

Mr. PARKER. In other words, we are taxing the net income practically the same as we are doing now, as far as the basis to which the tax rate applies is concerned.

Now, we have divided the corporations into two classes. We give the small corporations more relief and give them a chance to build up more surplus to get started.

(1) Adjusted net income \$10,000 or less—

If the adjusted net income is not more than \$10,000 the tax shall be computed under schedule I or, at the option of the corporation, under schedule IA (the tax being the same under both schedules).

Senator COUZENS. Now, what is the advantage under schedule I and schedule IA, what is the difference?

Mr. PARKER. Schedule IA is on page 17. Under that schedule you start out with two known factors, the adjusted net income and the dividends. We know what the dividends are. Table IA is the one that is going to be used in the majority of cases, because when the corporation comes to make out its return, the amount of its dividends paid will be a question of fact, so that in computing its net income it will look at schedule IA.

Senator COUZENS. On what page is that?

Mr. PARKER. On page 18. For instance, if the adjusted net income is \$10,000 and the dividends paid are \$1,600, of course that is 16 percent distributed and opposite will be the rate of tax, 24 percent. Then its tax will be 24 percent of \$10,000, or \$2,400.

Senator COUZENS. May we get an understanding between schedules IA and I before we get out of it? I still do not get it clearly in my mind as to the difference between schedules IA and I.

Mr. PARKER. On schedule I we just start at the other end of it. We assume here that we haven't paid any dividends—that will be the easiest way to look at it—and the director of the corporations sitting around the table will say, "How much money do we want to keep this year? We want to build this stable out here. That stable will cost us \$3,000. We have got \$10,000." Well, they will want to retain \$3,000. All right, if they want to retain \$3,000, and \$3,000 is 30 percent of \$10,000, if you look in column 1 of schedule I you will find 30 percent.

Senator LA FOLLETTE. What page?

Mr. PARKER. Page 16, column 1. Then you go down to column 1 and you get 30 percent. Opposite that, in column 2, you find 7.5 percent.

The CHAIRMAN. I do not get that.

Senator COUZENS. That is 7.5 percent of the full \$10,000?

Mr. PARKER. That is correct.

The CHAIRMAN. In the first column you find your 30 percent?

Mr. PARKER. The first column is the ratio.

The CHAIRMAN. Then you have to go to the other and get 30 percent?

Mr. PARKER. Seven and one-half percent.

Senator GEORGE. Is that on the full \$10,000?

Mr. PARKER. On the full \$10,000. These rates are expressed in percentages of adjusted net income.

Senator COUZENS. And on the assumption that there is no dividend?

Mr. PARKER. That is generally when you would use it. You could not very well use the table if you had already declared the dividends. If the time of that dividend declaration is over, you would not want to go to table 1, because that has become a question of fact and cannot be changed; therefore you would have to go to schedule IA. There is no use to figure how much you want to keep after you pay your dividends. That has become fixed.

Senator GEORGE. What would be the circumstances under which a corporation like you described would go to schedule IA? What would be the circumstances that would require them to go to schedule IA?

Mr. PARKER. That would be the usual case. You would sit down in March and compute your adjusted net income, in March 1937 for the taxable year 1936. You find out what dividend you paid. You know that.

The CHAIRMAN. They do not declare the dividends until they know what the surplus is, do they?

Mr. PARKER. Well, many companies have a rather consistent dividend policy. It is true that small and closely held corporations do not do that.

The CHAIRMAN. Let us take schedule IA. Suppose a corporation of \$10,000 or less makes \$8,000 and it wants to declare, say, 6-percent dividends. Figure that out.

Senator LA FOLLETTE. What did you say first?

The CHAIRMAN. A \$10,000 corporation makes \$8,000 and wants to declare 6-percent dividends.

Mr. PARKER. 6 percent on its capital stock?

The CHAIRMAN. Well, it has made \$8,000 in the surplus, and it is going to declare dividends of 6 percent.

Mr. PARKER. But dividends are ordinarily computed, of course, on the par value of the capital stock. So, let us assume that this corporation that made the \$8,000 has a capital stock of \$100,000; a 6-percent-dividend on \$100,000 would mean they would have to pay out \$6,000. All right; they have paid \$6,000. The adjusted net income, you say, is \$8,000. Of course, you divide \$6,000 by \$8,000 to get the percentage distribution, and that is just 75 percent. So now we look in table IA, 75-percent distribution, and we find the tax rate is 3.9286.

The CHAIRMAN. 3.9286.

Mr. PARKER. Yes; 3.9286.

The CHAIRMAN. Of course, that is perfectly clear to you; but I want you to repeat that proposition, so far as I am concerned. Go over that again.

Mr. PARKER. Would it be more helpful to put it down on the board where you can see the figures?

The CHAIRMAN. No; I do not think so. Just state the thing again. I think I got it, but I am not sure.

Mr. PARKER. You have, in the first place, a capital stock of \$100,000, and you want to pay 6 percent on that.

Senator KING. 6-percent dividends.

Mr. PARKER. So if you pay 6 percent, of course, it is obvious you pay \$6,000.

Senator COUZENS. That is 75 percent of your adjusted net income.

Mr. PARKER. Your adjusted net income being \$8,000, that is 75 percent of your adjusted net income. In other words, you have distributed 75 percent of your adjusted net income in dividends, you have distributed that percentage.

The CHAIRMAN. If you were distributing \$5,000, it would be five-eighths, then?

Mr. PARKER. That is right.

The CHAIRMAN. How would you get at that figure?

Mr. PARKER. Five-eighths would be $62\frac{1}{2}$ percent. Now, we look down in the table and we find there $62\frac{1}{2}$ percent, and the rate is 7.5. Now, it is very fortunate that $62\frac{1}{2}$ percent happened to appear there. That is rather a miracle. By some miracle you happened to strike a rate that comes at a point where the increment change in the rates changes. That is why we had to put in the $62\frac{1}{2}$ percent.

Supposing that percentage had been 60.5—I would like to explain that point—supposing this percentage dividend instead of being 62.5 had been 60.5? Now, that is the time that you use what we call interpolators, that follow the table. If you look down in those you will find in the very first paragraph, “If the dividend credit is a percentage of the adjusted net income which is less than 62.5”—well it is less than 62.5, since in my assumption it is 60.5—“(and such percentage is not shown in the foregoing table)”—60.5 is not shown in the table—“the tax shall be a percentage of the adjusted net income equal to the sum of 7.5, plus 11 thirty-firsts of the amount by which 62.5 exceeds the percentage which the dividend credit is of the adjusted net income.”

The CHAIRMAN. That is perfectly plain. That does not need any explanation at all.

Mr. PARKER. Yes, Senator; that is just simple arithmetic. All you have got to do is follow it. You take 7.5 and you put that down. Now, you take eleven thirty-firsts of 62.5 minus 60.5, which was our percentage; in other words, eleven thirty-firsts times 2 is 22 thirty-firsts, and then we add 7.5. You will have to, of course, change 22 thirty-firsts into decimals by dividing by 31. It is about 0.71. If we add to 0.71 the 7.5 percent, we have approximately 8.21 for the rate of tax.

Senator GEORGE. In declaring the dividend it would be much easier for the corporation to stick to whole numbers.

Mr. PARKER. Beg pardon?

Senator GEORGE. I say, in paying out dividends it would be much easier for the corporation to stick to whole numbers.

Mr. PARKER. It is just impossible to stick to whole numbers. You cannot stick to whole numbers because your net income is not going to come out \$10,000, it is going to come out \$10,219.31, or some such figure. That is never going to be an even percentage of the amount that you want to declare out in dividends. If you have got just 100 stockholders, you might declare out exactly the net income, but the American Telephone & Telegraph Co., or any company of any size, could never declare it all out exactly in even cents.

Senator GEORGE. Let me ask you in regard to your tables on pages 16 and 18. This table on page 16, your column no. 2, goes on up continuously, does it not?

Mr. PARKER. It goes up to 29.5 percent.

Senator GEORGE. Yes.

Mr. PARKER. Then you see you almost eat up the whole income, 70 percent of which you retain, plus the tax rate 29.5 percent, and you have got 99.5 percent now.

Senator GEORGE. And the table on page 18, when you pass 50 percent, your column no. 2 goes down, does it not?

Mr. PARKER. That goes down. It goes down because the more you distribute the less you pay in tax. If you go down to the end you distribute 100 percent and you have no tax.

Senator GEORGE. I am trying to keep to the tables. You say both of those are to be used by corporations with an income of less than \$10,000?

Mr. PARKER. You can use either one of them and they will produce the same result.

Senator GEORGE. They will produce the same results?

Mr. PARKER. They will produce the same results. Of course, my own personal opinion on that is that the dividend table is sufficient without the other, because the dividend is the thing that is going to be the question of fact. You cannot change it after you have paid your dividend.

The CHAIRMAN. All right, Mr. Parker, proceed.

Mr. PARKER. Now, schedules II and II-A are just exactly the same, only you always use those if your net income is in excess of \$10,000.

The CHAIRMAN. In other words, the principle is the same?

Mr. PARKER. The principle is the same.

The CHAIRMAN. The difference between schedules I and I-A and II and II-A is that one is \$10,000 and less and the other is \$10,000 and more?

Mr. PARKER. The rates are considerably different. In schedule I, if you retain 10 percent your tax rate on the entire net income is only 1 percent. Under schedule II, if you retain 10 percent your tax rate on the entire income is 4 percent. There is quite a difference between 4 and 1 percent for the same amount retained. In the same way, if you retain 20 percent under schedule I you only pay 3.5 per cent. If you retain 20 percent under schedule II, then you pay 9 percent instead of 3.5. There is quite a difference in the two rates.

Of course, that means that we have got to do something when we come to the case of a corporation, for instance, that has \$10,001 of net income. It will not do to increase its tax from \$100 to \$400. There has got to be a transition, there has got to be a leveling off, which is accomplished by schedule III, which affects corporations with a net income between \$10,000 and \$40,000. It does not always affect the corporation between \$10,000 and \$40,000, but that is the upper limit.

Senator KING. Mr. Parker, the theory of this bill disregards the invested capital?

Mr. PARKER. That is correct. The bill has absolutely nothing to do with invested capital.

Senator KING. So the illustration which I gave yesterday of a corporation of \$1,000,000 and only earning 3 percent, and another corporation that had only \$100,000 and it earned four or five times as much as the \$1,000,000 corporation—the \$1,000,000 corporation would have to pay the same tax?

Senator COUZENS. That is the law now.

Mr. PARKER. Yes; the same as the law now.

Senator KING. Yes.

Mr. PARKER. Now, this transition between these two schedules is accomplished by schedule III—that is on page 23. Before I go into that, however, I would like to point out that the corporation has the right to either compute its tax under schedule II or under schedule III, whichever will produce the lesser tax. It will happen, with certain percentages of distribution, that you will pay less tax under schedule II with a net income of \$35,000 than you would under the composite schedule III. So you are always entitled to the one that will give you the least tax. But if you do use schedule III, you start out by computing the tax on the entire net income under schedule I, and then you compute the tax on the amount of that net income in excess of \$10,000, using the schedule II rates. Then you add the two taxes together.

I think probably that the example in the report will explain that, and until the members of the committee are thoroughly familiar with the regular computation under schedule II we might leave that for the present.

Senator KING. Mr. Parker, there is one question which is not perhaps relevant. Did you find anything in the revenue laws of any country—from the most civilized to the least civilized—did you find any system of computing taxes such as is involved in this bill?

Mr. PARKER. No, Senator. Nothing exactly similar.

Senator KING. You struck out into new ground, did you?

Mr. PARKER. Well, undistributed-profits taxes have been imposed by some countries. These taxes are not like that proposed in this bill, but they are based on a similar principle.

The CHAIRMAN. What is the French system? Is the French system based on the distribution of earnings?

Mr. PARKER. No. Norway has what we call a funds tax, or undistributed-profits tax. Norway has this kind of a tax: It levies 8 percent on the entire net income, and then it levies another 8 percent on that part of the net income that is not distributed in dividends. It is just that simple proposition. They take the entire net income and levy 8 percent on it, and then they take this part that is not distributed in dividends and levy 8 percent on that. So it is an undistributed-profits tax.

The CHAIRMAN. How about France? Is there a different system there?

Mr. PARKER. France taxes a corporation. They have a 12-percent tax on the corporations, and then they make the corporation withhold on the stockholder, when they pay dividends. That withholding tax runs from 12 to 18 percent. They get everything they can at the source.

Senator GEORGE. Is that like the British system?

Mr. PARKER. No; the British system is still different. The British system just starts with the high rate, 22½ percent. By the way, I see from the papers that the British are increasing their rate again.

Senator GEORGE. It has been as high as 27.5?

Mr. PARKER. Yes, Senator.

Senator COUZENS. May I ask at this point—there is no consideration in the countries you have been talking about, either Norway or Great Britain, with respect to the capital invested, is there?

Mr. PARKER. I do not know of any country that now has a tax based on capital invested; no, sir. If they have, I do not recall it.

Senator COUZENS. If you do not want to answer this, it is perfectly all right; but is not an excess-profits tax a much fairer tax than this tax, having in mind the questions propounded by Senator King?

Mr. PARKER. I think that the excess-profits tax is a very fair tax, if you can get it on a fair basis. The great trouble is the measurement of the invested capital. I have never been able to find any good method of measuring invested capital. For instance, take our old excess-profits tax. Some people started a corporation in 1900, and they put in \$100,000, and they have kept their surplus. They have not reorganized; they built up a surplus. Now, in 1936 they have got \$2,000,000 in that company, and the property has appreciated, and the appreciation is not taken into account. It is true the original people only put in \$100,000, but they are out of the picture now; somebody else has bought their stock and invested \$2,000,000 in it.

Senator COUZENS. Yes; I understand.

Mr. PARKER. It is difficult to work out.

Senator COUZENS. I recognize the difficulties, but over the years has it not been pretty well established as to the amount of invested capital that they have got in making the income-tax returns, in their capital-stock tax, and all that? Hasn't their invested capital been fairly well established?

Mr. PARKER. Speaking frankly, I think you made a mistake in 1922 when you cut out the excess-profits tax. We went through all the grief of determining that capital. If we did not need the money, all right, but we could have kept 5 or 10 percent excess-profits tax in order to continue the system. All this litigation went on, and we finally got a basis for that invested capital, and you threw it out of the window.

Senator COUZENS. You think we cannot return to that now?

Mr. PARKER. Well, you would have the same trouble. We haven't kept it up. It is lost, to a great extent.

Senator COUZENS. That is where you and I differ. I do not think it is lost.

Mr. PARKER. Maybe you can go back to that period and start from there?

Senator KING. I do not think that you, by this bill, are throwing out of the window the experience that has been gained under the existing law. There is scarcely a period, a comma, or a paragraph in the existing law that has not been the subject of investigation and adjudication by the officials of the Internal Revenue Bureau, or by the Board of Tax Appeals, or by the Federal court.

Mr. PARKER. Well, you are not throwing it all away, Senator. We are introducing some new and striking things. Perhaps 90 percent of the bill is the existing law, under the same terms. You will note, going through here, that there is page after page of roman type. That means it has not been changed. It is only the matter in italics that has been changed.

Senator KING. But the lifeblood in this bill—if I may use the illustration—is in the system that you now explained with great clarity to myself; that is the bill, is it not, your new system?

Mr. PARKER. As far as the corporations tax is concerned, it makes a very radical change in our system of taxation, no doubt about that. As far as individuals are concerned, I do not think there is anything disturbing about that.

Senator KING. It does not need a prophetic spirit, does it, to determine that there will be a great deal of litigation and controversy by the officials of the various departments and by those who have to pay the tax?

Mr. PARKER. Well, there are some provisions in here that undoubtedly will bring about litigation, but I do not think we need to worry very much about litigation on this mathematical rule here. I do not see anything to litigate about that, unless somebody has got some constitutional point.

As far as the interpretation of these tax rates, I do not see any opportunity for any litigation in these pages that I have just been going over now. I would not worry a bit about litigation, unless you want to raise some constitutional question.

As to what this means, I think that is perfectly definite. I do not believe that there is a hole in that so far. On the mathematical computation in these schedules, I do not see a particle of possibility for litigation on those particular methods of computation.

Senator COUZENS. I think they are perfectly plain, but it still goes back to the question of the inequities resulting from the difference of invested capital. I think I still have a strong viewpoint about that.

The CHAIRMAN. All right, Mr. Parker; you may proceed.

Mr. PARKER. Now, on page 25, we come to some special provisions. We have already discussed some of them. We will start with section 14. This is what we call the rule that takes care of the companies that have a deficit. [Reading:]

If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being computed under section 13, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under par. (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) TAX NOT TO BE INCREASED.—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

Here is a corporation that has got a deficit. It is possible that under State law it would even be prohibited from paying out a dividend. Supposing that is the case; if it has a deficit, under State law it cannot distribute anything. Of course, under the existing law we tax them on the net income approximately 15 percent. Under this bill we tax them 22.5 percent. That is the only difference. The reason for coming up from 15 percent to 22.5 percent is because of the average increase proposed on corporate incomes. We are getting 50 percent more on this system of taxation from corporate incomes, so we are just raising that pro rata.

Senator COUZENS. That is a pretty big jump, 50 percent, is it not?

Mr. PARKER. It is a big jump.

Senator KING. Is that justified?

Mr. PARKER. Yes; I think so. You have got to have the money. Perhaps you would rather do it another way. That, of course, is a matter for the committee to decide.

The CHAIRMAN. Why did you arrive at 22.5 percent, Mr. Parker?

Mr. PARKER. We expect to get about 50 percent more from corporate earnings, either from the corporation or from the individual. Under the new plan we expect to get 50 percent more.

The CHAIRMAN. You are not phrasing it on that, because if they do not declare the dividends they will not pay the 22.5 percent.

Mr. PARKER. If they are in the situation where, in spite of this deficit, they declare out their earnings in dividends, paragraph (b) here takes that out. It says [reading]:

This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

Senator COUZENS. What you fear in connection with some of these cases is that in the case of a corporation whose capital was impaired the State will not permit a distribution?

Mr. PARKER. That is the law in many States.

Senator COUZENS. We do not take any cognizance of that, only in this particular paragraph that you just read.

Mr. PARKER. This does it perhaps indirectly. We had a lot of discussion as to whether to refer to the State law or not, but it is just a terrific problem, administratively, to have our law apply differently in every State, so we came down to the earnings and profits rule, which means we will set up our own computation to see whether they have a deficit or not. That may not exactly coincide with State law, but it seems to come near enough to take care of the hard cases.

Senator LA FOLLETTE. It comes very close to it?

Mr. PARKER. It comes very close to it. A similar provision, section 15 [reading]:

CONTRACTS NOT TO PAY DIVIDENDS

If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the dividend year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the dividend year from being paid as dividends during the dividend year; and

(2) A tax upon the remainder of the adjusted net income (less the tax under par. (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

Senator COUZENS. Is there any provision whereby a corporation is required to set up a sinking fund before it pays the dividend?

Mr. PARKER. There is no provision, unless that is done in terms of dividends. If they have agreed not to pay their dividends—that is, if they made a contract not to pay a dividend until their surplus is a certain amount—I suppose that would be all right; I mean it would come under this rule, but this was not made prospective be-

cause it was feared that it would present an opportunity for tax avoidance. This only applies to contracts executed before March 3, 1936.

Senator COUZENS. What I had in mind was: Suppose a corporation earned \$100,000 and they had bonds outstanding which required them to set up, say, \$90,000 a year in the sinking fund to pay off the bonds at maturity, would any consideration be given to the fact that they had to put \$90,000 aside for the sinking fund?

Mr. PARKER. Not under this contract section; but that would come under the debt provision in section 16, which would take care of that.

Senator COUZENS. All right.

Mr. PARKER. The contract section has the same provision as was the case with the deficit section. This section shall not operate to increase the tax.

The CHAIRMAN. Do you think this will have a tendency to cause them to desist from this contract system that they have?

Mr. PARKER. Yes; I believe it will. I believe they will not make contracts not to pay dividends if they can get out of it. Many of these existing contracts are with the R. F. C. or other loaning agencies.

The CHAIRMAN. Even if they had a contract, this would tend to abolish the contract proposition?

Mr. PARKER. Yes; I think probably it will, at least as to making future contracts.

Now, section 16. Debts.

Mr. BEAMAN. Just a minute.

Mr. PARKER. Mr. Beaman points out that in the general discussion on the bill there were practical ways mentioned in which a corporation can avoid being caught by excessive taxes. For instance, they might be in a situation where they were in great need of their earnings for the current year. Now, they could declare the dividend and issue along with it stock rights to the stockholders who would put this money back into the corporation. That is not tax avoidance. They simply pay the dividend out. The stockholder has to take it up and pay his tax on it, but if he wants to buy the additional stock, that is all right. That will work in a great many cases if the credit standing of the corporation is good. Of course, it will not always work in all cases where a corporation is in a very shaky condition, the stockholders may not want to put their money back in the corporation again.

Senator KING. You do not regard any provision of this bill as interfering with obligations which have been agreed upon by the debtor and creditor, under the terms of which no dividends shall be declared until a certain amount has been set aside for a sinking fund?

Mr. PARKER. If they have got a contract not to pay dividends, they are taken care of.

Senator KING. I know many corporations where the corporation is barred from issuing bonds. Those bonds have been bought by the public. Those bonds contain the provision there shall be no dividends until the sinking fund has been set up for the amortization of the obligation.

Mr. PARKER. They are not relieved from tax under the existing law, but we do not assert the maximum tax. They do not have to pay more than 22.5 percent. The maximum rate under the bill is 42.5 percent. So it is quite a protection to these corporations.

Senator KING. You can see if there isn't some protection to corporations that are in need of money for expansion and legitimate growth for development, they might find it difficult to obtain money to carry on the business.

Mr. PARKER. That is true. Now, this debt proposition is similar to the others. We spent about an hour on it yesterday. Do you think we can pass along?

The CHAIRMAN. Yes.

Mr. PARKER. Section 17. I call your attention to page 29. It says here:

If in the case of a corporation more than one of sections 14, 15, and 16 are applicable, the tax shall be computed under the one of such sections which will produce the least tax.

That is, we do not give them all three of these reliefs at the same time. They have to pick out one and use that.

Senator COUZENS. How far are you from the holding-company section? Are you anywhere near that?

Mr. PARKER. Yes; we are going to pass along pretty rapidly now. Page 33, paragraph (7):

Income exempt under treaty.—Income of any kind, to the extent required by any treaty obligation of the United States.

We have a tax treaty with France on double taxation, and there is some thought that this bill might supersede the treaty, being of a later date. That is about all there is to that.

Senator COUZENS. This takes care of that?

Mr. PARKER. This takes care of that.

The CHAIRMAN. Let me ask you, under this section (7), does the treaty obligations include trade agreements?

Mr. PARKER. I will ask the lawyers. What do you think, Mr. Beaman?

Mr. BEAMAN. I do not know.

The CHAIRMAN. How about that, Mr. Oliphant?

Mr. OLIPHANT. I would want to look into that.

The CHAIRMAN. I see. We will pass that up.

Mr. PARKER. On page 41 there is an important change to keep in mind. It is accomplished by omitting one subsection of the existing law.

The CHAIRMAN. What page is that?

Mr. PARKER. Page 41. You will note in line 19 this heading "Dividends received by corporations", the type is stricken through. It is just omitted from the existing law.

Senator KING. That is to say, that is the existing law, you haven't changed the existing law?

Mr. PARKER. We changed it; we struck out the provision.

Senator LA FOLLETTE. You mean you abandoned the intercorporate dividend tax?

Mr. PARKER. No; we have done something more than that. We have abandoned giving a deduction for dividends received by one corporation from another. In other words, applied to the 1934 act, this section allowed a corporation, in computing its net income, after having put into its income dividends received from other corporations, to subtract those dividends out again. In other words, divi-

dends from one corporation to another were entirely exempt from tax in the hands of the receiving corporation. Now, in 1935 we wanted to put a little tax on this, so instead of exempting 100 percent of the dividends received we exempted 90 percent. That meant that we will put a tax of 15 percent on 10 percent of the dividends. It amounted to a tax of about 1½ percent.

What was accomplished by striking out that language is that the corporation receiving the dividend puts it in net income and it stays there, there is no deduction at all. Of course, that is inherent in this plan. That has to be done, because here is a subsidiary that makes a million dollars and declares it all out to the parent that owns the subsidiary; that means the subsidiary does not pay a penny of tax, therefore we must make the parent corporation pay the tax, unless it in turn distributes it to its stockholders. That is, this plan would be completely defeated by not striking that language out.

Senator GEORGE. Now, Mr. Parker, in the case of one corporation operating, say, 25 different businesses, the entire stock of that corporation being owned by the parent, and suppose that these 25 different businesses pay profits into the first corporation, and it passes all that profit or the adjusted net earning, whatever you call it, on to the parent, and the parent also pays it all out, what would happen then?

Mr. PARKER. There is no tax on the corporation at all. You have to get the money from the shareholders. There is a special rule for the holding companies. Do you mean in the case of the holding companies?

Senator GEORGE. Yes; where there is a holding company, but it owns the entire stock in another company, that is, various operating units.

Mr. PARKER. That is going to come up in section 27. We are almost over to it.

Senator COUZENS. Let us settle the question right now that Senator George raises.

Mr. PARKER. If we have a group of companies that are all operating companies, with just one holding company that gets its entire net income from dividends, and they all declare out their profits to the parent, and the parent, which is a holding company, declares its dividends out to its stockholders, there will be no tax.

Senator BLACK. Where is the provision that says there will be no tax in that instance?

Mr. PARKER. That follows from the rate table. With a 100-percent distribution of your earnings the rate becomes zero. Now, the provision on page 53 is the section I wish to call your attention to—53, (j), intercorporate dividends.

If 80 per centum or more of the gross income of the corporation is derived from dividends, then the dividend credit with respect to each dividend payment shall be reduced to an amount equal to the sum of:

(1) The portion of such dividend payment paid to shareholders other than corporations;

(2) The portion of such dividend payment paid to corporations taxable under sections 104, 105, 201—

And so forth.

Senator BLACK. These are banks, insurance companies, trade-act corporations, and tax-exempt corporations.

Mr. PARKER (reading) :

(3) The portion of such dividend payment made to a corporate shareholder owning less than 50 per centum of the class of stock with respect to which the dividend is paid; and

(4) An amount of such dividend payment paid to other corporate shareholders which bears the same ratio to the total dividend payment paid to them as the part of the gross income not derived from dividends bears to the entire gross income.

Now, this has been a pretty tough proposition. It was put in to prevent tax avoidance by these corporate chains. That is the whole purpose of it.

Senator LA FOLLETTE. Explain how it works with an example.

Mr. PARKER. Assume first that this provision was not in this bill, assume we have an operating company, and then we have a chain, nine holding companies, if you please, each one holding the other's stock; now, there are two loopholes in such a case. One of them is that the first company, the operating company, could retain 10 per cent of its profit and declare 90 percent out to the second company. The second company could retain 10 percent of that and declare 80 percent to the next company, and so on. By the time you get to the parent, and before the money got into the hands of the stockholder, you would have that group retaining pretty near all of their profit. They would be paying a very low rate of tax. It would be 4 percent, because the rate on the 10-percent detention is 4 percent. Now, really they retain practically the whole of it, and we ought to get 42.5 percent. That is one serious loophole.

Another loophole occurs through the possibility of postponing the payment of the tax. One corporation would wait until after the close of the taxable year and declare out its profits in dividends. Now, we allow a little period after the close of the year for them to declare out those dividends, and the first corporation would get the dividend credit in 1936, the second corporation would pick it up in income in 1937, and the third corporation would pick it up in income in 1938, and it would be 10 years before we could get our tax on those dividends.

Senator COUZENS. Do you discern any difference between the declaration of a dividend and the payment of a dividend?

Mr. PARKER. Oh, yes. This bill here is constructed on the proposition of dividend paid.

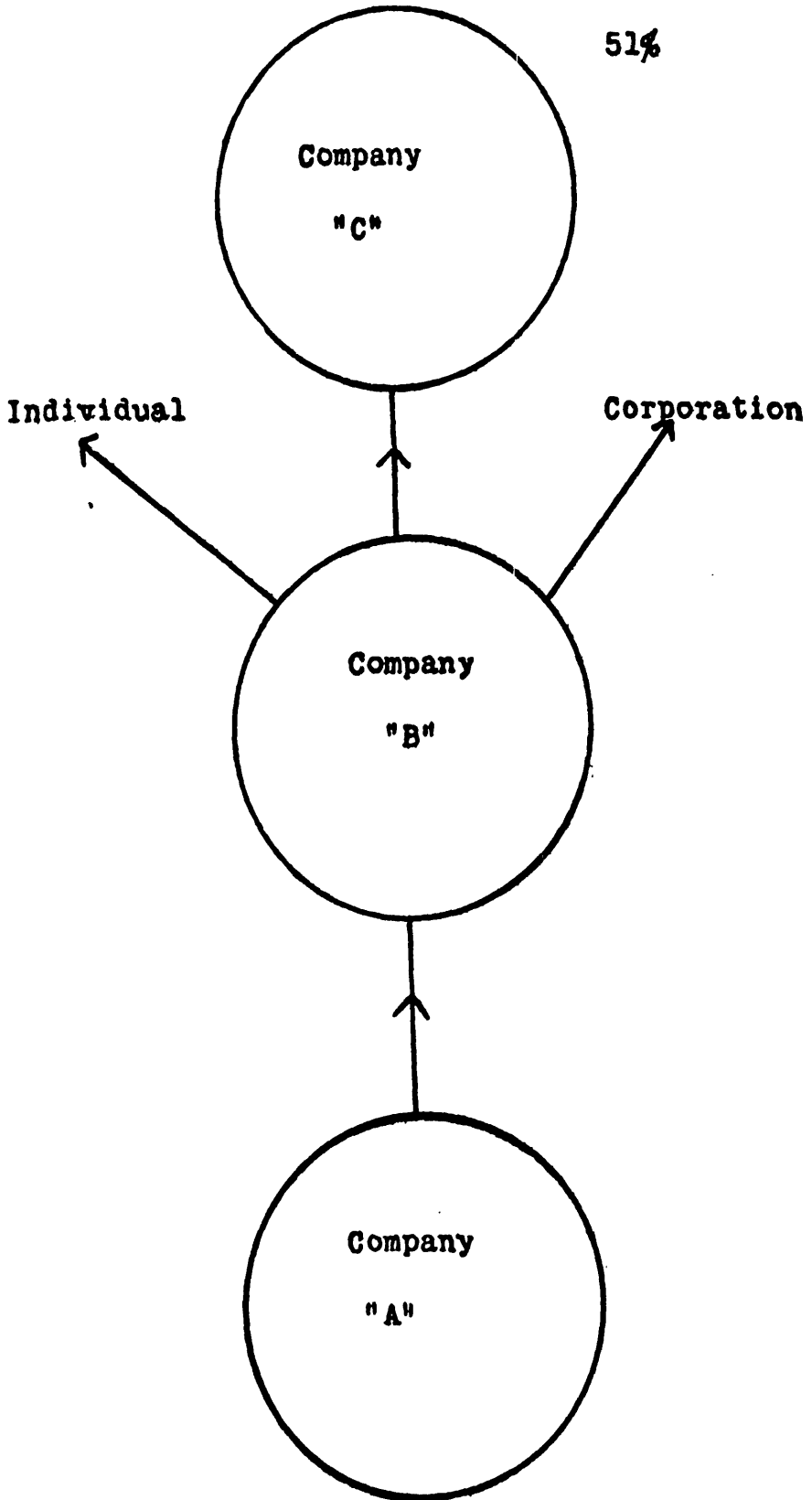
Senator COUZENS. Not on declared?

Mr. PARKER. That is correct.

Senator BLACK. Will you explain how this would make it impossible, if it does make it impossible, to accomplish just what you said?

Mr. PARKER. I think I can show this better by just a very small diagram on the blackboard.

(Mr. Parker drew the following diagram :)



Senator KING. While you are doing that, Mr. Parker, please indicate a case where there is just one holding company and there are eight or nine independent corporations, but the holding company owns the stock of each of those corporations, and those smaller corporations turn over all of their earnings to the parent corporation. Now, who would pay the tax and what would be the basis of taxation there?

Mr. BEAMAN. That is not involved in this part that we are discussing, Senator.

Senator COUZENS. Would you mind if we would get the first question answered?

Senator KING. That is a holding company.

Mr. PARKER. Now, assume you have an operating company, company A [illustrating on diagram], and 100 percent of its stock is owned by company B. This provision does not have any effect on any corporation unless 80 percent or more of its gross income is derived from dividends, which obviously applies just to holding companies. This company B holds 100 percent of company A, and we will assume that 100 percent of its income comes from dividends. Now, there is a limitation put on this company in respect to what amount will be allowed as a dividend credit; and you remember, of course, that the tax rate depends on the amount of dividend credit the corporation can get. The dividend credit of this company is going to be restricted if, as under paragraph (3), there is any company which owns more than 50 percent of its capital stock. Suppose company C does own 51 percent of the stock of company B; then company B's credit will not include the dividend paid to company C, and the dividend credit that company B gets will be made up in this case of 49 percent of its dividends paid.

That is what goes to individuals; what goes to tax-exempt corporations, banks, and so forth, and corporations owning less than 50 percent of its stock.

Now, of course that is pretty severe provision, because if this ownership here was 100 percent then corporation B would get no dividend credit at all, and in spite of declaring all its dividends out to company C it would have to pay 42½ percent tax.

Mr. BEAMAN. In other words, it pays 42½ percent whether it keeps it all or whether it distributes it.

Senator BLACK. Suppose it gets 75 percent of its gross income from dividends?

Mr. PARKER. Then it is out. It does not apply. It does not apply to any corporation where only 75 percent of its gross income came from dividends.

Senator BLACK. What would happen with reference to it? What would be the taxing situation with reference to it?

Mr. PARKER. They would get credit for any dividends paid out, just the same as any other corporation.

Senator BLACK. Would it have to pay any tax on dividends which it received from the other corporations?

Mr. PARKER. It would have to pay a tax on them if it did not, in turn, distribute it out. If it retained them, it would have to pay a tax. If it distributed all its earnings out, including the dividend received from the other corporation, it would not have to pay a tax.

The CHAIRMAN. So the joker is that these fellows cannot evade the law?

Mr. PARKER. It must be admitted that this is a very strict rule.

Senator COUZENS. Is there any reason why it should not be?

Mr. PARKER. Of course, if you just have one holding company, one parent, it is all right. It will be hard only where you have got a chain of holding companies.

Senator COUZENS. It will probably force some of these fellows to change their capital structure so they do not become so complicated.

Senator GEORGE. Is this built on anything permitting them to wipe out these holding companies—liquidate them?

Mr. PARKER. We put a provision in the 1935 act. I do not know whether it is a perfectly satisfactory provision. Under section 110 of the 1935 act we allowed one corporation to liquidate another corporation. It did not affect the individual at all; it just affected the corporation.

Senator GEORGE. It did not affect the individual holdings?

Mr. PARKER. That is right. We have put something in this law that I believe is a good thing, which allows personal holding companies and other corporations to be liquidated, and it affects the individual. We adopted a new rule in 1934 which provided that when a corporation was liquidating, the stockholder computed a gain on what he received in excess of what he paid for his stock, and while that was a gain in the nature of a capital gain, he had to put 100 percent of that gain in income. The result has been just the same as when we put the full tax on capital gains—to just put an embargo on those transactions. People will not liquidate and pay 75 percent. They will liquidate and pay 30 or 35 percent tax. We have gone back to the old rule now, and if you liquidate it is proposed in this bill that you take up that income just the same as any other capital gain.

The CHAIRMAN. Would that rule apply to this situation: The State of Pennsylvania, for instance, recently passed a law to abolish toll bridges. There are a great number of toll bridges. A good many have been asking large surpluses. They have got to liquidate; they have got to get out of business. They will be caught pretty heavily, with all these dividends that they have declared. Has that been brought to your attention?

Mr. PARKER. No; but I had a great deal of correspondence forwarded to me from Senators and Congressmen on this particular point.

Senator LA FOLLETTE. The corporation would not be caught if it paid out the dividends.

Mr. PARKER. I should think this provision as to liquidation would help the stockholders of these bridge companies. These companies want to liquidate. I presume the bridges are already sold to the State.

The CHAIRMAN. Yes.

Mr. PARKER. They can liquidate and stockholders can pay the capital gains tax. That is, if they held the stock for over 10 years, instead of paying the tax on 100 percent of the gain, they only pay on 30 percent of the gain. I should think that would take care of it—that is, to an extent. We want to get a reasonable tax.

The CHAIRMAN. Have you anything else on this point now?

Mr. PARKER. I was on page 41. Now, on page 46, there is another case where we have omitted a section from the existing law which is very important, and this is the main change which the bill makes in connection with taxing the individual.

Senator LA FOLLETTE. What are you referring to now, Mr. Parker?

Mr. PARKER. The language that has been stricken through on page 46. That change is what brings the dividends received by the individual under the normal tax. You see, we strike out the credit against the normal tax for dividends received, so, of course, when we strike out the credit against normal tax, that means they are taxed at 4 percent.

Senator COUZENS. That is also retroactive to January 1?

Mr. PARKER. Yes, Senator.

The CHAIRMAN. That is the one that affects largely the banks and insurance companies?

Mr. PARKER. It affects banks and insurance companies. They made no exception as to them.

Senator COUZENS. That is only the stockholders, not the banks or insurance companies themselves?

Mr. PARKER. No; just the stockholders. There was considerable argument on that point on the theory that the corporation had to pay the flat rate of tax on income, and dividends should be exempt, but the House did not do that.

Mr. BEAMAN. Senator, I do not want that to remain in the record without being corrected. In one sense it is retroactive to January 1. It is not retroactive to January 1 in the case of a man whose fiscal year does not begin until after January 1. In other words, this new bill does not apply until his taxable year begins.

Senator COUZENS. I understand, but I am talking about the individual, and most of the individuals are on a calendar-year basis.

Mr. BEAMAN. By and large, that is correct, subject to that qualification.

Senator COUZENS. Yes.

Mr. PARKER. Now, on page 50 there are some definitions which are important in connection with the general plan.

(a) *Definition of "dividend year."*—The term "dividend year" when used in this title with reference to a corporation means the period beginning on the fifteenth day of the third month after the day before the beginning of the taxable year (whether the taxable year is a period of 12 months or a shorter period) and ending on the fourteenth day of the third month after the close of the taxable year.

This language, of course, is to take care of the taxable year, whether it begins on the 1st of January or whenever it begins.

Senator KING. You are addressing yourself now to all the provisions of section 27?

Mr. PARKER. Under this subdivision (a).

Senator KING. All right.

Mr. PARKER. The dividend year in the case of a calendar-year return will begin on March 15?

The CHAIRMAN. Let me interrupt before we get into that.

(Short interruption.)

The CHAIRMAN. All right, Mr. Parker, you may proceed.

Mr. PARKER. All there is to this dividend year definition is this:

For the first year, 1936, assuming a calendar-year basis, the period from January 1 to December 31 is your taxable year.

Now, the dividend year corresponding with that, and the year that is used in the computation of your dividend credit, will extend from March 15, 1936, to March 14, 1937. That is on the theory that in the first few months of the year you are declaring out the profits of the preceding year, so that your dividend year begins 2 months and 15 days after the beginning of your taxable year and it closes 2 months and 14 days after the close of the taxable year.

The CHAIRMAN. In making my return from March 15, if I have got some dividends, and so forth, on the 1st of March, I would not include that in that year?

Mr. PARKER. This is not a question of when you receive them; this is a question of paying out dividends. You are a corporation, and you are paying them out.

The CHAIRMAN. I see.

Senator COUZENS. In other words, does this indicate some advantage or disadvantage to the corporation?

Mr. PARKER. It was supposed to be some advantage to them to allow them to complete their accounts at the end of the taxable year and then to declare out dividends in light of the facts.

The CHAIRMAN. It is convenient for them.

Mr. PARKER. On account of the fact that the tax depended on the dividends we give them 2 months and 15 days in which to figure out how much in dividends they want to pay; in other words, figure out the tax, because the tax is going to be dependent on the amount of dividends paid.

Senator COUZENS. All right.

Mr. PARKER. NOW—

DIVIDEND CREDIT IN GENERAL

For the purpose of this title the dividend credit shall be the amount of dividends paid during the dividend year corresponding to the taxable year.

That is, on dividends paid; it is not on dividends declared. Senator, you asked about that point. It is on dividends paid.

The CHAIRMAN. Now take paragraph (c).

Mr. PARKER. Paragraph (c) is a very important provision; and while it gives some relief to the corporation, I do not think it affects the revenue. It may, in effect, increase the revenue, or at least stabilize it.

DIVIDEND CARRY-OVER

In computing the dividend credit for any taxable year, if the dividends paid during the dividend year are less than the adjusted net income, there shall be allowed as part of the dividend credit, and in the following order:

and I will not read further.

We allow the excess of the amount of dividends in the 2 preceding years over the adjusted net income for those years to be carried forward and applied to the current year. For instance, supposing in 1936 the corporation's adjusted net income was \$100,000, but the corporation paid out in the dividend year \$120,000, without this section (c) that excess would be lost as a dividend credit, and the corporation paid out \$20,000 more than was necessary to escape the tax, and there was no tax. So this would provide, if in 1937

the corporation makes \$100,000, it can declare \$80,000 out in dividends in that year, and it can use this \$20,000 excess that it had in the preceding year and pay no tax.

That will be very helpful in allowing the corporations to maintain a standard dividend policy, because if you are going to take away that credit from them they will not declare out dividends until they are certain that they have net income, and they might even discontinue quarterly dividends, because it is not every company that knows, just because it makes some income during the first quarter of the year, that it is going to make income throughout the year. In that case they would not dare to make the quarterly dividends. The tendency would be toward making annual dividends, after the close of the taxable year, which would also delay the receipt of income by individuals and hurt the Government from a revenue standpoint. Their dividend carry-over is limited to 2 years, and they have to be taken off in a certain order as provided in this section.

Now, on page 51:

DIVIDENDS IN KIND

If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividend credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

The CHAIRMAN. How are you going to obtain the fair market value?

Mr. PARKER. Well, we have to determine that anyway, because if there is a dividend in kind paid, the stockholder always picks that up in his income at the fair market value.

The CHAIRMAN. Who passes on that? The Commissioner?

Mr. PARKER. Well, the taxpayer puts down the amount and the Commissioner of course checks it, to determine it.

The CHAIRMAN. He has to approve it?

Mr. PARKER. Yes, Senator.

Senator COUZENS. Let me ask you as to that language in brackets there "(including stock of the corporation if held by the corporation as an investment)", do you mean if it holds its own corporate stock?

Mr. PARKER. Yes, sir; that probably will not be very usual, the application of that provision, but we found some cases where it appeared that the corporation bought its own stock on the market and did not retire that stock, it held it, and it may distribute it as a dividend in kind.

Senator COUZENS. Supposing it is divided as stock of another corporation, which would not be in kind, should not that language include that also?

Mr. PARKER. The word "property" certainly includes everything else, and the courts might even construe it to include its own stock, but because of the fact that when we are dealing with the stock of the corporation itself there might be some doubt on that point, as to whether that would be included. There is no doubt about including the stock of any other corporation which it held and distributed.

Senator BLACK. What do you mean by "adjusted basis"?

Mr. PARKER. That is our ordinary income-tax language, "adjusted basis of the property." It has adjusted its book value down to date.

Senator BLACK. In other words, that means book value?

Mr. PARKER. Practically that, if the books are kept in accordance with the income-tax rules, you adjust it down. Supposing this thing was an automobile truck, supposing you paid \$5,000 for it, every year you have got \$500 depreciation; you are now distributing dividend in kind. You take off the depreciation that has been charged up on your books since the beginning.

The CHAIRMAN. We will recess until 10 o'clock in the morning.

(Whereupon, at the hour of 11:55 a. m., a recess was taken until 10 a. m. of the following day, Saturday, Apr. 25, 1936.)

REVENUE ACT OF 1936

SATURDAY, APRIL 25, 1936

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met in executive session, pursuant to adjournment at 10 a. m., Senate Finance Committee room, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, George, Barkley, Connally, Byrd, Lonergan, Gerry, Couzens, and La Follette.

Also present: Guy T. Helvering, Commissioner of Internal Revenue, Treasury Department; Herman Oliphant, General Counsel for the Treasury Department; Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue; George C. Haas, Director of Research and Statistics, Treasury Department; A. S. McLeod, statistician, Treasury Department; C. E. Turney, Assistant General Counsel for the Treasury Department; L. H. Parker, Chief of Staff, Joint Committee on Internal Revenue Taxation, and members of his staff; Middleton Beaman, Legislative Counsel, House of Representatives.

The CHAIRMAN. All right, Mr. Helvering. Mr. Parker was on the stand when we adjourned yesterday. What is your pleasure about proceeding with this explanation?

Mr. HELVERING. I thought you might possibly want to finish the explanation.

The CHAIRMAN. Yes; I think so. All right, Mr. Parker, where did you leave off?

Mr. PARKER. I think we just finished the debt proposition.

Senator GERRY. What page is that, Mr. Parker?

The CHAIRMAN. You were on page 53, were you not?

Mr. PARKER. That is right.

The CHAIRMAN. You were talking about intercorporate dividends, as I recollect.

Senator GEORGE. Mr. Parker, where a corporation under a previous contract, a contract made prior to a certain date, has agreed not to declare dividends, does it give some relief to the corporation which, under the law, cannot pay out while it has an impairment in the stock?

Mr. PARKER. That is correct, Senator. That is taken care of at page 25, at the bottom of the page, where it says, "Contracts not to pay dividends." It does not mean that they are not taxed, but they are relieved from paying the maximum rate on account of failure to distribute dividends.

Senator GEORGE. That is true where, under the State law, they cannot pay out also?

Mr. PARKER. That is taken care of, not by using that term, but by giving them relief in case they have a deficit. The application of the State law generally depends on whether or not they have a deficit.

Senator GEORGE. Oh, yes; of course they must have a deficit.

Senator GERRY. I was not here during all of yesterday's hearing. Page 25. Mr. Parker, does that cover all the relation to the State-law requirements?

Mr. PARKER. Page 25, section 14, at the top of the page, is the one that takes care of the deficit. When they have no earnings and profits accumulated in the past, you see, then they can come under the flat 22.5-percent rate.

Senator GERRY. Yes; but at the bottom of the page there is the question of contract. That is the matter that Senator George just referred to.

Mr. PARKER. This takes care of it, except we use the income-tax rules in computing that deficit, and the States might recognize certain other rules.

Senator GERRY. That is just what I have in mind. I haven't looked into the laws of my own State—I do not know enough about it—but I understand that certain States have their own requirements in regard to what is to be charged up as a deficit, and you are liable to have a conflict between the Federal law in this case and the State law, and the corporation would be between the devil and the deep-sea, because it would not know what it would have to pay out in order to conform with both statutes.

Mr. PARKER. That is quite possible, and I can give you an example of it. I do not think you will want to remedy it. For instance, we went through a period after 1921 of a lot of stock dividends. Now, when you distribute stock dividends as an accounting matter you are very likely, under some State laws, to dissipate the surplus. For instance, a company in 1925 might have had capital stock of \$1,000,000 and \$1,000,000 surplus, and they declare a \$1,000,000 stock dividend. Now, they have got no surplus, and when they run into a depression undoubtedly their books show a deficit. Now, we do not take into account, for income-tax purposes, that stock dividend. For income-tax purposes we say they have got capital stock of \$1,000,000, and they have still got the \$1,000,000 surplus, because you recall, Senator, we cannot tax the stock dividends. I do not think just because the corporation has been so unwise as to issue a lot of paper and overcapitalize they ought to be taken care of. I do not believe we can afford to do anything about that.

Senator GERRY. I was not worried about the question of stock dividends.

Mr. PARKER. That is a very important question.

Senator GERRY. That is an important question, but I was just wondering if there were not certain State statutes in regard to that, and what they would pay out where they are forbidden, under certain State statutes, to do that. Is there not a conflict right there?

Mr. PARKER. I think Mr. Kent can answer that better than I can. He made some study of it. He had a report from the Bureau on the State statutes.

Mr. KENT. We had a survey made of the State statutes with respect to this matter. We would be glad to provide the members.

of the committee with a copy of that. I believe it is in the House hearings. We will be glad to give you copies of that study, to show you just what the situation under the various State laws is.

State laws ordinarily forbid the directors to declare a dividend to the shareholders where there is a deficit or impairment in the capital of the corporation. But, you will probably find some differences in the interpretation of the statutes in different States.

Senator GERRY. If the directors disobey that, they are personally liable?

Mr. KENT. That is sometimes true, Senator.

Senator GERRY. There you have the situation where they declare the dividend they would have a personal liability, and the result would be that in those States they would not declare the dividend, they would pay whatever the extra tax was, and you would have the case of the Federal Government coercing the State government on how the corporations in that State should be run.

Mr. KENT. I believe that section 14 of the bill as drawn will take care of the meritorious cases.

Senator GERRY. Does that come later on? I do not want to bring it up if it comes later on.

Mr. KENT. That is in section 14 that we discussed yesterday, the section on page 25. That section is aimed to take care of any case where the dividend could not be declared, because there is a real deficit, a real impairment of the capital of the corporation, but there may be some cases where there is what you might call a paper deficit, or a paper impairment, which would not be taken care of by this section, but, as Mr. Parker said, it is very doubtful whether it would be wise to make any provisions for such cases, because such paper deficits can be readily taken care of in other ways.

In the case Mr. Parker has stated, if they have unwisely increased their paper capitalization by reason of stock dividends in the past, they can easily take care of the situation by writing down their paper capitalization as much as is necessary.

Senator COUZENS. In other words, they can, by arrangement with their States, reduce the capital to protect themselves?

Mr. KENT. That is right, Senator.

Senator GERRY. Of course, I do not know the particular case. The thing I was getting into was whether we have got a conflict between the Federal statute and the State statute whereby you are really coercing the State to drop legislation because the Federal Government wants it in a certain way, and the State may not want it. We are interfering with State rights.

Mr. KENT. Of course there is a great lack of uniformity in the State statutes with regard to this matter. Some States are of course notoriously loose in their corporations laws, and other are much more strict.

Senator GERRY. Of course, that is up to the States.

Mr. KENT. I do believe, Senator, that section 14 will take care of all the meritorious cases where there has been real impairment of the corporation's capital by reason of business adversity and operating losses.

Senator GERRY. Well, now, you have a memorandum on this subject, you say, or the Treasury has?

Mr. KENT. Yes, sir.

Senator GERRY. I do not want to take up the time of the committee if they have been over it. I would like to see the memorandum and later. Mr. Chairman, possibly I might want to ask some more questions in regard to that.

Mr. BEAMAN. The Ways and Means Committee, in their consideration of this matter, started out with the same idea you had in mind, namely, they approached the thing from the standpoint of granting relief wherever the State law prohibited the payments of dividends, but they found out, in the first place, along the line that Mr. Kent said, that this method gives relief in practically all the cases where it seemed right and just that relief should be granted, and, secondly, they confronted the situation that the corporations would immediately go over to their State legislatures to rig up their laws so the corporation would not pay any taxes, and practically turn over to the State the rights of the Federal Government in an income tax. If you leave it to the State, any time the State law prohibits the payment of dividends, it simply leaves it up to the States, and the corporations there will fix up their laws so they will not pay the income tax. That is a very serious danger that you run into. I think if you look into this you will find this gives relief in cases where you think relief should be given.

Senator GERRY. This is all covered in the memorandum?

Mr. BEAMAN. The only memorandum that I have ever seen on the one Mr. Kent refers to is simply a summary of what the State laws are.

Mr. KENT. That is right.

Senator GERRY. That is a rather difficult thing to delve into hastily, unless you have got something more on that, according to the statement that Mr. Beaman made.

Mr. KENT. I will be glad to provide you copies of it, and, if you desire, supplemental information.

Senator GERRY. Can Mr. Beaman give me the memorandum in the House hearing? I do not want to hold up the committee.

Mr. KENT. I think I was probably mistaken when I said it went into the record of the formal hearings. I believe that it was presented to the subcommittee during the preliminary discussions of the matter.

Senator GERRY. Mr. Beaman, have you got any memorandum on this, or any reference on this?

Mr. BEAMAN. No; not a thing in the world, Senator.

Senator GERRY. You were speaking of the House hearings.

Mr. BEAMAN. I did not say the House hearings, I said the discussion in the executive session of the committee. The way I look at it, the way the Ways and Means Committee looked at it, there is no memorandum of any use. When the State law prohibits the payment of dividends it is obvious, without any memorandum, a moment's reflection will show, that it leaves it up to the State to pass any kind of law it wants to to prohibit the payment of dividends, under any kind of circumstances.

Senator GERRY. Unless the State statute now existing prohibits it. Of course, that would obviate the future.

Mr. BEAMAN. Even then the same thing would apply. If some States, in their anxiety to attract corporations, made some foolish laws, the question is whether we should let that interfere with the

proper collection of Federal revenue. It will just take a minute to study this rule. It seems essentially fair. You see, the starting point of it is that in order to get the dividend credit the dividends distributed must be taxable. If it is a dividend that is not taxable to the shareholders, the corporation gets no credit. In order to be a taxable dividend under the income-tax law, it must be a distribution of earnings and profits. If the corporation has earnings and profits, the distribution may be taxable. Therefore, if the net income of the corporation for the year is greater than the accumulated earnings and profits at the end of the year, obviously they cannot distribute an amount equal to the whole net income as a taxable dividend. If their net income is \$100 for the year and the accumulated profits at the end of the year are \$80, it is obvious they cannot distribute more than \$80 of that as a taxable dividend. The other \$20, even if they distribute the \$20, would not be a taxable dividend; they would not get any credit for it. Therefore this law says that the amount by which their income for the year exceeds the accumulated earnings and profits, for that much they can get the lower rate.

Senator GERRY. Does not that go into the question of what the requirements are in regard to the accumulation of profits, and what is allowed to be charged off and what the general practice of the State is? I am not taking an extreme case, but where you have got the usual practice. Are your bookkeeping requirements, for example, in the Treasury the same as in most of the States?

Mr. PARKER. Well, the State laws are very loosely drawn, they are just in general terms. The State does not try to enforce the laws actively unless some of the minority stockholders make a kick about it. That is, in a great majority of the States the State does not go out and examine the books of the corporation to see whether they had declared a dividend or had a deficit or not. If the stockholders start a suit or something, then the State comes in.

Senator GERRY. I do not want to hold up the committee, Mr. Chairman. I will just talk with Mr. Parker about that.

The CHAIRMAN. All right, Mr. Parker.

Mr. PARKER. We were on page 51.

Senator KING. Mr. Parker, I should be glad to have the experts here to prepare a statement based upon the obtaining of a billion dollars' additional revenue, a billion dollars of revenue from income taxes and from corporate taxes, such as you expect to get revenue from, or taxes under your bill. I would like to increase it to a billion dollars and then obtain that billion dollars from lowering the exemptions and increasing the income tax, particularly in the brackets from \$10,000 to \$50,000, and then on up, and then, of course, the corporate taxes, perhaps 1 percent on each one, from 12½ up to 15, and see what the result would be under that schedule, or that plan, with the statistics which you have, using the basis which you have for computing the revenue to be derived under this bill as the basis for the computations, to raise a billion dollars.

Mr. Commissioner, I would like to have the experts prepare a statement along that line.

Mr. PARKER. If I understand you, Senator, you mean an entirely new plan, not this plan?

Senator KING. Not this plan at all.

Mr. PARKER. For a billion dollars instead of approximately \$800,000,000?

Senator KING. Increasing the present income from the corporate tax, to raise a billion dollars.

Mr. PARKER. We would have to get that into shape.

Senator KING. Do that please. I may offer that as a substitute, Mr. Chairman, in the committee.

The CHAIRMAN. Your idea now is to merely get the picture?

Senator KING. Oh, sure.

The CHAIRMAN. All right, Mr. Parker, you may proceed.

Mr. PARKER. Page 51, line 19, subparagraph (e), dividends in obligations of the corporation.

If a dividend is paid in obligations of the corporation, the amount of the dividend credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the dividend year in which the redemption occurs.

That simply means if a corporation makes a dividend payment in bonds or interest-bearing script, or what not, that such payment will be considered a dividend. That lays down the rule of taking the credit, either the face value, or the fair market value, whichever is lower.

The second part of the section gives the rule where you take the fair market value and then when it is redeemed you pay more than you have been allowed as a dividend credit, you get that excess amount in the year in which it is redeemed.

That particular form of dividends may be used to a considerable extent if this bill passes, because if the corporation desires to keep their earnings for some important purpose they would be able to lower their tax by distributing these bonds, but of course the stockholder would have to take those up in his income just the same as if he had received cash. So that the Government does not lose anything by that method.

Page 52, paragraph (f), taxable stock dividends.

Senator KING. Just before you leave that, see if I understand it. Under that plan the aggregate amount of tax would be paid whether it is paid in stock dividends or in cash, the Government would get the same amount?

Mr. PARKER. Yes; the Government would get practically the same amount. Of course, whether you are dealing with the face value, or the fair market value, the stockholder would take it up at the fair market value.

Senator KING. At the time of the declaration of the dividend?

Mr. PARKER. At the time of payment of the dividend. For instance, here is a corporation that makes \$100,000; it needs that money to put up a new plant; instead of giving a cash dividend to the stockholders it might give the stockholders notes for a year, interest-bearing notes. Now, the corporation would be entitled to use these notes as a dividend credit at their fair market value. If they bore no interest, probably the fair market value would be 94. or

something like that, and the stockholder would take it up at 94 and pay a tax on it. Then when the corporation redeemed it they would get the other \$6 as the dividend credit when they redeemed it, and the stockholder, if he got more than the value which he had reported on his return, he would have to report \$6 additional on his return.

Senator GERRY. In other words, that would apply to notes, bonds, and stocks, anything of that sort?

Senator KING. Any obligation.

Mr. PARKER. Any obligation. It would not apply to stock. The stock proposition is taken care of hereinafter.

In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 15 (f), the dividend credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

It appears from a recent case that there are certain kinds of stock dividends that can be taxed, and others that cannot. We are still prohibited, under *Eisner v. McComber* from taxing a straight stock dividend, where you have common stock and issue two shares for one prorated among all the stockholders. You cannot tax that. But one of the court decisions leads us to the conclusion that if you pay a stock dividend on common stock in another class of stock, like preferred, you might be able to tax it, and there is a provision in here later which says in so many words that all stock dividends are taxable to the extent that it is possible under the sixteenth amendment to the Constitution. So that the bill attempts to tax every stock dividend it can. Of course, it cannot tax what we might designate as a true stock dividend.

Senator BARKLEY. One difference between (f) and (e) is that one taxes bonds and the other is simply a stock dividend. In that case the fair market value is the measure instead of the face value, whichever is the lower.

Mr. PARKER. That is true, because the stock having no definite time of redemption is a different proposition, and of course, there might be no par stock, so the best thing to do is just take the fair market value in that case.

Senator COUZENS. In other words, when the stock dividends are issued, if the corporation takes no credit for them, then they would not be taxed.

Mr. BEAMAN. It works just the other way. If it is taxable to the stockholder, the corporation gets the credit. If it is not taxable to the stockholder, the corporation does not get the credit.

Senator COUZENS. I understand. When the corporation makes its report it takes credit for these stock dividends.

Mr. BEAMAN. If they are taxable to the stockholder.

Senator COUZENS. Then, of course, they are taxable to the stockholders, are they not?

Mr. BEAMAN. Not necessarily. That is a matter of law. The corporation gets the credit only if the dividend is, as a matter of law, taxable to the stockholder.

Senator COUZENS. So in that event there could be no evasion by the issuance of a stock dividend.

Mr. BEAMAN. That is right.

Mr. PARKER. Page 52, subsection (g), Distributions in Liquidation [reading]:

In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividend credit section, be treated as a taxable dividend paid.

In other words, if the corporation liquidates a total amount of \$100, and \$50 represents capital and \$50 represents earnings and profits, the dividend credit is \$50.

Senator GERRY. How do you compute your capital in that case? You say February 28, 1913.

Senator COUZENS. That is when the sixteenth amendment became effective.

Mr. PARKER. The day before.

Mr. KENT. This provision would not create any new difficulties.

Senator GERRY. What I have in mind is, where a corporation, for example, was liquidated, how would the capital in that case be computed?

Senator COUZENS. Would not that be a matter of record in the Internal Revenue Bureau?

Senator GERRY. No; it is a question, I should say, of interpretation of this section.

Mr. PARKER. We have to go way back to the beginning. In all these sections you find numerous references to earnings and profits. The determination of earnings and profits of course is an accounting proposition. The earnings and profits account may be built up from the time of the organization of the company. It is not an easy task to compute this account, but it has been done all through the war period, and it is generally done now.

Senator GERRY. What I am trying to get at is what your rate of tax would be. For example, supposing the corporation had made a valuation of the capital and it was a certain amount less, according to the appraisers, in February 1913, than it was when it was liquidated, then they pay a tax on the increased amount; is that it? They pay a tax on the capital?

Mr. PARKER. They would not pay a tax on the capital, they would pay a tax on the appreciation, if it is worth more.

Senator GERRY. But they pay a tax on the capital.

Mr. BEAMAN. You are going at this from the wrong angle. The general rule in computing the dividend credit is that you are only allowed credit for dividends paid which are taxable to the stockholders. Now, in the case of liquidation the amount received by the stockholder in liquidation is not taxable as dividend; it is taxable as capital gain. If the stockholder paid \$100 for the stock (and the basis has not been adjusted, it still remains \$100) he gets something in liquidation of that stock. he does not take that whole amount subject to normal and surtax. He compares what he gets for \$100. If he gets \$110 for his \$100 stock, that \$10 is capital gain; that is all he is taxed on.

This section is giving the corporation something that it would not get if you took out this subsection, because you are giving them as dividend credit a certain portion of the amount distributed in liquidation, although it is not taxable dividend to the stockholder. So

you are giving them something they would not get if you took this out.

Now, it seems apparent you do not want to give them a dividend credit for something that is not out of earnings, at least the part of the distribution which is not out of earnings and profits. To the extent that the distribution is out of earnings and profits, they can take it as a dividend credit even though it is not taxable dividend. In other words, it is giving them a favor.

The question you asked as to how they determine what is capital gain and what is earnings and profits, that is an old question that has been floating around in the Bureau and the courts for a good many years, and will probably continue to do so.

Senator GERRY. Now, that goes under your capital gain and profits?

Mr. BEAMAN. Personally, I do not know how they do it. I know they do it and have done it. That is not anything new. The thing I want to emphasize is this thing is a boon to the corporations, to give them something in order to be fair to them.

Senator KING. So that I will understand it, I will give a concrete example. Take a corporation organized, say, in 1920 or 1924, the stockholders each paid in \$100 and they had a corporation of \$100,000; in all these years since its organization no dividends have been paid. Some years there were profits, but they were plowed back into the concern to make it a going concern. In the meantime, in some years, in lean years, they had to levy an assessment, as many corporations did, upon their stockholders. Now they liquidate. How are you going to determine the value of the stock, based upon the fact that in all those years not a cent of dividend has been distributed and assessments in considerable sums have been levied upon the stockholders, how are you going to determine whether it has losses or gains?

Mr. BEAMAN. That hasn't anything to do with this particular thing here. The question you asked is what is the tax to the stockholder?

Senator KING. We are talking about distribution and liquidation.

Mr. BEAMAN. All you are talking about here, Senator, is the dividend credit to the corporation. This does not affect in any way the tax paid by the stockholder. I will be glad to go into the question, but it has no bearing here.

Senator KING. It would seem to me to be germane to the question of distribution and liquidation.

Mr. BEAMAN. This simply means that it deals with what is credited to the corporation, not what is the tax on the shareholder.

Senator KING. We will come to that a little later. Then I would like to find out how you would treat that.

Senator GEORGE. Mr. Parker, would this be giving the corporation full credit in each instance? Has some of the accumulated surplus already borne a tax?

Mr. PARKER. It will be giving it full credit under the new plan. They are getting full credit for the dividend paid.

Senator GEORGE. In some instances has it not already borne a tax?

Mr. PARKER. Oh, yes. Of course, when they get the credit upon complete liquidation, they never would pay a tax really. Under complete liquidation under this bill everything has gone out, every-

thing the corporation earned. If they really make it a complete liquidation and not a partial liquidation and pay everything out they could not pay any tax under this bill.

Senator GEORGE. You give them credit only for the original investment?

Mr. PARKER. We give them credit for the earnings and profits, and that is all they need, because the distribution of capital would not bring about any tax. You see, they might have some earnings and profits during the year. They might have had a capital at the beginning of the year of \$100, and they make \$100 during the year; that \$100 would be income, would be subject to taxation, and it would be taxed if we did not give them this dividend credit. Now we liquidate at the end of the year and distribute the whole \$200. The corporation does not pay any tax, but it would if we did not give it this dividend credit, because it had earnings and profits of \$100, and it needs that dividend credit. That is the thing that takes it out of the tax.

Senator GEORGE. This simply affects the corporation here?

Mr. PARKER. That is all, only the corporation.

Senator GEORGE. It does not affect the taxpayer at all?

Mr. PARKER. That is right. The taxpayers, the stockholders, may all be in different situations. On a liquidation it is impossible to have an entirely consistent rule. You may pay \$50 for your stock, and Senator Harrison may pay \$150 for his stock, and you both may get \$100. Of course, one has got a profit and the other a loss. We cannot follow the earnings and profits of the corporation through to the books of the stockholder, because every stockholder's situation may be different on liquidation.

The CHAIRMAN. All right, Mr. Parker, you may proceed.

Mr. PARKER (reading):

Preferential dividends: No dividend credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class, and each of the shareholders of that class, who are subject to taxation under this title for the period in which the distribution is made, receives a taxable dividend as a result of this distribution.

Now, we were informed that, in some States at least, it is possible for a corporation to make a dividend that is not prorated, and this is to stop a possible loophole. For instance, if we had two or three rich men in the corporation that were up in the 75-percent bracket, of course, they would rather have the money stay in the corporation and pay even the high rate of 42.5 percent, but they have some small stockholders, and the few big stockholders will say:

We will waive our dividend. We will pay a dividend to the small stockholders and we will get that dividend credit. They will not have to pay much tax. We will wait for our dividend a couple of years.

That will upset the whole plan, it will make a loophole there.

(1) Nontaxable Distributions: If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividend credit shall be allowed with respect to such part.

That is what Mr. Beaman touched on. If there is a distribution made and it is not a taxable dividend in the hands of the shareholders, then the corporation does not get the dividend credit.

Senator COUZENS. That is the part that Mr. Beaman explained which was reverse to the position I took a while ago.

Mr. PARKER. That is right.

Senator GEORGE. So it may get a credit, so far as its distribution to A, B, C, and D is concerned, and it may be denied to F, G, H, and I. Is that what it is?

Mr. PARKER. No; that will not generally occur.

Senator GEORGE. I am thinking, though, in the case of the administration of it.

Mr. PARKER. It does not mean it is taxed, it means it is subject to taxation.

Senator GEORGE. I understand.

Mr. PARKER. For instance, the corporation would still get its credit, even though the dividend would be paid to a charitable organization that was exempt from tax, or it would get its credit if it paid it to a man whose business losses exceeded this dividend and he would pay no tax, but the corporation would still get its credit. Of course, it would be impossible for the corporation to go to each shareholder and find out whether or not they were taxable. This simply means subject to taxation, it does not mean the shareholder has to pay us a tax.

Senator BARKLEY. In other words, if the corporation makes a distribution to its shareholders upon which the shareholder does not have to pay a tax, then the corporation will pay the tax, because it gets no dividend credit for that, is that correct?

Mr. PARKER. I think you could misunderstand it the way you stated it. It is a question of whether the dividend is subject to taxation.

Senator BARKLEY. Yes.

Mr. PARKER. That is different from paying an actual tax.

Senator BARKLEY. It may be subject to taxation, but the situation of the individual may exempt it.

Mr. PARKER. Yes.

Senator BARKLEY. If it is a taxable distribution the corporation gets the credit?

Mr. PARKER. If it is a taxable distribution the corporation gets the credit.

Senator BARKLEY. If it is not a taxable distribution, whether it is actually taxed or not, they get no credit?

Senator GERRY. I do not think I got that clearly, Mr. Parker.

Mr. KENT. I was thinking of this case: Suppose a corporation makes a dividend, a part of which is in cash and the balance of which is, under *Eisner v. McComber*, a stock dividend? That might happen. They might declare a dividend to their common-share holders of \$50 in cash and one share of common stock for each three shares of common stock that the shareholders already held. Now, under this section, since the \$50 dividend is generically a taxable dividend in the hands of the shareholders, they would get credit for that, but since the stock is, under *Eisner v. McComber*, not a taxable dividend to the shareholders, they would not get any credit for that.

Senator BYRD. Mr. Parker, then a stock dividend is not taxable in the hands of the shareholder?

Mr. PARKER. Not a true stock dividend.

Senator BYRD. I would like to understand clearly what kind of a stock dividend is taxable to the shareholder.

Mr. PARKER. It is only a special kind of stock dividend that we think is taxable to the shareholder, that is, where you get a stock dividend, say, on common stock and get paid in preferred stock, or another class of stock, or where the dividend is not prorated, or something like that.

Senator BYRD. Suppose a corporation has \$100,000 surplus, that is a book surplus, and they issue a stock dividend equally to the present stockholders, the common-stock holders of common stock, is that taxable?

Mr. PARKER. That is not taxable. We cannot reach it. The Supreme Court decided that.

Senator CONNALLY. If they pay that out in cash you would reach it?

Mr. PARKER. We would reach it.

Senator LA FOLLETTE. Or if they paid it in preferred stock, as I understand it, under some of the recent decisions, that may be taxable. You have attempted in this bill to reach them?

Mr. PARKER. We have attempted in this bill to reach them as far as we can; yes. Of course, that is not a loophole under this plan, because if they pay out one of these stock dividends that is not taxable to the shareholder they do not get any dividend credit. They make \$100,000 during the year and they pay out \$100,000 in stock dividend. We do not consider that as a dividend. We tax the \$100,000 at 42.5 percent.

Senator BYRD. That would be no relief to the corporation.

Senator CONNALLY. Of course, the stockholder would not pay it.

Mr. PARKER. No; he would not pay it.

Senator GEORGE. In other words, if it is not taxable to the stockholder the corporation gets no credit for it.

Mr. PARKER. It gets no credit for it.

Senator BARKLEY. In other words, this is in harmony with the old plan, this part of the bill, to tax these earnings in the hands of the corporation if they are not taxed in the hands of the distributee?

Mr. PARKER. That is right. On page 53, subsection (j). I have already described that. That is where we have a chain of holding companies that is just a special provision to prevent tax avoidance.

The CHAIRMAN. All right.

Senator BARKLEY. What was it you said about (j)? I was interrupted.

Mr. PARKER. I explained that the other day. It was to restrict the dividend credit in case of chain holding companies.

Senator BARKLEY. Yes; I see.

The CHAIRMAN. That was necessary because of the change in the philosophy of this corporate tax?

Mr. PARKER. That is right.

Senator GEORGE. I do not know as I understand that at all, but I do not think it will be necessary to go into it now.

Senator BARKLEY. Maybe it would be better to have him explain it again.

The CHAIRMAN. All right. Explain it briefly again, Mr. Parker; explain that intercorporate dividend.

Mr. PARKER. We were afraid of two things in connection with these chains of holding companies. One was that each corporation, going up the line, might keep 10 percent, and if you had 10 corporations, of course, they would either pay a 1-percent or 4-percent tax, according to the size of their net income. They would keep practically all their earnings in this group of companies. By retaining a very small part in each member of the chain the tax would be very substantially reduced.

Senator GEORGE. I understand that part of the problem.

Mr. PARKER. Yesterday I showed exactly what was done about this.

Senator GEORGE. Yes. If the dividends received by the subsidiaries were all paid to the parent corporation and the parent corporation in turn paid out all of those dividends, would it be entitled to full credit?

Mr. PARKER. Not if there were more than one holding company. This is a very severe provision and you undoubtedly want to give it a lot of thought.

Senator GEORGE. It does not seem to me that we are taking into consideration a vital fact.

Mr. PARKER. It should be kept in mind that we have got to have more than one holding company. We have got to have two, we have got to have a chain. If we have got one holding company and an operating company, that is all right.

Senator GEORGE. Then they get full credit?

Mr. PARKER. Then they get full credit.

Senator GEORGE. If everything is paid out.

Mr. PARKER. If you have an intermediate holding company then that intermediate holding company gets no credit for the dividends it pays to the holding company which owns all the stock.

Senator GEORGE. That is what I asked yesterday. That is built on the theory that all the holding companies have some insidious or sinister purpose in their formation. We have got in this country a large number of holding companies that represent nothing in the world but the normal expansion of a growing business. For instance, a corporation starts out and acquires other corporations directly in its line, and it goes on; we have got two or three holding companies, and yet where the dividends are passed back from the sub to the first and on to the second, the intermediate company gets the full credit where they are all distributed, completely distributed, where there is a complete distribution.

Mr. PARKER. This particular provision was put in at the last minute in the House. It is too strict in some cases and then again it does not close the loophole. I think there will be several suggestions made later on on this particular point.

Senator GEORGE. I just want to see that I understand its operations. I think I do now.

Senator KING. Take a case like this: I do not quite apprehend it—I have in mind a banking situation. During the depression a number of banks in a certain area were very weak, two or three of them were on the eve of failure; there was one very strong bank that had great credit, and it was importuned to take over these other organizations, take them under its wing; that bank organized a sort of a holding company and then issued stock to the owners of the small,

weak banks, where some of them were on the eve of failure, and the big bank had ample funds and ample capital to protect them. Now, those banks that were so protected were resuscitated and going concerns, but a large part of the stock, the majority of the stock was held by the holding company, which, in turn, was controlled by the big bank. Now, how would you tax those small corporations and that holding company, and then the big bank that extended the credit?

Here is a big bank organizing a holding company; here are six or seven or a dozen small banks; this big bank's credit was the basis of the holding company and was the basis of the security and the protection of these small arms that projected out from the holding company.

Mr. PARKER. And the big bank owns more than 50 percent of the stock of the holding company?

Senator KING. Yes; but the holding company issued stock, it bought bank aid and took control; that is, it got control of every stock in banks A, B, C, and D, so that the holding company really controlled all of the banks, but the big bank held the control of the holding company.

Mr. PARKER. Well, if 80 percent of the income of that holding company comes from dividends, they are going to be caught in this case.

The CHAIRMAN. Well, you experts will give further consideration to this proposition.

Mr. PARKER. We were not satisfied with that proposition.

Senator LA FOLLETTE. As I understand, Mr. Parker, this does take care of the holding companies in the first degree?

Mr. PARKER. Yes; if you have only got one holding company there is no trouble, except in a case like he mentions.

Senator KING. Where other companies are superimposed, one on top of another, this provision will reach them?

Mr. PARKER. Yes; where the holding company is in a chain between parent and subsidiary.

Senator KING. But they do continue as a functioning company.

Mr. PARKER. Yes, Senator.

Mr. BEAMAN. I am just thinking out loud here. I think you are wrong. The holding company gets the full credit.

Mr. PARKER. The bank owns more than 50 percent of the stock.

Mr. BEAMAN. The holding company pays dividends to the bank. Under section 104 they get credit for all dividends paid the bank.

Mr. PARKER. Oh, yes; that is right, it is a bank. If it had not been a bank my answer would then have been right. I was thinking of the general case.

Senator GERRY. Is not that just the exception, that it is a bank? You put a bank in a separate provision. There is a weakness in the section there.

Mr. BEAMAN. That is the trouble. That is what was intended to be done. It is just that situation that creates the loophole. That is the trouble. This is one of the things Senator Harrison asked about, whether we would give it further consideration. We certainly will. We will give it further consideration. Ever since the President's message came down we have been considering it, and have not found the solution yet. It is one of the situations where you cannot plug

a loophole without being rough. That is the thing. You will never find a solution to plug up the loophole just enough to stop the bad man and not enough to stop the good man.

The CHAIRMAN. You may proceed, Mr. Parker.

Mr. PARKER. Now on page 78, section 102, surtax on corporations improperly accumulating surplus. That is old 220 that we had in the law, then it was changed over to 104, and in this bill it is 102. When the subcommittee made its report to the House Ways and Means Committee they recommended taking out this section, as well as section 351, which is the one dealing with personal holding companies, which I am sure you remember.

The CHAIRMAN. That is the present law?

Mr. PARKER. The subcommittee of the Ways and Means recommended taking both sections out for the very obvious reason that this plan is so designed as to put a heavy tax on a corporation if it accumulates, and both of those sections are designed, especially 102, to take care of the case where the corporations accumulate beyond the reasonable needs of their business.

The CHAIRMAN. Would the tax that we are supposed to put in this bill be higher than the old law with reference to these holding companies on accumulated surplus?

Mr. PARKER. No; it would not be quite as high, but it would be 42.5 percent. In the old law it was the normal rate of 15 percent. Then there were two bracketed rates of 25 and 35, respectively. So the rate would be from 40 to 50 percent under the old law. It is very nearly as much.

Senator GEORGE. Mr. Parker, why did you keep this in?

Mr. PARKER. We kept it in just for certain classes of corporations. The general class of corporation does not come under section 102. We do not have to bother with them any more, on account of the nature of the general plan, but there are some corporations that take a flat rate, therefore we kept section 102 for those. For instance, "This section shall apply only to banks", which take the flat rate of 15 percent; "insurance companies", which take the flat rate of 15 percent; "foreign corporations", which take the flat rate; "corporations organized under the China Trade Act, corporations entitled to the benefits of section 251"—that is, corporations where 80 percent of their business is in the possessions of the United States; "and (6) personal holding companies as defined in subsection (b)."

Now, I think it is obvious as to why we kept it for the banks, insurance companies, and foreign corporations. Of course, it is not very likely that this section is going to be very effective as to the banks because they can always show the need of accumulating surplus, providing it is a legitimate banking business. If it is a fake bank, then it may do some good, but it will not hit legitimate business. And the same way with an insurance company; unless it is more or less a faked insurance company and the main part of its business is in investments for the benefit of a few of its stockholders.

Now, we also put in there the personal holding company. That is the one where 80 percent of the gross income comes from royalties, dividends, interests, rents, annuities, and capital gains, and 50 percent in value of its stock, or more, is owned, directly or indirectly,

by not more than five individuals, certain close relationships counting as one individual.

The CHAIRMAN. That does not change much from the present, does it?

Mr. PARKER. The definition is the old definition, with one important exception, that is that the word "rents" has been added. I think Senator Couzens will remember that.

Senator COUZENS. Yes. That is a very difficult situation, it seems to me, with respect to the holding of these big office buildings, or such as that, and I think that is one of the questions that was raised during the consideration of this matter in the first instance.

Mr. PARKER. That word "rents" does not appear in section 351.

Senator COUZENS. Did we take it out for a specific reason?

Mr. PARKER. Yes. Section 351 has one radical difference from this section. Section 351 operates under certain facts, there is no question of proving any purpose to evade taxes. Now, this is like old section 220 and like present 102. The Government, in order to impose this surtax, has got to prove a purpose to evade surtax. We thought, or rather the Ways and Means Committee thought, that if a real-estate company could prove a legitimate need of its earnings in business, that is all that is necessary; it is out. But if it accumulates it when it does not need it, then it is not out.

Senator COUZENS. What is the yardstick required to prove that it is not an attempt to evade?

The CHAIRMAN. What is the language there in this bill on that? Where do you find that, about this proof?

Mr. PARKER. It is over on page 80, line 17:

There shall be levied, collected, and paid for each taxable year under the net income of every corporation specified in subsection (a) 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 gains and profits to accumulate instead of being divided or distributed.

The CHAIRMAN. That is the present law?

Mr. PARKER. Yes; that is the present law. Well, that is retained. That is the yardstick.

Senator CONNALLY. Mr. Parker, is it not very difficult, though, for the Government to prove that?

Mr. PARKER. It is very difficult. If the corporation can show a reasonable need for money it is out, that is all.

Senator CONNALLY. It is almost impossible to prove the motive of a man or a concern when they do a thing of that kind, you have got to prove that they did it for that purpose.

Mr. PARKER. It is easier in the case of a pure personal holding company that simply has a lot of stocks and bonds down in the safety-deposit box. It is not impossible to catch them in that case.

Senator CONNALLY. No; it is not impossible.

The CHAIRMAN. Has the Treasury found any such cases and proved any such cases?

Senator COUZENS. Very few.

Mr. BEAMAN. May I say this, gentlemen: I think this is one additional advantage that we do not have under the present law. If you find one of these incorporated companies is making a substantial income and you find it is not distributing the income and paying a

tax of 42.5 percent, and you find in addition a number of the principal stockholders are gentlemen who fall into the 55, 60, and 70 percent surtax brackets, there isn't going to be much trouble in proving the purpose. Of course, if that tax has been availed of for the purpose of evading the surtax why in the world would they cheerfully sit there and pay 42.5 percent unless it was for just such a purpose? I mean, you have got that element here.

Mr. KENT. I might say our difficulties under section 102 in the past have been due largely to the fact that in most of the cases in which the section was involved it is very hard to convince the Board of Tax Appeals that there are not some legitimate business reasons for retaining a substantial portion of the earnings and surpluses. We have in the last couple of years met with a considerable degree of success in one line of cases. We collected several million dollars of revenue in cases of this type, where large accumulations were made out of earnings, and then the corporation would turn around and make what purported to be loans out of its surplus to large stockholders of the corporation who occupy a dominant position in its affairs. I would anticipate that in the case of these personal holding companies we would meet with a very high degree of success, because we have at least a prima-facie presumption in our favor under the statute, and I think it would be extremely difficult for personal holding companies to show a sufficient reason for the accumulation to overcome the presumption. So I believe it will be reasonably effective with respect to companies that are now covered by section 351.

The CHAIRMAN. That is where they are loaning their surpluses to their own stockholders?

Mr. KENT. Yes, sir; and where the corporations are of the personal holding type.

Senator GERRY. Has that section been changed from the existing law?

Mr. PARKER. The existing law refers to every corporation except the personal holding company. It affects every corporation except the personal holding company.

Senator GERRY. It just affects the holding companies, does it not?

Mr. PARKER. There is no holding company referred to. These other corporations pay a flat-rate tax.

Senator GERRY. It refers to benefits in section 251. What does that mean?

Mr. PARKER. Those corporations doing business in the possessions of the United States, like Puerto Rico, if they do 80 percent of their business there, they come under this classification.

Senator GERRY. Otherwise the statute is good, with those exceptions?

Mr. PARKER. It has been difficult to measure, but I think it has done more good than what you can really figure by way of money. The joint subcommittee made an investigation and report on it in 1927. At that time the Treasury had only collected \$75,000 from it. Two years later they collected \$6,000,000 under section 102, not usually in the courts, but often by compromise, and a couple of years after that the collections increased to \$11,000,000. There have been substantial sums collected, but the greater part of the income comes in a way that we cannot measure. The corporations, finding that

the Treasury is enforcing that section, declare more dividends, and of course we get additional taxes from stockholders, but we cannot measure that.

The CHAIRMAN. What is the next proposition?

Senator COUZENS. Just before you conclude that, Mr. Parker, do you think the inclusion of "rents" in there does not affect an honest and legitimate operating building company that relies solely on rents?

Mr. PARKER. What disposition do they make of the rents? What do they use the rents for, Senator?

Senator COUZENS. I do not know. We went through that before. My recollection is not exactly clear as to why we took the word "rents" out. I remember they made a pretty good case, sufficient any way to permit them to take it out.

Mr. PARKER. If you have a real-estate company that owns a number of apartment houses and they get these rents, and they use those rents in developing their property, or developing other property such as building streets, making replacements, tearing down old houses, building new ones, where the capital was used. I do not think this section would affect them at all, but if they take those rents and hold them in common stocks and bonds, it would affect them. If they kept the money and used it in the real-estate business I do not see any possibility that the Commissioner would be able to get taxes under this section.

Mr. BEAMAN. You do collect the 42.5 percent.

Senator COUZENS. That is the protection that the Government has that it did not have before?

Mr. BEAMAN. Yes.

The CHAIRMAN. Was there any question raised before the Ways and Means Committee on this "rents" proposition by the real-estate people?

Mr. PARKER. No, sir; they did not know about it at the time of the hearings. At the time of the hearings the subcommittee report, on which the hearings were held, as I pointed out in the beginning, recommended the elimination of section 102. If it was not for the fact that our surtax rates went to 75 percent and we could eliminate this personal holding company there would not be any need of it. Our surtax rates were a little too high to allow the differential to exist between 42.5 percent and the surtax rates.

Senator COUZENS. In other words, if it ran up to 75 percent they would rather sit by and pay the 42.5 percent and let the rest accumulate?

Mr. PARKER. That is right.

The CHAIRMAN. What is the difference between this bill and the old law in respect to the banks and insurance companies?

Mr. PARKER. As far as the banks are concerned, they are treated just the same as in the old law, except they pay a flat rate of 15 percent, instead of the graduated corporation tax, graduated from 12.5 to 15 that was imposed last year.

The CHAIRMAN. What is that?

Mr. PARKER. You will remember that last year the Revenue Act of 1935 imposed a graduated corporation tax, graduated from 12.5 to 15 percent. All of the net income over \$40,000 took the 15-percent

rate. So, practically speaking, except for taking away that graduation, the banks are treated just the same as they were before. The stockholders, though, do have to pay their normal tax on the bank dividends, just the same as anybody else. So the stockholders are affected to the extent of 4 percent more on the dividends.

Senator GEORGE. Mr. Parker, did you do anything in this act to make it easier for the personal holding companies to dissolve?

Mr. PARKER. Yes, Senator.

Senator GEORGE. What is that?

Mr. PARKER. We did something on that. We changed the rule on liquidation.

Senator GEORGE. Where they received the property in liquidation?

Mr. PARKER. The stockholder is taxed on the gain, but instead of being taxed on 100 percent of the gain he is entitled to use the bracketed rates of section 117, the capital-gain-and-loss section. For instance, if the stockholder held his stock for over 10 years, he only takes account in his income of 30 percent of the gain that he realized; and that encourages, I think, to a sufficient extent, the liquidation of these holding companies. I think it will bring in more money, because they will not liquidate if the tax is so high that they have to pay on 100 percent of the gain. They just will not liquidate. But if they can include 30 percent of the gain, or perhaps 60, if they haven't held it that long a time, I think that is a sufficient encouragement. That is all the Government can afford. It must have some tax.

Senator GEORGE. I have in mind where the holding company has completely liquidated.

Mr. PARKER. We only give them that right where there is a complete liquidation, not where there is a partial liquidation.

Senator GEORGE. Do you treat them there as you would a subsidiary corporation?

Mr. PARKER. Of course, this provision just affects the stockholders, so the stockholders can liquidate the corporation. What we did last year in the Revenue Act of 1935 was to permit one corporation to liquidate a subsidiary. That section did not relieve the individual at all, but it permitted corporations in certain cases to simplify their corporate arrangements by dissolving some of the subsidiaries.

Senator GEORGE. And we permitted them to dissolve tax-free did we not?

Mr. PARKER. Yes, Senator.

Senator GEORGE. But we did not permit the personal holding company to dissolve tax-free.

Mr. PARKER. I do not think we can do that, Senator. That would be too much. Those gains have been accumulated; they have only been taxed either 15 percent or not at all where the income has come from dividends from other corporations. Certainly on liquidation, if we do not get the tax, then we will never get it, because the man will just hold that stock until he dies.

The CHAIRMAN. Was there much liquidation under the last provision that you mentioned in the 1935 act?

Mr. PARKER. I could not state as to that. We heard a good many complaints, that they are unable to comply with that provision for one reason or another.

The CHAIRMAN. Then it did not do much good.

Mr. PARKER. I think it took care of the worst cases. I think it did some good; yes.

The CHAIRMAN. All right, Mr. Parker, proceed.

Senator GEORGE. I do not want to go back again, but I do want to ask you one other question, to see what you are thinking about it. Going back to the blackboard illustration that you made on that question, did you do anything with that to get these intermediate holding companies to dissolve?

Mr. PARKER. I think, in some cases at least, they can use the same provision that we put in the Revenue Act of 1935.

Senator GEORGE. Can they do that in all cases?

Mr. PARKER. I do not imagine they can.

Senator GEORGE. I would not think so. It looks like we are going to impose a very harsh remedy on a type of corporation that occupies a particular position. We ought to make it easy for them to get out of the situation. Of course we want revenue, but then we do distinguish in our levies in the character of the corporate organization, and it strikes me we ought to give some consideration to those corporations that are going to find that they are sternly dealt with. We should make it at least advantageous for them to dissolve, to get out of the picture as soon as possible.

Mr. PARKER. I think the first thing is to see what can be done with that provision that we have already criticized, section 27 (j), but we will have to work on that first. Possibly it will be discarded altogether, if we can find some other means of closing the loophole.

Senator LONERGAN. Mr. Parker, do I understand that the tax on life-insurance companies will be 15 percent?

Mr. PARKER. Fifteen percent on all insurance companies.

The CHAIRMAN. I asked you a question about that. I asked you about insurance companies and banks and you told me that the insurance company is the same as the bank proposition.

Mr. PARKER. The insurance company is the same thing, 15 percent.

The CHAIRMAN. The same as the bank proposition?

Mr. PARKER. That is right.

The CHAIRMAN. That is life insurance that you are talking about?

Mr. PARKER. All insurance companies. The next thing we are coming to on page 83 is banks.

The CHAIRMAN. Did they deal with the question of the difference between mutual fire-insurance companies and the other insurance companies over in the House?

Mr. PARKER. Well, that law has been left the same as it is now. Of course a great many of the mutual insurance companies are tax-exempt under section 101. In the second place, those mutual insurance companies that do not qualify for complete exemption get a very liberal treatment in the method of computing their net income.

The CHAIRMAN. It has been brought to my attention that these mutual insurance companies, some of them, have grown so large that they are competing absolutely with the others, being tax free.

Mr. PARKER. I do not doubt that that is so. The Bureau has had no success in getting any tax from those insurance companies.

The CHAIRMAN. Have you given any thought to that proposition?

Mr. PARKER. Yes. The Bureau had a memorandum on that. I think Mr. Lusk had a memorandum on that.

Mr. KENT. The principal difficulty with certain of these mutual-insurance companies is this: To the extent that a mutual-insurance company uses all the premiums which it receives either for the purpose of covering losses or of making refunds, that is what it amounts to, to the policyholders of a portion of the premiums which they have previously paid in, there isn't any real tax problem presented, but there is a considerable group of these companies which have accumulated large surpluses. The figure that I have in mind runs around \$200,000,000 at the present time, which is invested in securities of various sorts, and on which a substantial income is being received. Now, under the law as it stands at the present time, we simply have not been able to get at that time, and I think that is the weakness in the present structure. That really needs to be taken care of. There is an income there upon which the Government is entitled to some revenue, and I think the proper approach would be to find some method of getting some revenue out of that sort of income.

Mr. PARKER. You are not referring, Mr. Kent, to life-insurance companies at all, you are referring to mutual-insurance companies other than life-insurance companies?

Mr. KENT. That is right.

The CHAIRMAN. All right, put your heads together in working on that proposition.

Mr. KENT. We shall do so, Senator.

Mr. PARKER. Page 83, section 104. Tax on banks and trust companies.

As used in this section the term "bank" means a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits and the making of loans and discounts.

Senator COUZENS. Why should there not be an addition to that provision requiring that they shall have a bank charter under the Federal laws or under the State laws rather than just a question of receiving deposits?

The CHAIRMAN. It says "incorporated under the laws of the United States or of any State or Territory."

Senator COUZENS. Yes; but it may be incorporated under some other law, not under the banking laws. I just wondered whether it would not be better to define that.

Senator GEORGE. Senator Couzens means where they are incorporated for certain purposes and yet the substantial business is the banking business.

Senator COUZENS. I think they ought to be chartered under the State statute for banking purposes and not have some other charter and come within the bank exceptions.

Senator GEORGE. One of the oldest institutions in my State was organized under a railroad charter.

Senator BARKLEY. Well, it is a bank if the substantial part of the business is receiving deposits and making loans, no matter what other purposes they were incorporated for.

Senator COUZENS. In other words, if two or three men organize under this provision, as I see it, they can do a large part of the business in some other way except accepting deposits, then they come under the law.

Senator BARKLEY. If these shall be incorporated under the banking laws of the State, then all those who are incorporated under some other law of the State and do a partial banking business would be left off.

Senator COUZENS. They should come under the provisions of the law.

Senator CONNALLY. This language, though, says "a bank or trust company."

Senator COUZENS. Yes; incorporated under the laws of any State.

Senator CONNALLY. Still it has got to be a bank or trust company, no matter how it is incorporated, under this language, in order to be exempt under the provisions of this bill.

Senator COUZENS. They might get a charter under some other provision of the State law.

Senator CONNALLY. I understand that. We cannot regulate as to how they should get their charter.

Senator COUZENS. I do not know why we cannot. If we make an exception as we do here, I do not know why we cannot regulate it.

Senator BARKLEY. Suppose they organize a grocery company under the general incorporation laws of the State and suppose they branched out as a grocery company or lumber company or any other kind of corporation, and started up a banking business and did a substantial business, they would not be banks under the laws of the States; they would be taxed according to our corporation tax laws.

Senator COUZENS. Maybe your proposition is all right.

The CHAIRMAN. You gentlemen look into that, will you?

Mr. PARKER. That bank definition is not an easy proposition at all. We had a lot of discussion on that. I do not know whether it can be improved or not. Perhaps it can be.

The CHAIRMAN. All right.

Mr. PARKER. Of course, under subsection (b) it provides for a 15-percent flat rate of tax.

Senator CONNALLY. This provision relating to interest on certain obligations, you mean tax-free interest?

Mr. PARKER. That is an interest on Government obligations which are subject to surtax.

Senator CONNALLY. But they deduct that?

Mr. PARKER. They deduct that.

Senator CONNALLY. Before they compute their net return?

Mr. PARKER. That is correct.

Senator CONNALLY. On the theory that if it were in the hands of an individual he would have that right; therefore you ought to tax it in the hands of the bank; is that right?

Mr. PARKER. That is right. Those obligations, of course, were issued free from the normal tax, free from income tax except for a graduated income tax that is called a surtax.

Senator GEORGE. You treat domestic corporations in the hands of receivers in the same way?

Mr. PARKER. We impose a 15-percent tax, under section 105, on domestic corporations in the hands of receivers.

The CHAIRMAN. All right. The next is "Tax on domestic corporations in receivership."

Mr. PARKER. We just discussed that.

Senator GERRY. Are you going into that domestic corporations in receivership section?

Senator COUZENS. They have just explained it; yes.

Mr. PARKER. What did you ask, Senator?

Senator GERRY. I asked in regard to section 105.

Mr. PARKER. That is to allow a corporation in receivership to pay a flat 15-percent tax on its net income. In other words, its tax is the same as it is now, practically speaking.

Senator COUZENS. What is the next section?

The CHAIRMAN. Page 106. There is an amendment there. What is that now?

Mr. PARKER. That is in respect to the 1934 act. We made certain changes and we gave a new election in respect to percentage depletion in that act. The committee did not want to give a new election in this bill. The committee was afraid if we did not put something in there that the wording of the statute would give them a right to a new election.

The CHAIRMAN. In other words, you want to let it remain in status quo?

Mr. PARKER. They mean they want to give no new election.

Senator COUZENS. That does not refer to amortization or obsolescence at all, just depletion?

Mr. PARKER. Just depletion.

On page 108 is a provision which we have referred to before, which allows the stockholder, upon the complete liquidation of a corporation, to be taxed under the rules laid down in section 117, capital gains and losses, on whatever gain he may have. The old rule was stricken out there, in lines 6, 7, and 8.

Despite the provisions of section 117 (a), 100 percent of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation.

Then it goes on here to define what the complete liquidation is. So that if there is a liquidation and you have only held your stock 1 year, of course, you would be taxed on 100 percent of the gain. If you had it 10 years, then you would be only taxed on 30 percent of the gain.

The CHAIRMAN. We do not change that law?

Mr. PARKER. No; as Senator George said a minute ago, the present law is simply preventing transactions from taking place, and we are certain, from certain cases that we know about, that there is going to be a substantial amount of liquidation, if we make the change suggested. This will result in more revenue.

Senator GERRY. If a corporation reduces its bonded indebtedness, how does that come in?

Mr. PARKER. That would not be liquidation. Of course, there is not very much gain or loss in such a case unless the bonds have been very low.

Senator GERRY. And that simply goes in the other section in regard to indebtedness, does it not?

Mr. PARKER. When you liquidate a corporation, of course, you surrender your stock. It is on the question of gain or loss in the stock of the corporation that you hold.

Senator GERRY. This refers to total liquidation?

Mr. PARKER. This refers to complete liquidation. We have been informed that a number of holding companies have been set up, both in this country and in Canada, and in other countries, where people want to liquidate, but they will not liquidate if they are taxable on 100 percent of the gains.

Senator GERRY. They are referring to partial liquidation?

Mr. PARKER. We do not take care of partial liquidation.

Senator GERRY. You do not take care of that at all?

Mr. PARKER. No, sir.

Senator GERRY. That is clear under the old law, is it?

Mr. PARKER. In regard to partial liquidation, of course, it is a question of getting the gain first. If you get a partial liquidation and it is not equal to what you paid for the stock, there is no tax. If the partial liquidation is more than you paid for the stock, then there begins to be a tax. Under this bill, if there is a partial liquidation and it is more than what the stock gives you, then you pay on the amount of the excess just the same as if it were interest, or any other form of annual income. You will not be entitled to any reduction on account of the length of time for which you held the stock.

Senator COUZENS. Is there anything in this thought, in connection with the "purposes of the preceding sentence", that among the other things that have to be accomplished to secure the benefit of that provision, whether the surrender of its charter is not a factor? I know some corporations, even though they canceled their stock, value their charter. It seems to me if you are going to have complete liquidation that not only the provisions provided in this particular section should be brought about, but the surrender of the charter ought to be a part of the liquidation.

Mr. PARKER. Of course, I do not know just what troubles we will run into. We are going to have to make an examination of the State laws. As I recall the laws in some States, it takes quite a long time to actually surrender the charter.

The CHAIRMAN. Would there be any legal complications in that, Mr. Kent? I mean so far as abridging the right of the State and State laws with reference to the issuance of charters.

Mr. KENT. There might be. I would be glad to look into that, Senator. There are a good many differences, of course, in the State laws. Some State laws will provide in cases of liquidation for the appointment of trustees for a certain period; for instance, against whom creditors of the corporation can enforce their rights. That is the point I would have to check up on. Other laws may differ as to the actual status of the charter during that period.

The CHAIRMAN. Some States have different laws with reference to giving up the charter of the corporation?

Mr. KENT. That is right. I will be glad to look into that.

Mr. PARKER. On page 110, the top of the page, stock dividends. Here is the general rule that we were talking about earlier:

General rule: A distribution made by a corporation to its stockholders in stock of the corporation or in rights to acquire stock of the corporation shall be treated as a taxable dividend to the extent that such distribution constitutes income to the stockholder within the meaning of the sixteenth amendment of the Constitution and represents a distribution of earnings or profits accumulated after February 28, 1913.

The CHAIRMAN. That is the general rule you are putting in to take care of the decision?

Mr. PARKER. The general rule. The intent is to tax every stock dividend that can be taxed under the Constitution.

Senator GEORGE. How many do you think you are going to get under that?

Mr. PARKER. I do not think we are going to get very many.

The CHAIRMAN. It sounds good anyhow, does it not?

Mr. PARKER. Yes.

Senator BYRD. Your opinion is that the preferred-stock dividend would be taxable?

Mr. PARKER. To the common shareholders?

Senator BYRD. Yes.

Mr. PARKER. I think so, because I think the argument of just having a certain number of pieces of paper to represent the same thing does not apply. When you get another class of stock your proportionate ownership may change. It might be, in some cases, that would be all right. That is, if you had all common-stock holders and you give them all one share of preferred, maybe we cannot tax it. I do not know that that can be settled.

Mr. KENT. That would be a clear case, Senator Byrd, in which the Board of Tax Appeals, and one or two of the circuit courts of appeals, have held that the common-stock dividends are taxable, as long as the common stock is issued as a dividend to the holders of preferred stock, where you have a different group of persons holding the preferred stock than hold the common stock of the corporation. There is a case coming up in the Supreme Court which will be argued next week, that involves one of the situations, but it is quite possible that that case will be decided not on the constitutional ground but simply on the ground of the proper interpretation of this old provision of the statute that stock dividends shall not be subject to tax. Whether Congress, in putting that into the law, after *Eisner v. McComber*, attempted simply to exempt those stock dividends that under *Eisner v. McComber* would be constitutionally beyond the reach of the taxing power, or whether Congress intended to go further than that and extend the exemption to all stock dividends, that case may throw some light upon this question.

Senator BYRD. Suppose a common-stock holder received a dividend in common stock, and that the value of the stock remained the same after the dividend was paid, would he have to pay anything then?

Senator COUZENS. Oh, yes, because they would come under the capital gains in any event.

Mr. PARKER. Yes; he pays a tax on the gain.

The CHAIRMAN. All right, Mr. Parker, you may proceed.

Mr. PARKER. Now, on the same page, under paragraph 2, is a provision to take care of a special case. I think I will ask Mr. Kent to

explain that, because I never read that case. That is a court case. I know what it does in general, but I am not familiar with it.

Mr. KENT. There have been several decisions to the effect that if a corporation declares a dividend of so much in cash, or in lieu thereof, at the option of the shareholder, one share or two shares of common stock, let us say, that is a taxable dividend. The question has never been passed upon squarely by the Supreme Court of the United States, but the Supreme Court did deny a certiorari in one case where the lower court held such a dividend should be taxable.

The theory of the decisions in those cases was simply this: That if the shareholder were given the option to take cash or stock and he decided to take stock, it was just as though the dividend had been paid in cash, and then the shareholder had turned around and had taken advantage of a stock right and had purchased additional stock of the corporation. We feel pretty confident of our ground on this particular provision.

Senator BYRD. Supposing he only had the option as to a fractional share to take cash, or buy the full share?

Mr. KENT. Let us take a concrete case. Suppose you have the declaration of the dividend of \$200 with an option to pay \$100 in cash and one share of stock, it would still fall within the provisions of this section. On the other hand, if the dividend were \$100 in cash and one share of stock, with no option——

Senator BYRD. That is not what I mean.

Mr. KENT. Pardon me, Senator.

Senator BYRD. Suppose, for the purpose of convenience, you would issue a stock dividend of one share of stock for each four shares outstanding, and then the fractional shares, the stockholder would have the right to a full share or to receive his fractional share in cash from the company. Many companies do that, because they do not issue the fractional shares.

Mr. KENT. Yes, sir.

Senator COUZENS. That would not involve a great deal of money, would it, because it is a fractional share?

Mr. KENT. It would be a cash dividend to the extent of the amount of cash that could be applied to the purchase of a share.

Senator BYRD. What I was getting at is that if he had a right to exercise that option to the extent of the fractional share, would that change it?

Mr. KENT. I do not think so, Senator. That would not apply in that case.

Senator BYRD. The same principle would apply only in amount?

Mr. KENT. Yes, sir.

Senator BYRD. It would be a very inconsequential amount?

Mr. KENT. Yes, sir.

The CHAIRMAN. All right, Mr. Parker.

Mr. PARKER. Now, there is a change in another provision.

Senator COUZENS. We cut out certain language on page 111. What is the purpose of that, on page 111, subsection (h)?

Mr. BEAMAN. That is probably more or less a current amendment, Senator. Several times in the old law they said something should not be considered distribution of earnings in property. That is the meaning of the section, for the purpose of determining the tax, for the purpose of subsequent distribution. That was in the old exist-

ing law. That is the only purpose for which it would have any bearing.

Under the new law the status of the earnings and profit account becomes important in other respects, as, for instance, in determining whether or not this relief provision on debts, where the income is in excess of the accumulated earnings and profits, it becomes important to have these rules apply in all these cases, as well as in this case.

The CHAIRMAN. All right. Mr. Parker; proceed with page 112.

Mr. PARKER. Well, the next change, I think, is on page 112, valuation of dividends.

If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Senator COUZENS. That is understandable.

Mr. PARKER. In the case of the corporations, in dealing with dividends in kind, bonds, and so forth, we took the market value, or the face value of the obligations, whichever was the lower, but in the case of the stockholder there is only one rule, the fair market value.

The CHAIRMAN. All right.

Mr. PARKER. Page 125. I think we better omit that. This foreign corporation system will have to be described as a whole and in a different order from what it comes in the bill, so we will pass that over for the time being.

The CHAIRMAN. Page 141.

Mr. PARKER. There is a little change at the top of page 139 that I want to call your attention to. You remember that railroads are the only corporations which are permitted to file consolidated returns, and they had to pay, under the Revenue Act of 1935, three-fourths of a percent more; they paid 15¾ instead of 15 percent. The committee, in view of the condition of the railroads, did not make any differential in rate in this bill. The railroads simply come under the undistributed-profits plan. There is no differential in rate. They can still file the consolidated return.

The CHAIRMAN. We do not permit any other consolidated returns except railroads?

Mr. PARKER. Except railroad companies. There has been an amendment made here on account of a doubt as to the intention of Congress at the last session. The word "railroad" on page 140—

As used in this paragraph, the term "railroad" includes a street, suburban, or interurban electric railway.

The Treasury ruled, under our railroad definition, that when we said "railroad" we did not include electric railway. I think it was rather a close question.

Senator COUZENS. Now you intend to include them?

Mr. PARKER. The committee think they should go in as well as steam railroads. They are not in very good financial condition.

Senator LA FOLLETTE. Just a minute. What is that going to do to these utilities that go out and buy a street railway? Is that going to permit them to file consolidated returns?

Mr. PARKER. No, no; they have to be railway companies. A waterworks company cannot file a consolidated return with a street railway. They have to be street railways.

Senator LA FOLLETTE. I wanted to be sure of that.

Senator COUZENS. They would not have a railroad charter, would they?

Senator LAFOLLETTE. I do not know.

Senator COUZENS. There are special charters issued for railroads.

Mr. PARKER. On page 139, in paragraph (3) it describes them.

Each of the corporations is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad.

Senator LA FOLLETTE. That is all right.

Senator COUZENS. While you are on that question, Mr. Parker, the question has been suggested to me, under the holding company provisions of this bill railroads might be able to escape because, under the Interstate Commerce Act, we attempted to reach the holding companies, put them under the jurisdiction of the Interstate Commerce Commission, but we have not been very successful at it. Do you know anything about that? Do you know whether the railroad holding companies would receive any different treatment because they were railroad holding companies rather than any other holding companies?

Mr. PARKER. I think if they are holding companies, with the strict provision we were talking about in 27(j), if they had a chain of holding companies, it would pretty nearly put them out of business, all of them.

Senator LA FOLLETTE. Then, when you consider a revision of that section it would also include a consideration of the railroad-holding companies?

Mr. PARKER. That is right.

Senator BARKLEY. You struck out the language on page 139?

Mr. PARKER. That is just the differential in the rate.

Senator BARKLEY. You just eliminated that?

Mr. PARKER. Yes, sir.

The CHAIRMAN. They made it straight 15 percent.

Mr. PARKER. Now, on page 141 there is a special rule to take care of railroads in receivership:

If the common parent corporation of an affiliated group is taxable under section 105 (relating to the tax on corporations in receivership), the affiliated group shall for the same period be taxed under that section instead of section 13. In all other cases the affiliated group shall be taxable under section 13 regardless of the fact that one or more of the corporations in the group are in receivership or in bankruptcy.

In other words, if the parent corporation is in receivership it is taxed at the flat 15-percent rate, but if the parent corporation is not in receivership and there happens to be one corporation in the group that is in receivership, why, the whole consolidated return comes under the undistributed-profits tax in section 13.

Senator COUZENS. So no exception is made?

Mr. PARKER. We either compute the tax all one way or the other. We could not split up the consolidated net income tax into the different parts.

Senator COUZENS. I see.

Mr. PARKER. Section 143, on page 144, I want to pass over that for the moment, because that is part of the foreign-tax problem. It

ought to be considered as a whole, and we ought to start from the question of what the tax is rather than starting, for instance, from how much we will withhold, because you levy the tax and afterward you withhold it.

The CHAIRMAN. All right; what is your next section?

Senator COUZENS. Does section 144 come under that same classification that you just mentioned, Mr. Parker, on page 148?

Mr. PARKER. That is right. I thought we would clean up everything but the foreign corporations. The next is on page 167, section 201.

Senator GERRY. What is on page 149 where you have stricken out something there?

Mr. PARKER. That is the change we have made in the tax on foreign corporations and on resident aliens. We want to make one consolidated statement on that.

Senator LA FOLLETTE. Page 161, at the top of the page, what about that?

Senator COUZENS. All that comes under the same classification.

Mr. PARKER. That is just a clerical correction.

The CHAIRMAN. That is all it is.

Senator COUZENS. The next is insurance companies?

Mr. PARKER. Insurance companies, page 167.

The CHAIRMAN. What is your explanation as to paragraph (b)?

Mr. PARKER. All there is to that is that these insurance companies, both domestic life insurance companies and foreign life insurance companies, pay 15 percent.

The CHAIRMAN. I am talking about (b) on page 166, "Partnership years beginning in 1933."

Mr. BEAMAN. That is just a clerical amendment.

The CHAIRMAN. That is clerical?

Mr. BEAMAN. Yes.

The CHAIRMAN. All right.

Senator COUZENS. Now under section 201 can you take into consideration, by redrafting this section, the matter raised by Mr. Kent of the profit of these mutuals other than the premiums?

Mr. PARKER. These are life insurance companies. As I understand, Mr. Kent had no objection to the life insurance companies.

Mr. KENT. It is a problem in connection with mutual insurance companies, other than life insurance companies.

Senator COUZENS. Are there any mutual life insurance companies?

Mr. KENT. Yes, sir; quite a number.

Senator COUZENS. Are they taxed under this particular section?

Mr. KENT. Yes. There has not been any differential in the past legislation between stock life insurance companies and mutual life insurance companies.

The CHAIRMAN. They are all the same?

Mr. KENT. Yes, sir.

The CHAIRMAN. But there is a differential on fire insurance companies?

Mr. KENT. That is right, Senator.

The CHAIRMAN. I think that grew up because there were some local insurance companies in local places.

Mr. KENT. Yes, sir; there were a lot of small farmers' cooperative insurance companies covering fire and other risks.

The CHAIRMAN. Why could we not work out something that might exempt these purely local companies?

Mr. KENT. They are largely under the present law, but some of them—that is a condition that Congress probably never contemplated—have grown very large, and some of them are really not farmers' companies at all, and they have accumulated these very considerable investment surpluses.

Mr. PARKER. You see, we have an existing law in section 101 that entirely exempts—

farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses.

Senator LA FOLLETTE. What page is that on?

Mr. PARKER. Page 75. That is the existing law. That exempts a good many insurance companies.

Going back to page 169, of course the insurance companies formerly received dividends from domestic corporations, and we just allowed deductions for them. We have stricken out the deductions because of the dividend credit allowed to the payor corporation. We have to make the receiving corporation pay the tax. Of course, they get just that much more in dividends since the payor corporation has not paid the tax.

Here we come to insurance companies other than life insurance companies on page 172. Insurance companies other than life or mutual. They are taxed at 15 percent.

The CHAIRMAN. We will take that up later.

Senator LA FOLLETTE. That is just putting the stock and mutual companies on the same footing, 15 percent.

The CHAIRMAN. Yes. Mr. Parker, may I ask you, we have got very much on that windfall tax, have we not?

Mr. PARKER. We haven't described the system of taxation on foreign corporations.

The CHAIRMAN. With that exception, you have covered it?

Mr. KENT. And the capital-stock tax on page 228.

The CHAIRMAN. What do you do to capital stock? You reduce that, do you not?

Mr. PARKER. You remember we made a change in the capital-stock tax in the Revenue Act for 1935. We increased the rate from \$1 per thousand to \$1.40 per thousand. We made some changes in the excess-profits tax and somewhat increased those rates. We gave the right to make a new election. Now that was prospective legislation. It would come into effect in the capital-stock tax paid under the Revenue Act of 1935, to become due on June 30, 1936. The President's message suggested the repeal of the capital-stock tax, but the Committee on Ways and Means extended it for 1 year. There will be one more capital-stock tax—that is the tax due on June 30—but they cut the rate in half, Senator: they cut the rate from \$1.40 to 70 cents.

The CHAIRMAN. For that 1 year?

Mr. PARKER. For that 1 year.

Senator BYRD. How much do you estimate we will get from that tax?

Mr. PARKER. We have estimated that we would get about \$80,000,000 from that tax instead of \$166,000,000.

The CHAIRMAN. I think we better put off this "tax on unjust enrichment", because it will take some time to discuss that. As soon as we get through with this, then we will take up this estimate. Who is going to handle that phase of it?

Mr. HELVERING. Mr. McLeod, the statistician of the Treasury.

The CHAIRMAN. We will meet on Monday morning at 10 o'clock. The clerk will give notice that public hearings will begin on Thursday morning at 10 o'clock.

(Whereupon, at the hour of 12 m., the committee recessed until Monday, Apr. 27, 1936, at 10 a. m.)